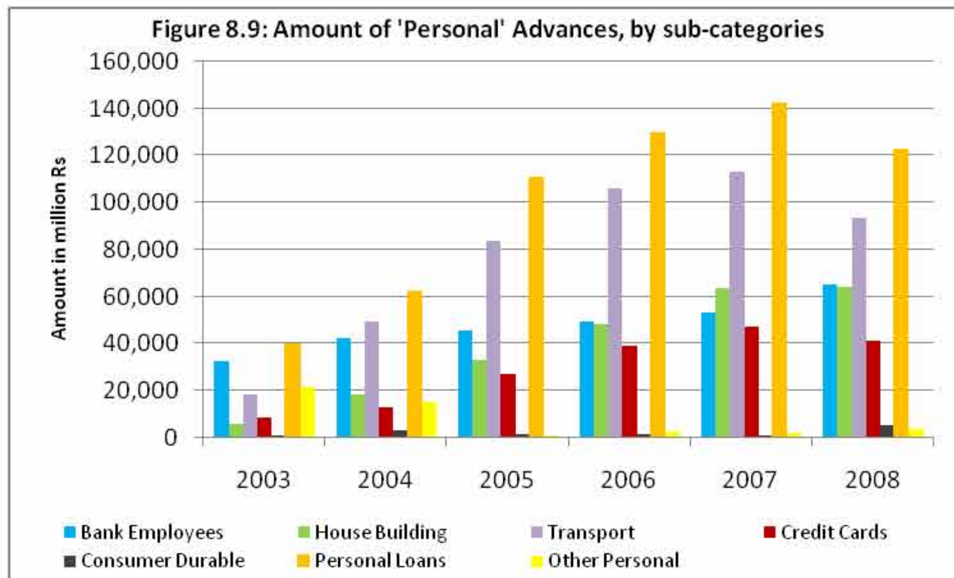

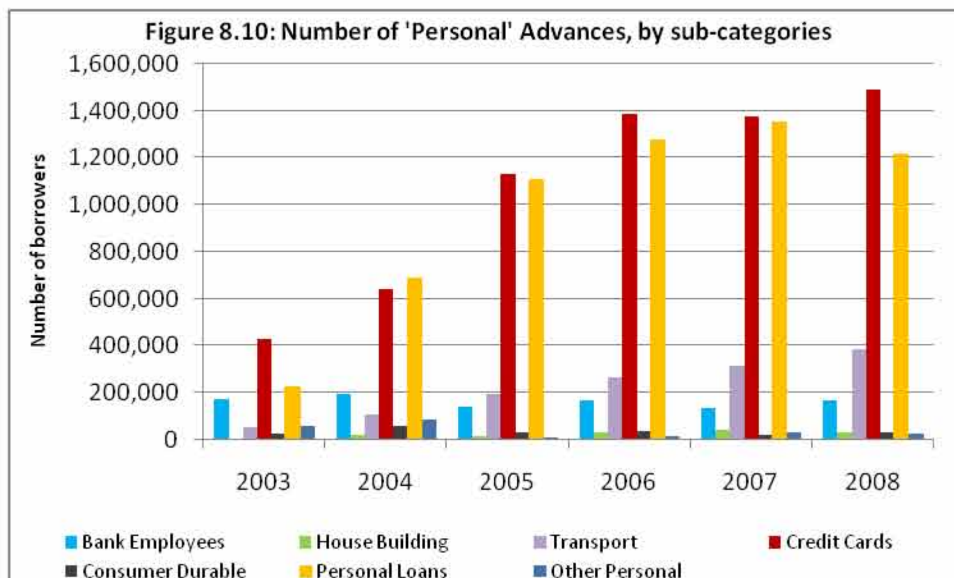

The two most significant segments in which commercial banks have competed vigorously in the past 5 years are those of personal and automobile loans. This can be seen from Figure 8.9. Personal advances reached an all-time high of Rs 142 billion in 2007, rapidly rising from Rs 39 billion in 2003 (only 4 years previously). The number of these borrowers also rose from 225,342 to 1,216,113, with an average personal loan size of around Rs 100,000. Meanwhile, the number of automobile loans rose from a modest 52,932 in 2003 to 388,266 in 2008 but since these were larger-sized than the personal loans[137], the amount disbursed was much larger. In 2007 auto advances reached Rs 113 billion.

[137] An average car loan of around Rs 400,000 is four times the size of a personal loan of around 100,000. However, the actual car loans have varied considerably.

The market segment in which the banks most vigorously went out in pursuit of customers was the thin crust of credit cards. The number of credit card holders, of the two foreign banks that supplied them, was insignificant in 2001.[138]

In 2003, there were 429,096 known card holders, to whom an amount of Rs 8,766 million had been advanced, suggesting an average advance of Rs 20,429. This number (of credit card holders) rose rapidly to reach 1,489,136 by 2008. (Figure 8.10) The average size of credit card advances remained roughly the same, but because of the five-fold increase in new customers that had been enrolled as bank clients, the amount advanced to them became respectably large (Rs 47 billion) by 2007. But this segment still had only tertiary significance. Its credit advances of Rs 41 billion (in 2008) constituted only 10% of the advances under the 'personal' category (implying that they formed only a small part in consumer financing) and only 1% of total bank advances. Yet, the credit card accounts constitute 44% of the 'personal' category loan accounts and 28.5% of the total number of loan accounts maintained by the banks in 2008. These card holders represent less than 1% of the country's population, but the number of accounts maintained for them is not only the highest among the 'personal' category accounts, but almost equals the entire number (1,849,567) of private sector business loan accounts. The disproportionately high transaction costs that must be involved in servicing this large number of accounts, involving relatively small amounts of per capita lending, could be justified only through premium pricing, high returns or cross subsidy.

House building advances represent a small sliver of the market. Even though housing advances are secured, they formed only 4.6% of the 'personal' category loans in 2003, and stood at a modest Rs 5.9 billion. Their share within this category, however, rose steadily to 9% in 2004, then to 11% in 2005, to 13% in 2006, to 15% in 2007 and to 16% in 2008, when the housing advances outstanding were Rs 64 billion out of the total 'personal' category advances of Rs 396 billion. Even with this ten-fold increase, this "housing mortgage" market constitutes only 2% of the advances made by the banking sector, which is only a drop in the ocean. In more advanced countries, mortgage finance is a significant part of commercial lending. It is a reflection on the state of under-development of financial markets in Pakistan that housing loans should be such a small fragment. The post 9/11 liquidity was expected to have been channeled by the banking system into productive infrastructure, including housing. The Government made substantial claims to this effect. Yet, the data point in the opposite direction. This market segment may have been even more neglected than agriculture and SMEs.

Bank employees, on the other hand, got a fair share. It has been noted elsewhere that almost the entire amount of 'personal' advances of the specialized banks were to their own employees. The private banks also appear to have been quite liberal in extending loans to their employees. The amount advanced to them always exceeded house-building advances to the public. They comprised 16% of all 'personal' category lending. The average size of each employee loan was usually three times the size of ordinary personal loans to the public at large, and was (presumably) made at a lower (possibly subsidized) rate of interest.

Financing of consumer durables has attracted some adverse public notice. It is in fact the smallest, and the least significant, segment of this market. These loans are small-sized, usually

[138] Statistics on the number of such card holders and the amount advanced to them in 2001 were not available

around Rs 50,000. There were only 25,246 customers in 2003, 32,365 in 2008. The amount outstanding was Rs 1 billion in 2003, Rs 3 billion in 2004, Rs 1.6 billion in the next two years, dropping to Rs 1.1 billion in 2007, becoming Rs 5.5 billion in 2008. This could very well be a reflection of bad debts, the inability of commercial banks to recover the amount advanced in earlier years, resulting in a rise in the outstanding balance. Failure to recover loan amounts could also be the cause of the contagion that is reported to have hit the entire market of consumer finance in 2007.

Credit risk

In the absence of collateral, banks face the risk of default. This is the case in all three markets (SME, agriculture credit and consumer finance) and the question might well be asked why the banks risked their excess liquidity in consumer finance and not in SME or agricultural lending. The answer is an obvious one: the risk-adjusted rate of return was higher. As the State Bank reported:

> "The banks have penetrated into some of the previously underserved areas like consumer finance which has witnessed substantial growth in recent years. This trend was not exceptional in Pakistan, since across many emerging market countries, the growth rate of consumer credit even has outpaced other sectors.[139] The contributing factors behind such a high growth in consumer finance may include low interest rates, flush of liquidity, product innovation, increased competition, financial liberalization, and growing income level in the back of on-going high economic growth. Besides high return and risk diversification considerations, banks may have been taking higher exposures in consumer finance to avail the benefits of Basel II as consumer finance products relatively require lower capital charge under credit risk (consumer 75 per cent and mortgage 35 per cent) compared to unrated corporate loans which carry a charge of 100 per cent."[140]

The higher rate of return, implicit in unsecured consumer finance, must be considered sufficient justification for entry into this market. However, it appears that once competition in consumer lending got underway, the problem of risk management surfaced and the banks were unable to handle the complexity of transacting with an additional million credit card enrolments, a million additional personal accounts and more than 300,000 new automobile leases on different terms and variable interest rates. The risk of contagion could no longer be contained by the 10 banks operating in this market[141]. The infection ration (NPL to loan ratio) increased from 1.1% in 2005 to 2.2% in 2006 and to 4.4% in 2007 and to 5.5% in 2008. Although this ratio was still lower than that for corporate lending (7.6%) and the overall ratio of 7.7%, it appears to have signaled extreme caution to the suppliers to this market[142].

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[139] See "Perspectives on Consumer Finance in Pakistan" (p. 89), Chapter 5 of *Financial Stability Review 2007-08*, which gives the examples of other emerging economies, such as Singapore, where household credits are 51.6% of all credit to the private sector. Thailand's consumer financing is cited as 48.1% of private sector credits, while Malaysia's is 30.4%. Indonesia is 45.4% . China is 11.3% which is lower than Pakistan at 12.4%

[140] *Banking System Review, December 2006*, p. 24.

[141] The supply to this market was more concentrated than in other markets. The five-firm concentration ratio was 57% in 2006 and 55% in 2007, as already noted in the previous Chapter.

[142] *Financial Stability Review 2007-08* has concluded on the basis of bank-wise data provided to the State Bank that, with the 10 banks in the market, the Herfindahl-Hirschman Index was 1,000, which was higher than that for

The result was a fall in consumer lending by 2008. Of the 10 banks involved in consumer finance, the foreign banks that had in fact introduced credit cards in Pakistan and been the most innovative in taking the lead in automobile loans, appear to have been the most exposed. Table 8.5 shows the receding profile of foreign banks versus the domestic commercial banks.

Table 8.5: Consumer financing by foreign and domestic[143] banks amount in Rs million

	Transport		Credit Cards		Consumer Durables		Personal Loans	
	Foreign	Domestic	Foreign	Domestic	Foreign	Domestic	Foreign	Domestic
2003	5,126.8	13,419.7	5,204.0	3,562.1	0.1	1,005.7	7,159.7	32,194.9
2004	6,174.4	43,078.9	6,768.6	6,387.2	0.0	3,129.2	12,019.9	49,714.3
2005	7,897.1	75,664.2	11,968.8	15,284.3	0.1	1,647.7	16,326.6	93,911.5
2006	5,563.2	100,523.7	11,801.2	27,352.3	15.5	1,558.5	15,331.7	114,104.3
2007	5,264.7	107,608.7	9,964.7	37,273.2	4.5	1,041.8	7,087.1	134,438.2
2008	3,516.8	90,245.8	9,303.4	31,789.5	7.4	5,479.7	4,586.1	117,649.8

Table 8.5 also suggests that these narrowly- based consumer market segments have, within 5 years of their opening up, already shrunk. They reached their peak in 2007. To a great extent, this was inevitable. The middle class in Pakistan, and in particular the salaried class which is the target of consumer financing, is not broad-based enough to sustain a credit boom. Although this class is rising in numbers, its gains are being increasingly offset by a more and more skewed income distribution. The segment is becoming a smaller niche in relative terms.

Added to this demographic factor is the central issue of managerial ability that has been found lacking in commercial banking. Market surveys and reports from the Banking Mohtasib (Ombudsman) attest to this failing. Since this has a bearing on competition, we must take note of the issues that have already been raised publicly, in these reports, with particular regard to consumer financing.

Issues in Consumer Finance

The five year period (2003-2008) of consumer finance has raised a public discussion on its implications and desirability. Critics have pointed out that increasing consumerism, a consequence of this bank lending, has decreased national savings, caused inflation and led to greater speculation in capital markets. The State Bank has dismissed each of these three contentions, and argued[144] back that the increased standard of middle-class life, to which consumer financing has contributed, has strengthened the economy, and that the average saving rate of the 2000s is actually higher than that of the 1990s. Also, core inflation has been contained, and, in any case, international prices contribute more to inflation in Pakistan than does consumer finance. Moreover, personal loans (argues the State Bank) are competitively priced,

all other markets, namely corporate sector loans (700), SMEs (800) and of aggregate loans (700). See p. 91 of "Perspectives on Consumer Finance" in *Financial Stability Review 2007 – 08.*

[143] Only Pakistani Commercial Banks

[144] See "Perspectives on Consumer Finance in Pakistan" in *Financial Stability Review 2007-08*, pp. 89 - 94

and cannot attract speculators. These loans are, in any event, available mostly to the salaried class, which (being risk averse) is not prone to speculation. In other words, there is no possibility of arbitrage.

The State Bank's weak counter-arguments, to a weak case by the critics, were quite unnecessary. A linkage between macroeconomic indicators (inflation level, savings, investments) and a transient small-time consumer bubble is difficult to make out. It serves only to detract from the real issues raised by the consumer market activity. Those issues stem from unethical behaviour and malpractices by bank officials, unprofessional conduct and mismanagement that has been spawned mostly by consumer finance.

The litany of public grievances against consumer financing by commercial banks has been investigated and documented, after a market survey, by the Consumer Rights Commission of Pakistan (CRCP) under The Asia Foundation sponsorship. CRCP (2008)[145] reveals the public grievances in each segment of this market.

The largest number of complaints is against credit card providers and ATM machines. The most serious problems arise from the banks arbitrarily changing the schedule of charges, without informing the client of any change. Late fees are charged even when timely payments have been made, and late fees are sometimes charged even before a credit card has been activated. Unauthorized withdrawals and hidden charges are common. Complaints are plentiful, and relate to high mark-ups, card processing delays and bank staff's indifference and the banks providing misleading information.

Auto loans are the most complex of the consumer products. Banks are supposed to provide a choice between fixed interest loans and those at a variable rate, the former being at a higher interest rate than the latter, but the latter involving greater future uncertainty. However, the choice is more illusionary than real. In practice the variable interest rate rises only upward. The customer is mostly ill-informed and banks make no effort to be transparent or conform to requirements of disclosure. Hidden charges are the biggest complaint. 85.7% of the respondents surveyed by CRCP (2008) complained of these. 71.4% registered complaints against the attitude, unprofessional conduct and poor service provided by bank staff. The insurance premium was found to be too high in 71% of the cases, and in 75% cases the customer was given no option in the choice of the insurance provider.

In the case of personal loans, which form the largest share of this market, borrowers have greater experience, in choosing their bank, and a majority of them said (in the survey) that their choice was based on the most competitive offer. Yet, 40% of them were not told about changes made in charges applied to them. 50% complained of hidden charges. 80% were dissatisfied with the bank of their choice, with regard to delays, quality of service and the absence of a mechanism for redressing grievances.

The levy of arbitrary and unwarranted charges by banks appears to be a universal complaint cutting across all sections of consumer finance. Even in house building loans that take a long time processing and are supposed to be scrutinized more thoroughly, 76% of borrowers

[145] *Consumer Finance in Pakistan: Issues, challenges and way forward.* CRCP, Islamabad, 2008, pp 137

complained of being charged late fee when they had made timely payments, 44% complained of higher mark-ups.

When there is an actual default in payment, the consequences for the borrower can be grim. Banks have resorted to repressive means of loan recovery that can be life threatening. In an extreme case, reported by The News, Karachi on Monday April 28,2008, harassment by the loan recovery agents of the MCB was so extreme that it drove the borrower (one Muhammad Tufail, 27 year old son of Mohammad Munchi) to commit suicide. It appears that the bank business of consumer finance has gone beyond the realm of competitive behaviour, beyond malpractice and unethical conduct, possibly into the domain of actionable criminal offences.

IV. REGULATORY FAILURE

Having documented the litany of grievances, CRCP identifies the key issues in consumer finance. The central issue, CRCP argues, is the high banking spread (the highest in Asia-Pacific region), and the resultant high profitability of the banks that makes them impervious to the public interest. The report holds the State Bank responsible for this state of affairs:

> "High interest rate spread indicates that competitiveness in the banking sector is either absent or is very poor. A cartel-like behaviour in banks appears to have taken place within the policy space provided by SBP[146]. In April 2006, the present Governor of the SBP had said that banking spread was very high in the country and termed it an inefficiency of banks. In December 2006, she said that spreads were high because the sector was not facing competition and it was hurting the economy.[147] However, she said that time was yet to come when SBP should exercise its powers.
>
> "This issue is largely attributable to weak SBP regulation of interest rates despite that it has the powers to bring down the spread through monetary policy. While non-operating loans and high administrative costs could be considered as the major reasons in countries where spread is high, these reasons cannot be said to be true of Pakistan because banks are earning huge profits at the cost of savings of the depositors". CRCP (2008, pp. 65–66)

Unregulated debt collection, unrestricted levy of arbitrary charges, unauthorized debits, unsolicited financing, misleading advertising, inadequate systems to redress grievances are being cited as examples of the State Bank's failure to regulate banking conduct, despite the existence of prudential regulations and the Consumer Protection Department (CPD) in the State Bank.

The Banking Mohtasib (Ombudsman), established in 2005, provides another mechanism to redress public grievances. Its jurisdiction is excluded from cases that are sub judice (in Banking Courts, for instance) or have been decide by the State Bank. It cannot intervene in bank policies relating to interest rates, product pricing, mark-ups, personnel matters or the grant of loans and advances. This reduces the scope of its operations to willful misconduct on the part of the banks and its functionaries. According to the latest (2008) Report of the Banking Mohtasib, 30% of complaints made to the institution pertain to consumer financing, while advances and deposits

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[146] BY way of an example, CRCP (2008) cites the case of the Enhanced Savings Accounts Scheme, fixing 4% interest rate, for which the participating banks and the Banking Association were taken to task (February 2008) by the Competition Commission.

[147] The News, March 6, 2008.

account for 25%. Out of the complaints relating to consumer products, 68% pertain to credit cards, 22% to automobile loans and 11% to consumer loans.

The 2007 report of the previous Mohtasib identified some of the causes of public grievances against banks. Indifference on the part of bank staff, a callous attitude, was high on the list. Service quality was very low. Insofar as the main source (consumer products) of complaints was concerned, the Mohtasib found that banks were not screening loans or credit applications in order to determine capacity to repay. No risk analysis was done or credit worthiness analyzed. Naturally, therefore, the portfolios were bound, sooner than later, to become afflicted. The latest report (2008) puts it all down to "systematic deficiencies and control weaknesses within banks" (Annual Report, 2008, p.8).

Conclusion

The three markets that we have analyzed have thrown up different issues and facets. The SME market was characterized by complacency, the agricultural market by neglect and consumer financing by management failure. None of these attributes could possibly have come to the fore, let alone allowed to last for any length of time, had the banking system been accountable to the market. An inefficient, mismanaged bank cannot survive competition, let alone earn-above normal returns. However, when there are barriers to exit, or a provision for "safe" exit --- because no bank failure can be tolerated, on the basis of spurious arguments of essential banking stability --- then all failures have to be tolerated. Competition is then replaced by consolidation. Price competition is over-ridden by the prevalence of high banking spreads – rightly pointed out by all analysts, including the Governor of the State Bank herself, as the prime source of failure of financial intermediation.

The corporate finance markets, analyzed in Chapter 7, were supposed to be competitive ones, at least in relation to the deposit markets that had been admitted by the State Bank to be uncompetitive. The evidence did not, however, point in that direction. We turned therefore, in this chapter, to three of the smaller markets that were very similar in many respects, yet dissimilar (seemingly) in competitive terms.

The consensus among analysts had been that consumer financing was very competitive indeed and had attracted all the excess liquidity that had become available to Pakistani banks in the 2000s. Had this been channeled to the SMEs (so went the argument) and had banks provided the SMEs with the same kind of unsecured (not collateral-based) credit that they furnished to consumer products, the engine of economic growth could have been started. Having looked at the kinds of tools used in consumer finance, one wonders whether diversion of credit allocations to SMEs would have made any difference. After all, forced diversion, through monitored targets, made no difference to the agricultural sector. If anything, it made the plight of agriculture much worse, resulting in the chronic condition of the neglect that we have witnessed.

Whichever way one looks at it, to whichever market one turns, the basic facts are the same. The consolidated banking system is profitable, stable and secure. It earns above-normal returns that are assured through maintenance of high banking spreads that the regulators do not want to bring down. As a consequence, there is a failure of competition. One can hide behind fragments of statistics (as is done in cross-country quantitative analyses discussed in the earlier chapters of

this report) and draw comfort from diminishing concentration ratios and rising industry-wide "contestability" indices. Yet, the moment one inspects the data more closely and looks at product-markets, a totally different picture emerges. That is the virtue of competition analysis. It is also the only remedy.

CHAPTER 9

THE CORE ISSUES & RECOMMENDATIONS

I. DENIAL OF ACCESS

Financial Exclusion

There are 25 million deposit account holders in Pakistan. This represents only 15% of the country's population of 160 million. An even smaller number (3% of the population or 5.2 million persons) have access to credit.

Table 9.1: Total number of borrowers' accounts, 2001-2008

	2001	2002	2003	2004	2005	2006	2007	2008
Government	98	78	76	87	100	112	114	159
NFPSEs	448	197	230	164	202	191	269	744
NBFIs	171	180	232	314	326	397	374	569
Private Sector Business	1,681,895	1,711,691	1,827,170	1,902,542	1,987,384	1,745,769	1,622,968	1,849,567
Trust Fund & GOs	515	568	528	684	340	357	752	1,064
Personal	599,963	469,072	973,244	1,797,676	2,632,973	3,178,720	3,277,215	3,352,250
Others	13,143	10,278	21,431	21,391	40,642	13,271	18,142	15,533
Total	**2,296,233**	**2,192,064**	**2,822,911**	**3,722,858**	**4,661,967**	**4,938,817**	**4,919,834**	**5,219,886**

A similarly small number of depositors (5.5 million) reside in rural areas, and their access to banking facilities is much less. Only 7% of the country's bank lending is to the rural population, whose share in national deposits is also meager (10% in value terms). This highly skewed distribution is reflected in the number of bank branches: 2,580 branches for 105 million rural population which translates to 42,000 persons served (on average) by a bank branch (Akhtar, 2008).[148] Low savings and lack of access are perhaps two sides of the same coin. Table 9.2 shows the urban/rural split of bank branches.

Table 9.2: Rural/ Urban Bank Branches

	Rural (#)	Urban (#)
Top 5 banks	2,247	3,315
Private domestic banks	143	1,830
Specialized banks	179	360
Islamic banks	11	207
Foreign banks	-	51
Total	2,580	5,763

Source: SBP September 2008, also shown in Table 1.3 in World Bank, 2009 p. 9.

[148] It appears that the number of persons covered by a bank branch is increasing, implying reduced coverage. Historical data on the urban-rural split are not available. An estimation can, however, be made on the basis of country-wide statistics on bank branches. In 1971 there were 2,396 bank branches in West Pakistan. On average, a bank branch served 29,000 person (in 1970), with the number going down to 11,300 later in the 1970s. See Chapter 4.

While analyzing this skewed distribution and its competition dynamics, the State Bank's *Financial Stability Review 2007-08* notes that 48.4 per cent of the total deposits of the country were mobilized from the two largest cities (Karachi and Lahore), while 64.2% of bank advances (lending) went to these two cities. There was very little competition in the smaller cities and rural areas (the *Review* went on to say) and basic facilities left much to be desired. The loans given out by a rural branch were one-tenth the level of an urban branch (in one of the 5 leading cities), while deposit mobilization was one-fifth. What made the situation worse, insofar as competition is concerned, is that the big "five banks have a virtual monopoly in the rural areas owing to their large branch network and economies of scale acquired over the years. (Khan, 2008, p. 83)

The State Bank has become concerned about the rural starvation of credit and has issued a Branch Licensing Policy (2007) guideline that 20% of bank branches planned for the future must be in rural areas. There is a long history of such effete policy guidelines and quota allocations, which are more likely to distort natural forces of competition than oblige commercial banks to re-allocate their resources or to meet the desired ends of rural welfare. In order to mobilize larger deposits from rural areas the State Bank has also stipulated a minimum floor of 5% profit on savings/PLS accounts. This direct policy intervention also militates against the principle of allowing free market competition to determine interest rates. Its impact, like that of the other policy intervention, has not yet been gauged.

In order to bring finance to the poor and undeserved population, Pakistan introduced (November 2005) the concept of a "basic account" that could be opened with a deposit of Rs 1,000 and would have no requirement of a minimum balance or maintenance fee. Two free transactions, by way of deposits and withdrawal, were allowed in a month and unlimited ATM usage. If the account remained frozen with a zero balance, it would be closed. This was indeed the outcome in many cases. Customer response to the scheme was as equivocal as the response of the commercial banks.

In this regard, Pakistan's experience has been similar to that of other countries where "basic bank accounts" were introduced, apparently with limited success. Basic banking schemes were introduced in Malaysia, Mexico, Vietnam, Brazil and India. Reports about marked improvements in access have not come in from any quarter. Only the Indian scheme has been evaluated. Its impact has been marginal (see World Bank, 2009, pp 56 – 57).[149]

It would be worthwhile to examine the impediments to the basic account in Pakistan. It is possible that it is less on account of indifference on the part of customers than the indifference of the banks. Being less than enthusiastic towards SMEs and farmers, banks are not likely to be very keen to provide a basic and universal service, the transaction cost of which would exceed the benefit accruing from it to the bank. In the absence of a cross-subsidy, the banks would not want to vie for customers.

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[149] It may be recalled that this was also one of Cruickshank's recommendations of a free universal service. It was introduced also in South Africa, despite the reservations of the Task Group (see Chapter 3).

In any case, it is recommended that a sample survey should be conducted on the extent of "universal" coverage that has already been provided, the level of satisfaction with it and the impediments that lie in the way of its extension.

Such a survey would help identify specific barriers to access in rural and urban areas of Pakistan. Some survey data are already available. The most recent World Bank study on Bringing Finance to Pakistan's Poor,[150] sampled 10,305 households in order to determine the factors that were adversely affecting access to finance in Pakistan.[151] The most adverse factors were found to be the very high levels of poverty, lack of awareness of financial services and gender bias. The results of this survey have confirmed what must have been intuitively obvious to policy makers. Yet, the survey does not address the more deep-seated malaise that prevents the banks from penetrating and catering to the lower-income (especially rural) market – complacency, indicative of lack of competition.

A different study, also by the World Bank, tackles the same subject, although through a different approach, with a different methodology and with a different cross-country perspective. Beck, Demirguc-Kunt and Peria (2007) examine indicators of barriers to access with information from a sample of 209 banks across 62 countries.[152] The barriers that preclude access to savings and current accounts and to consumer loans, SME loans, ATM card services and other banking products relate mostly to transaction costs. The costs of maintaining minimum balances, fees payable, documentation requirements and processing time are some of the factors that impinge upon accessibility. The effect of each factor is assessed in an econometric analysis covering the cross-section of 62 countries. Statistics for each country are reported on a scale of 1 to 5.

In terms of physical access for opening a deposit account, Pakistan scores 2.0 in this cross-country World Bank study. For the number of documents needed to open a checking account Pakistan scores 2.64 and 2.43 for opening a savings account. On these counts it falls in the median range of barriers. Pakistani banks do not impose annual fees on checking and savings accounts and their fees on consumer loans, SME loans and other credits are below the median range. However, the delays in processing SME and consumer loan applications are of the longest duration recorded in the sample study.

There would, no doubt, be a host of other country-specific parameters that restrict access to the banking system. Delay has already emerged as a most significant factor. Although transaction costs do not appear to be the highest in the world, they are not insignificant. One transaction cost that has not been looked at in either of the World Bank studies is the cost of switching accounts from one bank to another.

[150] Nenova, T. and C.T. Niang (2009), 'A Study on Access to Finance for the Underserved and Small Enterprises', The World Bank

[151] The two-stage stratified sample survey was designed and carried out by the Federal Bureau of Statistics, October 2007 – March 2008. The questionnaire covered demographic, literacy related, economic, gender –biased and income related factors that might influence access to financial products (deposits, advances, payment system) and other formal and informal financial services. 75 variables were considered in the score card.

[152] The study and its results are discussed in Chapter 1

Switching costs

Every country study on competition in the banking sector (e.g., Ireland, South Africa, U.K.) has underscored the need for reducing switching costs because they constrain competition. When banks lock customers in, usually through incentives upon initial introduction, they raise the cost of customer exit --- Kemppainen (2003) cited the example of Finland (see Chapter 3) where switching cost was as high as 6% of the average current account balance. This deters a rival bank from attracting a customer who already has an account with another bank. Customer loyalty thus becomes forced, and is not a matter of choice. While the practical difficulty of transforming a loan account from one bank to another can be appreciated, there is insufficient justification for restricting the transport of a current account.

The imposition of high switching costs upon customer accounts has become increasingly indefensible in the face of successful competition in several product markets. In the market for mobile telephone connections the EU has stipulated that a customer cannot be locked in beyond a reasonable length of time, which is to be specified in advance with full disclosure and advance consent of the customer. The principle has been applied by the Competition Commission of Pakistan in the case of the Black Berry handset marketed by Mobilink. The consequential untying of products (there are several other examples from different markets in which "tying" restrictions have been lifted) has led to a universal ease of switching accounts between different service providers. Mobile telephone service providers in Pakistan now openly, and aggressively, solicit the accounts of its rivals, inducing them to switch. The promise of lower cost or higher quality service that actually results in effortless and cost-free (or relatively inexpensive) switching attests to the success of competition.

In the banking sector, the universal practice of offering to transfer the balance of a credit card account from that of a rival service-provider is a prime example of competition ensuring cost-free switching. The practice can, and should, of course, be extended to other consumer products and different kinds of accounts. The current account can easily be made transportable, along with other additional services that can be provided through the "gateway" provided by this account. In one sense, it is already transportable through the medium of electronic banking. In the payments network, an ATM machine can cater to clients of different banks on a uniform basis, although account and that of rival bank accounts.

What constitutes a high switching cost and what is reasonable, is, of course, a matter to be determined by the regulator. Ideally, the market forces of competition should determine the minimally acceptable (preferably zero) switching cost. In a less than ideal world, however, regulatory intervention would be required.

It is recommend that the State Bank should determine, with some policy input from the Competition Commission, the range of permissible and reasonable restrictions and charges on switching of accounts that a bank might be able to impose upon its customers.

II. NEGLECTED PRODUCT MARKETS

While denial of access, or insufficient access to banking services for less affluent classes of society, is possibly the most important public policy issue, from the perspective of competition

there are other facts that also merit urgent attention. We begin by stating the facts that have emerged from our historical review of the banking system in Pakistan. These facts might seem unrelated. Yet there is a common thread that binds them.

Rural banking coverage

Throughout its history Pakistan has been beset with the problem of providing rural credit for agriculture. Tomes of reports have been written on the subject, repeated policy interventions have been made, but all attempts to promote rural supply of banking services have been plagued by failure. This is manifest in the statistics: only 7% of lending is to the rural areas that account for only 10% of deposits. The official history of the State Bank has recounted the repeated attempts by the State regulator to promote rural banking. Every encouragement has been provided throughout the country's history to increase the number of rural branches. Even now the State Bank is actively encouraging this promotional effort. Through its circular of 12 October 2007 it has revised its Branch Licensing Policy, making it mandatory that 20% of additional bank branches be located in such rural areas or underserved villages, small town or *tehsil* headquarters that do not have any existing bank branch. Yet, as already mentioned, the loans given out in rural area are one-tenth the size of urban loans, and deposits of a rural branch are one-fifth those of an urban branch. 48.4% of national deposits accrue from Karachi and Lahore. It is worth repeating, for the sake of emphasis, that these two cities take up 64.2% of bank advances, and the top 10 cities account for 75% of deposits and take up 85% of advances. While there may be some rudimentary competition in urban banking, there is none in rural areas.[153]

The failure to integrate rural deposits and credit supply into urbanized banking services begs the important question of whether rural banking is indeed a separate market. Determination of the "relevant geographic market" is a significant competition-related question in any jurisdiction, and it is necessary to answer this question. The Courts that adjudicate competition issues can define the "product market" and the "geographic market" narrowly or widely, depending on where competition is actually taking place. The determination of what constitutes the relevant market then becomes an empirical question. The available empirical evidence suggests quite strongly that the performance and financial activity in the rural market is contrary to that in the urban market. A reverse trend is noticeable.

Time series data on the rural-urban split were not available from the State Bank, and the present Report could not go into a detailed examination of this aspect. However, some indicators point towards the trend. The national Committee on Rural Finance (1999) found that 78% of bank deposits accrued from urban areas and 22% from rural areas. This ratio has worsened in 2009 to 90%:10%.[154] In 1999, loans and advances in urban areas were 89% of total lending, while rural lending was 11%. In 2009 this ratio has worsened to 93%:7%. In 1999 50% of bank branches were located in rural areas (3,529 rural branches, 3,513 urban branches out of the total of 7,042 bank branches). Ten year later (2009) the number of rural branches is only 31%. As shown in Table 9.2, there are 2,580 rural branches versus 5,763 urban branches.

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[153] These statistics are taken from Hasan Khan (2008),"Concentration and competition in the banking system", Chapter 4 of *Financial Stability Review 2007 – 08* of the State Bank of Pakistan, pp. 83 – 84.

[154] The State Bank is the source of both these statistics, as it is of all other statistics reported here.

In 1999 the top 5 banks, namely HBL, NBP, UBL, MCB and ABL, had a virtual monopoly in rural banking. Nation-wide they had 6,696 branches of which 3,183 were in rural areas and 3,513 in urban areas. The ADBP had 346 rural branches. Thus, 90% of rural banking was in the hands of the 5 commercial banks, with ADBP controlling 10% of the total 3,529 rural branches. The market share of the same top 5 banks has declined over the next ten years. They control 87% of the branches: only 3% less than what they did in 1999. The actual number of these branches has fallen from 3,183 to 2,247. Meanwhile, the share of ZTBL (formerly ADBP) and PPCB has also declined from 10% to 6.9%. The number of their branches has fallen to 179. The remaining share of 7% has fallen to the lot of the other commercial banks. However, their presence is not yet a significant one. As shown in Table 9.2, based on the World Bank survey, the private domestic banks have penetrated the rural areas only to the extent of adding 143 branches in 10 years. Islamic banks have added 11 branches. With the specialized banks (ADBP, PPCB) having suffered a significant decline, as discussed in Chapter 6, and with the number of their branches having been reduced from 10% to 7% (in actual numbers from 346 to 179), all that has happened is that some of their lost share has been taken up by the smaller private commercial banks, while the dominance of the top 5 banks has remained intact.

The continued dominance of the top 5 banks is however not an exceptionable fact by itself. What is regrettable is the decline in real terms of the volume of agriculture credit. Since time-series data on this market are not available, and the only detailed rural credit and deposit figures that the State Bank has provided pertain to the year 1999, when the Government's Committee on Rural Credit was set up, no historical comparisons can be drawn. None the less, the State Bank (or at least the Governor of the State Bank) confirms that deposit mobilization from the rural economy, and credit extension to agriculture, are both insufficient to meet national needs. The causal link between the continuing virtual monopoly of the big 5 banks (itself a strong evidence of lack of competition) and insufficient deposit mobilization and credit supply may be difficult to establish in the absence of hard data. Yet, it is safe to infer that the neglect of the agricultural sector is partly on account of the absence of any banking competition to secure the rural clientele and meet the vastly unfulfilled demand.

The causal link between the uncompetitive market structure of rural banking – as characterized by the dominance of 5 banks, without entry of other banks to mobilize rural deposits – and the performance of the rural market, has remained hidden from public view because of three basic reasons.

Firstly, it has not been possible to focus attention on this market because it has not been defined, identified and segregated as a separate market – least of all for data-provision purposes. The State Bank does talk about agricultural credit but it does not provide statistical data on this specific category on an annualized basis. Since its data collection and reporting categories are meant for altogether different purpose, product markets per se are not a matter of interest, and are therefore not reported upon. In Chapter 6 and Chapter 7 we have shown how product markets can be defined meaningfully and delineated through a re-classification of existing data. In this schema, the relevant rural market that needs separate identification is that of agricultural borrowers whose average borrowing of unsecured credit ranges between Rs 100,000 to Rs 300,000. Its upper limit would be Rs 500,000. Unfortunately, no time series can be constructed for this market segment in the absence of hard data. Nor can competition for deposits be assessed for this segment.

Secondly, there has not been any significant public policy intervention in the agricultural banking sector in the last 10years. The market has not been re-visited since the 1999 study by the National Committee on Rural Credit. In the meantime the ADBP/ZTBL and PPCB, the main instruments of possibly subsidized credit, have suffered disuse.

Thirdly, it has not been recognized that commercial banks cannot be compelled to operate in markets that they do not consider lucrative enough. If sufficient profitability is available from other products, banks cannot be induced to enter a less profitable market, unless there is a competitive pressure to do so. No amount of exhortation or homilies can spur banks to divert their attention to the rural agricultural market. The prescription of penalties is ineffective. The Government imposed penalties on nationalized banks if they did not meet the quota of agricultural lending. The banks happily paid the penalty and avoided the quota prescription. That is why the current mandatory requirement imposed by the State Bank, that 20% of new branches must be in rural areas, is also going to be ineffectual.

In order to redress the problem one must first understand it fully. To do that one must have an objective analysis of the situation. *Consequently, it is recommended that another National Committee be set up by the Government to re-visit the 1999 Report and provide an up-date.* There have been significant economic developments in the past decade and the state of rural finances, indeed the rural economy, might well have changed, possibly become worse. *The Committee must be charged with the task of a needs assessment study and an explicit analysis of the institutional failures (including failures of competition) in the rural economy.*

At the same time, and as a part of this exercise, policy makers and economic analysts need a database of agricultural finances. The State Bank can of course re-classify its published data so as to provide annual statistics specifically catering for the agricultural finance market. However, these data would be limited to the banking sector and the non-banking federal institutions. Rural finances (especially, money-lending) go far beyond this and cover non-institutional credit arrangements, supplier-credit – especially for farm commodities and inputs such as fertilizer – that lie outside the purview of the State Bank. The provincial governments have their own credit lines and financial instruments. A holistic approach to the problem demands a framework of inquiry that goes beyond the banking sector, and covers the cooperative societies and the informal sector. Insofar as data sources are concerned, the provincial as well as the federal government have access to all the data, through the Revenue Departments, the Agriculture Departments and through the Federal Agricultural Census Organization.

These different agencies are seldom harnessed at once to provide the necessary inputs. Yet, that would be starting point of a composite review of this essential product market. This is all the more important because a competitive, market-based, incentive-based solution is not going to rest on further reliance on the existing banking system. The existing banks have no incentive (nor can be given adequate inducements under the current dispensation) to increase their coverage of this market. They have never had that, as the history of the past 60 years has shown. *Only economic agents from outside the present banking system can provide the much-needed impetus. For that to happen, however, the regulatory and other barriers to entry which favour the incumbent banks, have to be removed.* Who these agents might be, and how competitive entry from outside the industry is to be promoted, is a question that cannot be answered without a

detailed and comprehensive study. *That is why the setting up of the National Committee is a priority.*

SMEs

The lack of access is not limited to the rural sector. It has been chronicled for the SME sector as well. The World Bank study (2009) on 'Bringing Finance to Pakistan's Poor' documents the problems faced by SMEs in obtaining bank financing. In essence, the lack of access stems not from any failing on the part of the SMEs in meeting any credit benchmark, but the failure (or indifference) on the part of commercial banks to process the loan applications and evaluate the credit worthiness of the applicant. Commercial banks are simply not pushed to provide credit without collateral. They will not assess risk. This translates into complacence and is a reflection of the failure of competition, as observed in Chapter 8.

Part of the problem here, as in the case of agricultural credit, is that it has not been isolated. An SME loan has not been regarded as a product distinctly separate from a larger-sized collateralized corporate loan. Until recently, no data were available on specific SME lending by banks; they were subsumed in other categories of bank advances. Indeed, this is the first year that product-wise data are being provided for SME lending, but even these data are not very detailed. It is hoped that in the years to come, annual statistics would be published on all SME lending by the different banks. Only then can the problem be assessed more carefully.

For the moment the SME market appears to comprise advances ranging in average size from Rs 100,000 to Rs 300,000 (usually without collateral) but extending possibly up to Rs 500,000. At present these loans constitute only 12% of the portfolio of banks. The vast number of potential SMEs, estimated to be up to 3 million in number, makes this a highly significant market that deserves special consideration.

It may be appropriate to mention here that the problem of SMEs is not limited to Pakistan. It appears to be a universal banking problem that has been accorded special consideration in almost all competition-related analyses of the banking sector. In the U.K., the Cruickshank Review singled this market out as a problem of competition that needed an investigation by the Competition Commission of the U.K. as a "complex monopoly". In South Africa, the Task Group recommended a special investigation on the SME market and a comprehensive second follow-up study was indeed conducted.

In Pakistan, the problem of SMEs has defied any solution or improvement. An Enquiry Commission was formed in 1959 and it submitted a comprehensive Report (see Chapter 8) that was not acted upon. A second Committee was set up in 1962 to consider the same problem. It endorsed the recommendations of the earlier Commission. However, both Reports and all subsequent ones remained a dead letter. The same fate is likely to befall the most recent World Bank (2009) report on this subject.

A common thread between all these Reports and studies is that they have sought a solution from within the banking system, and through the existing banks. Yet, it should have become obvious by now that, like agricultural credit, SME credit is not worth the while of the commercial banks. They cannot be compelled to provide it. The incentive structure of the banking system does not

favour it. In fact, in the absence of any competitive compulsion, there is a disincentive in operating in the SME market.

As in the case of rural finances, the problem of SME financing can only be solved, if at all, by allowing, and in fact encouraging, enterprises from outside the banking industry to enter this market. Scheduled banks that are centrally controlled and have national distribution networks have a high opportunity cost in operating this market. Locally- operated enterprises (such as microfinance organizations, cooperatives and NGOs) have lower transaction costs, less information-gathering problems and greater capability to assess the local client's credit worthiness. Distance-related risks can be lowered only when the credit-provider is at the grass-roots or (at the very least) a regional level. National-level banking is therefore not the answer. Nor is the regulatory paraphernalia that accompanies it.

Low-cost housing

Although the House Building Finance Corporation (HBFC) has been extending loans since 1952, it has not made an appreciable difference in the last 57 years in realizing it stated objective of promoting SMH (small and medium housing). Consequently this segment of the market has remained even more neglected than that of other SME products. By 2007, HBFC's total housing advances stood at Rs 40.6 billion. The total number of houses that had been financed by HBFC was 446,343. In 2006, HBFC disbursed Rs 2.254 billion of lending, and its loan portfolio in 2007 was Rs 14.182 billion[155]. As against this figure, the house building advances made by commercial banks were Rs 63,619 billion[156]. This suggests that the HBFC's share in nation-wide housing advances was only 18%.

In the post 9/11 scenarios when commercial banks were awash with liquidity, it was expected that surplus funds would be diverted towards providing housing loans. Indeed, the government of the day made loud pronouncements towards this end. Yet, as was shown in Chapter 8, the surplus cash went into other forms of consumer lending (e.g. automobiles) and, at their height, house building advances were no more than 16% of the 'personal' category of advances. True, they rose sharply, but since their rise was from a very narrow base, the effect was not significant. In 2003, housing advances were only 4.6% of the personal category advances. They increased to 16% by 2008. But the total bank advances in 2008 were still only Rs 64 billion, constituting only 2% of the advances made by the banking sector.

There is a further problem that these data camouflage. Advances by commercial banks are made to the higher income class of borrowers. This upper end of the market has recourse to other funds and is not, in any case, the market segment where the need is the greatest and which is the one that is neglected the most. Data on housing loans does not distinguish between the low-income/middle income level market and the upper income housing market. This is a universal deficiency arising from the fact that data are provided according to the industry (suppliers of credit) and not according to the product. The SMH (small and medium housing) market is distinctly different from the general housing market. Yet, it is not treated separately. It is not the

[155] HBFC's website is the source of these statistics

[156] See Table 8.3 (Chapter 8) based on banking statistics furnished by the State Bank

focus of attention for policy purpose, for data collection purposes, for market purposes, for development purposes, or for competition analysis purposes.

The existing data do show that after 9/11 the share of disbursement of housing loans by commercial banks did increase. By 2007, 67% of the total amount disbursed was by commercial banks. The remaining 33% was by HBFC. This might have been as much a result of increased lending by commercial banks to higher value customers, as a decline in HBFC lending. Of the total amount outstanding, 84% was that of commercial banks, only 16% was of HBFC[157].

However, as the Quarterly Housing Finance Review (September – December 2007) notes, this was an "increasing trend at a decreasing rate." Moreover, while the amount of loan disbursement increased by 8%, the total number of loans decreased by 18% (from 151,881 to 125,490). This was partly the result of the slowing down and failure of HBFC, although the lacklustre performance of commercial bank is equally to blame.[158]

The inadequate level of housing finance, in particular the denial of funding for low cost housing (construction, purchase or renovation),is the result of an institutional failure. Not to speak of the complete absence of competition in this market, there has not even been a presence outside the House Building Finance Corporation. Set up in 1952 as a statuary body, HBFC functioned as another government bureaucratic entity, oblivious of market needs of mortgage finance. Its management was outside the purview of the State Bank of Pakistan. The State Bank wanted to regulate its credit operations and the Credit Enquiry Commission of 1959 did in fact make this recommendation, but the regulatory oversight by the State Bank was denied by the Federal Government in the same way that the State Bank's desire to oversee the cooperative societies was rejected by the Government.

The Credit Enquiry Commission also recommended the setting up of a 'Mortgage Bank' to cater exclusively to the needs of small/medium Housing (SMH). No action was taken by the Government on this recommendation, just as no action was taken on any of the other recommendations of that (1959) Commission or of the subsequent (1962) Credit Committee or any later Committee or Commission. Nevertheless, eventually in July 2007, HBFC was corporatized, when it was finally recognized that it had failed in the original purpose for which it was set up way back in 1952. It may or may not be privatized, but in the present state of neglect of this market, that does not matter.

What matters most is that in Pakistan there is really no mortgage bank, no building society that caters exclusively to the low/middle class housing needs (SMH). The result is that 'mortgage lending' is only 1% of GDP. This compares unfavourably with that of India (2.5%) and that of

[157] These statistics are derived from the State Bank's *Quarterly Housing Finance Review,* Sept – December 2007.

[158] Among the banks, the domestic private banks provided 69% of the housing advances, and the public sector banks 12%. The remaining 19 % came from Islamic, foreign and other banks. In terms of number of loans, the domestic private banks contributed 58% while the public sector banks 27%, the remaining 15% coming from other banks. (*Quarterly Housing Finance Review, Ibid)*

other developing countries. In Colombia it is 5% in Chile 14%.[159] In the developed world, mortgage finance is a prime lending activity. For instance, in the U.S. it constitutes 65% of GDP.

The need for specialized building societies arises from the exclusivity and focus of their operations. Because of that focus, their costs of financial intermediation are bound to be lower. Hence their interest rate spreads can be expected to be lower than those of other nation-wide commercial banks. Regional building societies and mortgage banks are expected to have a different deposit mobilization strategy than national banks operating out of distant headquarters with insufficient information regarding potential borrowers and depositors – who, in the case of building societies, can be the same lot. Local building societies, like cooperative societies, are expected to have much lower transaction costs and more efficient risk assessment and risk management.

In each of the three product markets that we have analysed in this section – namely, agricultural credit, SME financing and SMH lending --- the solution to the chronic problems of policy neglect and bank complacency (a reflection of indifference to competition requirements) must be sought outside of the banking industry. No amount of exhortation or incentives to commercial banks has worked for the past 60 years, as this Report shows. It will not work in the future, because, for commercial banks, the opportunity costs of entering these three markets is much too high – because of prospects of 'monopoly rents' accruing elsewhere in lucrative markets from which there is no competitive compulsion to diversify out of.

The only solution thus is to open these three product markets to economic agents outside commercial banks and the Government. This would be a welcome invitation to NGOs, MFBs, cooperative societies, all outside the regulatory purview of the banking system. What is required is some thinking "out of the box". *Towards this end, it is recommended that the National Commission, which is proposed to be set up by the Government, should analyze the three specific products (agricultural credit, SME financing and SMH lending) that have been identified in this Report as areas of neglect and total failure of competition requirements.*

III. COMPETITION INDICATORS & BANKING INTEREST SPREADS

H. statistic of contestability

This Report has reviewed the application of contestability indicators, such as the H-statistic, and of market structure indicators, such as concentration ratios and Herfindahl Hirschman Index, in cross-country studies (see Chapter 1) and in the banking systems of specific countries (see Chapter 2). These statistical analyses have had the unsatisfying property of not yielding any useful results. The universal conclusion of scores of studies -- that 'monopolistic competition' prevails in every country of the world --- does not add to our knowledge. The actual H-statistic derived for each country is not convincing, as illustrated in Chapter 1. The excuse that data are not available to allow a proper analysis begs the question of why a statistical inquiry is attempted in the first place when statistics necessary for that inquiry are lacking. One wonders how an input-output analysis can be conducted, or should even be attempted, when data on input costs of products and price elasticity of demand are not known. It is not surprising, therefore, that

[159] *Quarterly Housing Finance Review, Ibid*

statistical analyses based on insufficient statistics and on mere assumptions should lead to meaningless results.

The evidence of 'H-statistic' studies classifies Pakistan as a 'medium competition' country, in the same league as Ukraine and Norway. All three countries are reported by Bikker and Spierdijk (2009, Appendix, pp. 31 – 35) to have an H statistic value of 0.47. This puts Pakistan very close to India (H value = 0.48), the United States (H = 0.49) and Belgium (H = 0.49), and not too far from the slightly more competitive banking systems of Japan and Zambia, both of which have H-values of 0.50 according to the same study (Bikker and Spierdijk, (2009, *Ibid*). These findings are somewhat inconsistent with the earlier study by Bikker et al (2007) in which Pakistan scored 0.724, while India was 0.736 and the United States 0.583. The results reported by Claessens and Laeven (2004) were different but, even in those earlier findings, Pakistan was in the same league (see Table 2.6 in Chapter 2): its H-score was 0.48, while that of India was 0.53 and that of the United States was 0.41, suggesting that the American banking system was less competitive than that of Pakistan. In both studies, Bangladeshi banking was much more competitive than any of the other countries. Its H-statistic in Claessens and Laeven (2004) was 0.69 and had the much higher value of 0.966 in Bikker et al (2007), suggesting that Bangladesh banking has nearly attained the state of 'perfect competition' denoted by an H value of 1.0.

Similar conclusions were reached by Prasad and Ghosh (2007, p.282) who reported India's H value of 0.51 --- through the same Panzer-Rosse (PR) input- output elasticity analysis --- to be very close to the global average of 0.50 and much more favourable than that of the United States and Spain (both 0.283). The comfort drawn by Prasad and Ghosh from this finding is comparable to the similar comfort that Hasan Khan has obtained from his own PR analysis[160] in which Pakistan's H-statistic is 0.869 according to one specification and 0.899 according to another.

The international comparisons drawn from all these competitiveness studies are clearly not very convincing. Such comparative studies should not, in fact, have been attempted in the first place. They were bound to lead to erroneous findings. There are two obvious reasons for this. Firstly, the data sets across countries are not comparable, because reporting of accounting statistics is not standardized. Hence we are not comparing like with like. Secondly, the available data are simply insufficient for calculation of elasticities. Researchers get round this problem by sweeping data deficiencies under the rug and making theoretical assumptions that can result only in widening the margin of error.

Does this imply that the PR methodology is so flawed that it should not be used to analyse market contestability? No, that is not the case. The current application of PR methodology serves no useful purpose, but the concept is not flawed. It only needs to be applied in a more meaningful way. Firstly, it should be stated quite categorically here that universally standardized accounting data are not going to be available, in order to calculate uniform elasticities of input-output. Secondly, it is not going to be possible for any academic researcher to obtain the full set of data required from several countries in order to make meaningful statistical comparisons between them. Cross-sectional, cross-country contestability comparisons are therefore inherently too difficult to make and had better not be attempted.

[160] see Concentration and Competition in the Banking System, in *Financial Stability Review 2007 -2008*, State Bank of Pakistan, p.81, See also the discussion on this in Chapter 2 of this Report.