Recommended application of H-statistic

An intra-country analysis is however not only possible but is also desirable. It is possible for the central bank of a country to obtain from each bank its input costs of deposits, wages and capital (i.e. its interest payments, personnel expenses and capital expenses) for each of the product-markets that the bank is operating in[161]. Banks are not likely to provide this product-wise information to any individual researcher; indeed no bank has ever done so. However, a country's central bank can, and should, obtain these cost figures from each bank on an annualized basis and estimate the price-cost margins for each product of every bank. These price-cost margins should form the basis for estimation of the price/interest elasticity – H-statistic, which is actually a summation of the various elasticities.

Having reported and reviewed the cross-country H statistics, and having found that they do not provide a useful measure of the level of competition (contestability) prevalent in different countries, it is recommended that the State Bank's annual assessments (through the *Financial Stability Review*) need not report the results of cross-sectional international comparisons. Instead, the H-statistics should be calculated by the State Bank for the commercial banks every year. The State Bank is the only institution that is in a position to do so, having access to the data and the necessary technical expertise to do so.

A time-series of a country's H-statistic would be a far more relevant and useful indicator of banking sector competition than a cross-sectional analysis of cross-country panel data. *The State Bank should establish the base-line H statistic for the country's banking system for the year 2010, and also publish the subsequent annual progression of this competition indicator, as a matter of course.* Together with the Herfindahl-Hirschman Indices of the product markets, the H statistics would capture the level of competition from year to year. This measure is, however, predicated upon *a prior definition of the product-market for which these statistics are to be calculated. An industry-wide statistic will not help. The data have to be disaggregated, and costs and profits allocated to different products. Only the State Bank can do that. Hence this recommendation is directed exclusively towards the banking sector regulator.*

Global Competitiveness Index

The World Economic Forum also furnishes different indices to measure the global competitiveness of different countries. In the overall global competitiveness index (GCI) Pakistan ranks 101 out of 134 countries. The GCI comprises 12 pillars. Two of these (the third and the eighth pillars) encompass the banking sector. The third pillar is that of macroeconomic stability which comprises five measures (government deficit (surplus), national savings rate, inflation, government debt and interest rate spread), one of which – the interest rate spread – relates specifically to the banking sector. Pakistan is ranked 87th on this count. The eighth pillar

[161] A major difficulty with the PR methodology (on which the H-statistic is based), and one which is well recognized in the literature, is that of segregating input costs in terms of products, in order to estimate price-cost margins obtaining in different product-markets. The PR methodology can measure the change in a bank's profitability (revenues obtained from each of its product-markets) as a result of a change in the cost of each of its factor inputs. This provides an indication of the elasticity of demand in the product-market which is the central concern in determining whether there is perfect competition (H=1; i.e., perfect elasticity) or monopoly (H =0; inelastic demand) or some intermediate degree of monopolistic competition.

is that of financial market sophistication in which Pakistan is ranked 79th. Two constituents of this, the eighth pillar, relate exclusively to the banking sector: ease of access to loans and soundness of banks. Insofar as 'ease of access' is concerned Pakistan is ranked 52nd in the world, while for soundness of banks it is 71st.

The highest score that Pakistan has gotten for any GCI index is domestic market size for which it is ranked 24th. However, this is not really an indicator of efficiency or competitiveness. Rather, it is a measure of the real size of the economy[162].

The GCI indicator of ease of access to loans, according to which Pakistan is ranked 52nd, is not based, however, on any objective criterion. It is based on answers to the question "how easy is to obtain a bank loan without collateral?" posed to a sample of country residents, whose answers are quantified on a scale ranging from 1 ('very difficult') to 7 ('very easy'). The sampled responses are part of the Executive Opinion Survey carried out in each country to gauge the domestic residents' view of their own country's perceived standing or competitiveness. The response of the Pakistanis to this question was assigned a numeric value of 3.2 on a scale of 1 to 7. The same numeric value of 3.2 was obtained for the United Kingdom, Sri Lanka, Portugal and Japan, suggesting that the residents of those countries felt the same way about obtaining loans from the banks of their countries as did the Pakistanis about the ease of getting loans from Pakistani banks.

According to this particular indicator, Luxembourg, with a score of 5.0, ranked first in terms of ease of obtaining loans, followed by Qatar (4.8). Montenegro was 9th (4.4 score), Panama 15th (4.3), while the United States was 33rd with a score of 3.7. India came 34th with a score of 3.6.

Likewise, the other indicator, regarding the soundness of banks, is equally subjective. It is based on answers to the question "how would you assess soundness of banks in your country"? (1 = insolvent; 7=generally healthy) obtained from sampled residents of the country, quantified through the Executive Opinion Survey and incorporated in the sub-index of the GCI. According to this self-perception based indicator, banks in Chile, Namibia, Panama are assessed to be very sound, Chile being ranked 4th with a score of 6.5, Namibia ranked 7th with a score of 6.3 and Panama (number 9) and Brazil (number 10) with the same score (6.3). Pakistan is ranked 85th with a score of 5.0, which is much higher and more favourable than the score of 3.8 of the United Kingdom which is ranked 126th. The United States is ranked higher than the U.K. 108th – with a score of 4.7 that is almost comparable with the score of Bangladesh, ranked 101st. Pakistan can draw comfort from the perception that its banks have been assessed to be far more healthy and much more sound than those of the U.K. and the U.S.

The Executive Opinion Survey that forms an integral (and well-publicized) part of the Global Competitiveness Index will unfortunately have to be discarded in any serious or objective analysis of competition or competitiveness of the banking sector. The criteria of its indices are entirely subjective, are based on self-perception and lack all objectivity. The only objective criterion that the GCI provides for measuring banking performance (or any implicit lack of competition) is the "average interest rate spreads" (the difference between typical lending and

[162] It is measured as the logarithm of the sum of GDP valued at purchasing power parity, and imports minus exports, normalized on an scale of 1 to 7 for the Index.

deposit rates) in different countries during 2008. Hungary has the smallest "spread" of 0.3%, followed by Lithuania (0.8%) and Finland 1.3%. The United States ranks 12th -- with a spread of 2.1% ---and the U.K 17th-- with 2.6%. China is 25th with 3.1%. Pakistan comes 64th with an average spread of 5.5%, while Bangladesh is 81st with 6.7%. India is ranked 85th with 7.3% and Brazil 128th with 35.6%.

Financial Development Index

The Global Competitiveness Index of the World Economic Forum now has a supplementary index tailored specially for the financial sector. This is the Financial Development Index 2009-2010[163]. It is based on 'hard data'. That makes it more authentic and more objective than the 'soundness of banks' and 'ease of obtaining loans' indicators of the GCI, although the financial index too has its problems.

Financial development has been defined in terms of "the factors, policies and institutions that lead to effective financial intermediation and markets as well as deep and broad access to capital and financial services."

Competitiveness of the banking system is not covered directly by this Index, its objective being to assess financial development, as defined. The Index is based on seven pillars: institutional environment, business environment, financial stability, banking financial services, non-banking financial services, financial markets and financial access.

In overall financial development, the United Kingdom has come out on top in 2009.[164] Australia, that was ranked 11th last year, is now in second place. The United State is in the third place; it was in the first place last year. Singapore is number four, Hong Kong number five and Canada number six. Switzerland is at seventh place, Netherlands eighth, Japan ninth and Denmark tenth. Pakistan is ranked 49th out of the 55 countries assessed, while India is ranked 38th. See Table 9.3.

[163] See 2nd edition, published 8th October 2009, on World Economic Forum website.

[164] It was in second place last year, while the U.S. was on top.

Table 9.3: Financial Development Index 2009/2008 Overall Rankings

Country/Economy	2009 Rank	2008 Rank	2009 Score (1–7)	Change in score	Country/Economy	2009 Rank	2008 Rank	2009 Score (1–7)	Change in score
United Kingdom	1	2	5.28	-0.55	Panama	29	32	3.63	+0.03
Australia	2	11	5.13	+0.15	Kuwait	30	26	3.62	-0.31
United States	3	1	5.12	-0.73	Chile	31	30	3.60	-0.19
Singapore	4	10	5.03	-0.12	South Africa	32	25	3.48	-0.51
Hong Kong SAR	5	8	4.97	-0.26	Czech Republic	33	35	3.48	+0.05
Canada	6	5	4.96	-0.30	Brazil	34	40	3.46	+0.18
Switzerland	7	7	4.91	-0.32	Thailand	35	29	3.35	-0.48
Netherlands	8	9	4.85	-0.37	Egypt	36	37	3.33	+0.01
Japan	9	4	4.64	-0.64	Slovak Republic	37	42	3.30	+0.05
Denmark	10	n/a	4.64	n/a	India	38	31	3.30	-0.34
France	11	6	4.57	-0.68	Poland	39	41	3.27	0.00
Germany	12	3	4.54	-0.74	Russian Federation	40	36	3.16	-0.24
Belgium	13	17	4.50	-0.06	Hungary	41	33	3.08	-0.45
Sweden	14	13	4.48	-0.27	Peru	42	46	3.07	+0.01
Spain	15	12	4.40	-0.50	Mexico	43	43	3.06	-0.15
Ireland	16	14	4.39	-0.33	Turkey	44	39	3.03	-0.27
Norway	17	15	4.38	-0.28	Vietnam	45	49	3.00	-0.03
Austria	18	18	4.28	-0.27	Colombia	46	44	2.94	-0.27
Finland	19	21	4.24	-0.21	Kazakhstan	47	45	2.93	-0.20
United Arab Emirates	20	16	4.21	-0.40	Indonesia	48	38	2.90	-0.41
Italy	21	22	3.98	-0.40	Pakistan	49	34	2.85	-0.61
Malaysia	22	20	3.97	-0.51	Philippines	50	48	2.84	-0.19
Korea, Rep.	23	19	3.91	-0.64	Argentina	51	47	2.77	-0.26
Saudi Arabia	24	27	3.89	-0.01	Nigeria	52	50	2.72	-0.04
Jordan	25	n/a	3.89	n/a	Ukraine	53	51	2.71	-0.02
China	26	24	3.87	-0.22	Bangladesh	54	n/a	2.57	n/a
Bahrain	27	28	3.85	-0.04	Venezuela	55	52	2.52	-0.18
Israel	28	23	3.69	-0.45					

Source: Financial Development Index 2009, World Economic Forum

For the third pillar, that of financial stability, the ranking becomes different. Neither the United States nor the United Kingdom is in the top 20 countries. The first place for banking stability goes to Norway, the second to Switzerland, third to Hong Kong, fourth to Chile and fifth to Singapore. Pakistan is much lower down at serial number 48. The United Kingdom is at serial number 37 and the United States at number 38.

The fourth pillar of the Index (see Table 9.4), which comprises banking financial services, appears to be the one that is most relevant for present purposes. It consists of three indices: a size index that is assigned 40% weight, an efficiency index assigned a weight of 40% and financial disclosure with a rate of 20%. The size index includes the indicator of the ratio of private credit to GDP, in which Pakistan is placed 45th, and the ratio of bank deposits to GDP, in which Pakistan is ranked 44th. In the efficiency indicators, Pakistan is ranked 41st for aggregate

profitability, 26th for bank overhead costs, 42nd for public ownership of banks, 40th for the ratio of bank operating costs to assets and 47th for the ratio of non-performing loans to total assets. In financial disclosure, Pakistan is ranked 45th for the coverage of private credit bureaux and 15th for coverage of public credit registry. The overall rating for 'banking financial services' --- encompassing the indicators just mentioned --- is very low. Pakistan is ranked 46th out of 55 countries, while India is ranked 39th. It may be mentioned, that in this banking financial services index, the United States is at 20th position and Switzerland 14th. The top rank is secured by Hong Kong, while the UK is at second place – Japan is third, Spain fourth and Australia fifth.

Table 9.4: Banking Services Index of Financial Development

Country/Economy	Rank	Score	Country/Economy	Rank	Score
Hong Kong SAR	1	5.39	Finland	29	3.78
United Kingdom	2	5.32	South Africa	30	3.75
Japan	3	5.15	Saudi Arabia	31	3.58
Spain	4	5.07	Bahrain	32	3.57
Australia	5	5.01	Slovak Republic	33	3.50
Ireland	6	4.98	Thailand	34	3.49
Netherlands	7	4.90	Brazil	35	3.46
Canada	8	4.83	Chile	36	3.43
Belgium	9	4.79	Vietnam	37	3.29
China	10	4.77	Poland	38	3.17
Singapore	11	4.68	India	39	3.12
Malaysia	12	4.66	Egypt	40	3.09
Sweden	13	4.61	Turkey	41	2.96
Switzerland	14	4.56	Argentina	42	2.78
Jordan	15	4.42	Peru	43	2.77
Norway	16	4.34	Indonesia	44	2.63
Denmark	17	4.34	Philippines	45	2.63
Austria	18	4.24	Pakistan	46	2.62
Germany	19	4.23	Colombia	47	2.57
United States	20	4.21	Kazakhstan	48	2.52
United Arab Emirates	21	4.17	Venezuela	49	2.49
Korea, Rep.	22	4.16	Nigeria	50	2.45
France	23	4.05	Bangladesh	51	2.44
Panama	24	4.05	Ukraine	52	2.38
Italy	25	4.01	Hungary	53	2.37
Israel	26	3.97	Mexico	54	2.37
Czech Republic	27	3.85	Russian Federation	55	1.80
Kuwait	28	3.79			

Source: Financial Development Index 2009, World Economic Forum

The 7th Pillar, which is that of access to financial services, provides ranking according to some hard data,[165] but the two most relevant indicators are based on entirely subjective perceptions. The 'ease of access to credit', for which Pakistan is placed 28th with a score of 3.51 on a scale of

[165] For instance, FDI to GDP (Pakistan is 34th), market penetration of bank accounts (Pakistan is 34th), number of commercial bank branches (Pakistan is 40th), number of ATM's (Pakistan is 42nd), number of POS (Pakistan is 4th) and MFI borrowers' penetration (Pakistan is 16th)

1 to 7, is a quantification of the response of a sampled group to the question: "During the past year, has obtaining credit for your company become more difficult (= 1) or easier (=7)?." Similarly, for the 'ease of access to loans', for which Pakistan is ranked 32nd (score of 3.18), is based on answers to the question: "How easy is it to obtain a loan without collateral (1 = impossible; 7=easy)?" Because of the subjective nature of these indicators, the benchmarks for access to financial services, as cited by the Financial Development Index, cannot be relied upon. A much more meaningful study is the World Bank Report (2009) on access to financial services in Pakistan, discussed at the beginning of this Chapter.

This leaves us with only two indices to rely upon. One is the efficiency index of the banking financial services that is part of the 4th pillar of the Financial Development Index, in which Pakistan is ranked 46th out of 55 countries, with its sub-category efficiency indicators also showing Pakistan's position mostly in the lower percentiles, as enumerated above. The low efficiency indicators do not, however, have a direct bearing on the state of banking competition, although some uncompetitive behaviour can be inferred from them. The other index, and one from which lack of competition can be deduced much more directly, is the 'interest rate spread' of the Global Competitiveness Index. In this index Pakistan comes out 64th out of 134 countries.

Interest Rate Spreads

Arguably, the interest rate spread is the best index of the efficiency of financial intermediation by the banking system and is a proxy indicator of competitiveness. The difficulty with the index is that there are many different ways of measuring the difference between deposit rates and lending rates and even if one takes weighted averages of the two, there will be discrepancies arising out of accounting differences in calculating them. There is no standard definition that would apply across countries. Thus, the Global Competitiveness Index of interest rate spreads is compiled from varied sources – IMF International Financial Statistics, Economist Intelligence Unit, CountryData Database and national sources. The figures cited in an earlier paragraph (e.g. Hungary 0.3%, Finland 1.3%, U.S. 2.1% U.K. 2.6%, Pakistan 5.5%, India 7.3%) for 2008 are thus not likely to be a comparison of like with like. The yearly data furnished by the International Financial Statistics of IMF suffer from the same deficiency and need to be viewed with caution in drawing cross-country comparisons.

The State Bank does make these cross-country comparisons based on the IMF's reported International Financial Statistics[166], but the utility of these international comparisons is limited in view of these definitional problems. All that can be established from these data is a rising or declining trend. However, for a trend analysis, one is better off with an annual record of net interest margins or interest rate spreads of a single country rather than multi-country statistics.

Time-series analysis of net interest margins (the difference between interest earned and interest paid) or of interest rate spreads (difference between lending and deposit rates) in Pakistan show a widening gap that has become a serious national concern:

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[166] See, for instance, "Efficiency of Financial Intermediation: An Analysis of Banking Spreads", in Chapter 1 of *Financial Stability Review 2006*, pp. 23 – 34, State Bank of Pakistan.

"The presence of high banking spreads generally give rise to policy issues regarding the competition in, and efficiency of, the banking sector. 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."[167]

Several apologies have made by bankers to explain away these high spreads. It has, for instance, been argued that the high rates and profitability accrue from non-interest income. Yet, income from fees, commission and brokerage (FCBI) is not a significant part of bank earnings. In 2007, FCBI was reported to form 13% of the income of public sector bank, 12.5% of the income of private commercial banks and 17.8% of that of foreign banks[168]. The high percentage of non-performing loans (NPL) is usually cited as the other excuse. Yet, the presence of a high NPL ratio is not an exogenous factor. It reflects adversely on the banks' own lending decisions, even when such decisions might have been influenced by extraneous political considerations. Non-financial considerations, or imprudent lending, on the part of bank mangers, is an aggravating factor, it cannot be an extenuating circumstance.

Although the accuracy or comparability of the exact statistical value of the NIM (net interest margin) or of the banking interest rate spread may be disputed, it has by now been universally acknowledged and accepted that these spreads are indeed very high in Pakistan, and are also a reflection of inefficiency and lack of competition. The exact figures do indeed vary. Qayyum and Khan (2007, p.14), in their PIDE study on banking efficiency, cited in Chapter 2 of this report, have calculated the spreads separately for domestic, foreign, top five, and all Pakistani banks. They found considerable variations across the different kinds of banks and also over time (see Table 2.2 in Chapter 2). Similarly, the State Bank has found similar variations, depending upon the method of calculations. In Chapter 1 of *Financial Stability Review 2006* ("Efficiency of Financial Intermediation: An Analysis of Banking Spreads", pp. 23-26) seven different calculations are given, all based on audited accounts of the scheduled banks. They are different from the statistics that have been posted on the State bank's official website, and are reproduced below in Table 9.5.

Table 9.5: Interest Rate Spread (Percent)

	1998	1999	2000	2001	2002	2003	2004	2005	2006
Average yield on earning assets (a)	14.0	12.7	11.3	11.2	8.7	5.7	5.0	7.5	9.1
Average cost of interest liabilities (b)	8.5	7.7	6.6	6.1	4.3	2.0	1.5	2.6	3.9
Spread (a-b)	5.4	5.0	4.7	5.1	4.5	3.8	3.5	5.0	5.2

Source: State Bank website www. sbp.org.pk

The former Governor of the State Bank, Shamshad Akhtar 2008), has a somewhat different set of statistics to offer. See Table 9.6.

[167] State Bank of Pakistan, *Ibid.* p. 29

[168] See Annex 1: Financial Indicators of Banking System, p. 245 of *Financial Stability Review 2007-08*, State Bank of Pakistan.

Table 9.6: Weighted Average Interest Rate Spreads

Month/year	12/04	12/05	12/06	12/07	6/08
WALR	6.69	9.81	11.10	11.27	11.96
WADR	1.30	2.55	3.66	4.13	5.18
Spread	5.39	7.26	7.44	7.14	6.78
Real WALR	-0.68	1.30	2.22	2.48	-9.54
Real WADR	-6.07	-5.96	-5.22	-4.66	-16.32

Source: Table 3 of "10 year Vision/Strategy", para 92, p. 22; see www.sbp.org.pk

The causes or determinants of these high spreads have also been investigated (see "Efficiency of Financial Intermediation", *op cit*, pp. 23-34) and dwelt upon by different analysts, including those from the State Bank. It is generally accepted that, in addition to macroeconomic factors such as GDP growth, inflation and changes in monetary policy, the most significant determinants of interest rate spreads are the extent of competition in the banking industry and the income and cost structures of the banks. In order to analyse the effects of these factors, the State Bank performed a regression analysis in which the bank's cost structure (administrative expenses to total assets) came out as the most significant explanatory variable.

The high level of administrative cost of the banks is possibly the single most important factor in keeping the interest spread high. This is not peculiar to Pakistan. There is an almost universal complaint being voiced nowadays in the world press against the excessive payments -- by way of bonuses and other remunerations to bank managements-- that drive up costs, mostly at the expense of the taxpayer that has had to finance the expensive bailouts of the banks.

The banking system in Pakistan also has a regulatory regime of minimum capital requirements (MCR)[169], cash reserve requirements (CRR)[170] and statutory reserve requirements (SLR).[171] While the need for these triple regulatory requirements cannot be belittled in the context of maintaining the stability of the financial system in Pakistan, these mandatory provisions imposed by the State bank are bound to constrain competition and drive up the interest rate spreads. As the State Bank explains:

> "Specifically, there are at least two factors that play an important role in determining the banking spread, but could not surface in the regression analysis due to the problems of confounding and variability. These two factors are reserve requirements and structure of bank deposits."[172]

The State Bank study ("Efficiency of Financial Intermediation", *op cit*) found that most of the Pakistani banks had a similar deposit structure. The study calculated the effect of non-

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[169] The State Bank raised the minimum paid-up capital requirement (MCR) from Rs 500 million to Rs 750 million (1 Jan 2002) to Rs 1 billion (1 January 2003), to Rs 1.5 billion (31 December 2004) to Rs 2 billion (31 December 2005) to Rs 3 billion (2006) and so on to Rs 6 billion by 31 December 2009. The State Bank intends to further increase it three fold to reach the equivalent of $300 million (Rs 23 billion) by 2013.

[170] The State bank requires a cash reserve requirement (CRR) of 8% on all demand deposits (and time deposits of less than one year) which means that banks are left with 92% of their deposits for on-lending. This constraint impairs the banks' flexibility and can increase the spread.

[171] SLR requires banks to invest a portion of their deposits in zero-risk and low-return government securities. The higher the SLR the higher the spread is likely to become.

[172] Financial Stability Review 2006, op cit, p. 30

remunerative deposits upon spreads and found that the current liquidity preference, expressed in terms of rising current accounts, was adding to the spread[173].

Another highly significant factor in this regard was the presence of PLS deposits which constitute 90% of the total deposits. Although these PLS deposits are not zero-rated , their rate can be changed at will by the banks. This flexibility in varying the cost of deposits to suit ones own balance sheet is bound to result in greater convenience available to the bank, to drive up interest rate spreads.

The root causes of the high interest rate spread lie in the opaque nature of banking and administrative costs, deposit rates and non-competitive regimes. Insofar as regulatory requirements are concerned, the State Bank concedes that its mandatory reserve and capital requirements are restrictive of competition, but it cannot ease these restrictions in the interest of systemic stability. Insofar as the structure of deposits is concerned, the State Bank's policy prescription goes no further than:

> "Keeping the structure of deposits in mind, the first step in reducing banking spread could be to create awareness among the depositors so that they can place their deposits in relatively high return fixed deposit schemes. Therefore, depositors should be encouraged to shift their extra funds from the regular savings and call deposits towards the more lucrative term deposits". [174].

Through this homily the State Bank hopes that:

> "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."[175]

As for administrative expenses, which have a high coefficient in the regression analysis that seeks to explain the determinants of interest rate spreads, the State Bank's policy suggestion is equally trite:

> "Banks should be encouraged to curtail their administrative expenses, increase their core business activities and follow prudent lending policies. All these factors will help in reducing the currently wide level of banking spread." (*Ibid*, p.32)

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[173] These non-remunerative deposits (mostly current accounts) were found to constitute one quarter (25%) of deposits. If they were excluded, the average cost of funding increased by 118 bps and the spread narrowed by 118 bps. The increasingly large portion of non-remunerative deposits were thus found to have significantly depressed the cost of deposits and contributed to the increased spread.

[174] Financial Stability Review 2006. P. 32

[175] Financial Stability Review 2006, pp. 10-11.

As noted in Chapter 6, this shift may be more illusionary than real, and is possibly contradicted by the increasing liquidity preference, which too has been simultaneously noted by the State Bank

Transparent interest rates

Every Report on the banking sector of every country has advocated greater disclosure on the part of banks and greater transparency. Nowhere is this need more acute than in Pakistan. Bank operations are opaque in their deposit mobilization, their lending criteria, their charges of interest rates and financial services, their loan provisioning and their administrative expenses, including remunerations. Full public disclosure and operational transparency are not only essential regulatory requirements, but they are also the *sine qua non* for competition.

The most glaring lack of transparency lies in the fixing of interest rates. 90% of bank deposits have been reported to fall under the nomenclature of "profit and loss sharing accounts" (PLS). The rates of return that are offered initially by commercial banks to depositors on their PLS accounts are not adhered to, and banks revise and adjust them at will according to their preferences or internal corporate needs. This is an unfair practice.

These so-called Islamic banking accounts (PLS) were declared by the Supreme Court (on 23 December 1999) as <u>not</u> being *Shariah* complaint. They lost their Islamic justification a decade back. Yet, they continue to be the predominant form of deposit accounts. The State Bank has serious reservations about these accounts. Yet, the only position it has taken is to make weak suggestions that this concept be re-visited or re-considered. Such faint and hesitant hints are not likely to result in any policy change. More affirmative action is called for in view of the fact that the rate of interest on PLS is not determined according to its proclaimed principle. Also, Islamic banks have, in the meantime, entered the market and have reportedly gained 4.3% market share now. Customers wanting to avail of Islamic banking products have unfettered recourse to these banks. This makes the PLS accounts of the regular (non-Islamic) banks all the more indefensible. Theirs is an unconscionable and non-transparent practice that must be discontinued. *Hence, the PLS accounts, which are a misnomer, should be legally disallowed.*

In addition to the discontinuance of the PLS accounts and the conversion of the existing accounts to normal deposit accounts, as agreed to by the existing customers, all deposit rates offered on all types of accounts must be disclosed fully by every commercial bank. *All deposit rates offered on each type of account need to be posted in detail on the bank's website.* In view of the financial illiteracy and lack of internet - access to most depositors, these *interest rates must also be displayed prominently at each bank branch.* The State Bank is not averse to this kind of disclosure. However, it needs to make sure that the banks actually comply with this requirement.

It is not only interest rates that need to be disclosed on the bank's website. *Different service charges need to be known publicly.* The current thinking in the State Bank appears to favour the standardization of charges for services that entail comparable costs. For instance, the State Bank circular of 1 August 2007 fixed Rs 50 per month as a flat service charge on account balances below a prescribed minimum. Likewise, it has recommended uniform charges on standardized services such as issuance of bank drafts, pay orders, travelers' cheques, ATM cards and cheque books. The trouble with the recommended uniformity of such charges in that the difference between desirable standardization and undesirable collusion can become blurred. It is therefore perhaps more sensible not to determine uniform charges for all banks, but let individual banks fix their own charges, as long as these charges are made known publicly. *It would be a fit case for the Office of Fair Trading (within the Competition Commission) to take up. The OFT can legitimately demand public disclosure of all interest rates and charges levied by the commercial*

banks. However, ensuring full disclosure and transparency might well require some regulatory and legislative cover.

This is an opportune moment for making such regulatory changes to promote transparency, in line with the evolving international trend. Every Report on banking competition in other countries has recommended greater transparency in income statements, interest charges and costs. Pakistan must be no exception to this, especially when the need for it is great. *There are five areas in which greater disclosure is warranted.* The *first* is with regard to interest rates on deposits. These need to be widely known publicly and adhered to by the banks – something that can happen only after the PLS account is discontinued. The *second* form of transparency must be with regard to service charges, including FCBI. The *third* disclosure should with regard to loan provisioning. The *fourth* should be that of administrative costs. The *fifth* relates to remunerations, including salaries and bonuses and other payments made to senior bank management and Boards of Directors. The growing international awareness of current excesses in respect of these payments warrants a closer scrutiny of the same in Pakistan. Audited statements of these remunerations --- and indeed of all administrative costs --- are available and are not confidential documents. Indeed they cannot be confidential in nature. Yet, they are not publicly known.

These five requirements are not only in the public interest, they are also the requirements of promoting greater competition. The time is ripe for providing a legislative cover to these needs, since the State Bank is reportedly submitting (or has already submitted) a new draft Banking Act to the Government for enactment. The 19 Objectives of this draft Act, appended to the "10 year Strategy paper for the banking sector reforms" prepared by the State Bank[176] has many useful recommendations pertaining to prudential regulation and better bank management. Yet, the promotion of competition is absent from these 19 declared objectives, possibly because the State Bank does not officially consider 'competition' to be part of its mandate. If so, it might be justifiably abstaining from it for jurisdictional reasons. Whatever the reason for the State Bank's abstention, it is within the jurisdiction and ambit of responsibilities of the Competition Commission of Pakistan to propose to the Government the inclusion of the above five recommendations in the newly proposed revised Banking Act. This should be in addition to the CCP recommending to the Government that it should disallow the continual currency of PLS accounts under the guise of an Islamic practice, contrary to the Supreme Court judgment of 23 December 1999. Shorn of its Islamic credentials, the PLS is an unfair practice a misleading advertisement that is actionable under the law. Simultaneously, *the Competition Commission needs to help create public awareness, preferably with full support from the State Bank of Pakistan, on the five-point disclosure and transparency agenda recommended in the previous paragraphs.*

IV. STRUCTURAL ISSUES

In the Structure-Conduct-Performance (SCP) model, industry structure ---- as characterized by entry conditions, economies of scale and other variables (see Figure 1.1 in Chapter 1) ---- is the exogenous determinant of performance. In this 'structuralist' approach, it is argued that supernormal returns (say, of commercial or investment banks) are the result of market

[176] see State Bank's website www.sbp.org.pk

concentration and barriers to entry. This argument was advanced, for instance, in the UK Review (2000) which held that the existence of supernormal profits was sufficient proof of structural constraints, such as barriers to entry, and that absence of competition could be deduced there from. Cruickshank (in the UK Review) went further to cite the existence of specific exclusionary barriers erected by incumbent banks as part of an unwholesome "informal contract" --- between banks and successive British governments --- that precluded competition and acted against the public interest. Cruickshank went on to argue that the banking structure that had perpetuated itself in the UK had been supported by the Treasury, the Financial Services Authority (FSA) and the Bank of England. The avoidance of risk, the protection and the special consideration given by the three regulatory institutions to the commercial banks was based on a rather perverse logic. Cruickshank called it an "Alice in the Wonderland" logic that made no sense.

If this approach is taken in the case of the banking industry in Pakistan, the evidence of all successive Governments and the State Bank having made a similar "contract" with commercial banks and having allowed the perpetuation of an uncompetitive banking structure, is irrefutable. It can, of course, be argued back that this was necessary in the interest of stability. This counter-argument carries some weight. In this Report we have traced the genesis of commercial banking in Pakistan from the vacuum of 1947 to the crafting of financial institutions, beginning 1948-1949 (founding of the State Bank and National Bank of Pakistan), followed by a decade of rapid financial development (1959 – 1969) that spawned the political turbulence of 1969 – 1972, which was, in no small measure, the result of financial and industrial concentration of wealth in one segment and in one geographical market. Despite the political and the social fall-out of the skewed distribution of bank lending and investment that contributed towards the alienation that led to the secession by one half of the country, despite the social protest against it (in the form of public burning of bank branches in East Pakistan), the banking system survived --- even though it had to be nationalized. Defenders of the system can legitimately point towards this continuing 'stability' as justification for the tripartite "contract" between the government, the regulator and commercial banks through which the system has been propped up.

Further evidence of this social contract is furnished by the cartelization of banks sponsored by the State Bank. This cartelization goes back to the 1950s, as narrated in Chapter 4. Price fixing has not only been the norm, it has also been espoused as a desirable practice. Witness --- for instance --- the 1959 Inter-Bank Agreement and the micromanagement of deposit rates by the State Bank. Witness, for instance, the unabashed promotion of banking agreements,, including mergers, by the State Bank throughout the 1960s. The collusion and cartelization of the 1950 and 1960s was replaced by complete nationalization and State-control for the next twenty years. During these years of State monopoly, 'stability' was ensured not through the State Bank of Pakistan but by a parallel regulatory body--- the Pakistan Banking Council that stifled all possibility of any independent action by any bank and kept competition away from all commercial banks which came under its protective umbrella. This protection continued even in the post-nationalization period. Having allowed private banking entry in 1991, the government placed a moratorium on further entry in 1995. The incumbents were further protected after 1997 through increased capital adequacy ratios and minimum capital requirements. During the last decade, these entry-deterring requirements have been further fortified in a quest for consolidation. A fresh moratorium has been placed on new entry. The MCR is being raised continuously every year, in accordance with an announced schedule through 2013, to squeeze

out the smaller banks in a supposedly risk-reduction exercise based on the comforting premise of "too big to fail".

An alternative hypothesis, found in the literature, is that industry structure is not an exogenous determinant, but is the result (not cause) of some past strategies pursued by firms. According to the alternative hypothesis, entry barriers are erected by the firms (banking firms in this case) in the industry through their choice of production and marketing strategies. Through these strategies, such as the exploitation of economies of scale and scope, firms acquire efficiency gains, as a result of which only the few that are the most efficient and fit enough to survive, actually stay in business, the inefficient fall by the wayside. The problem in accepting this hypothesis is that none of this has happened. Efficiency gains have simply not occurred. The State Bank and PIDE that have both looked at this aspect, have not noticed any. Nor have there been any exits on account of failure. Rather, the State Bank has provided "safe exits" to failing banks through mergers. In the absence of any competitive failures it cannot therefore be concluded that the present consolidation is the result, or cause, of natural efficiency gains.

This leads to the inescapable conclusion that the present banking structure, as imposed and mandated by the regulator (the State Bank openly advocates its virtue and facilitates the required consolidation of banks) is what inhibits competition. The structure has not evolved as a result of competition. On the contrary, the failure of competition is the result of promotion and perpetuation of this structure under the "special contract." The neglect in providing agricultural credit and lack of transparency in deposit-taking from rural areas is attributable to it. Indeed, it has been identified as a major failing by the former Governor (Shamshad Akhtar) of the State Bank in the ten-year strategy paper. However, the expectation of this strategy paper that increased competitive pressure in providing advances will eventually lead to greater competition in deposit- mobilization, is unrealistic as long as the banks have sufficient maneuverability under the interest rate spread. Equally unrealistic is the expectation of PIDE (Qayyum and Khan 2007) that greater consolidation will lead to greater efficiency, which will in turn lead to greater competition. There is no evidence, or basis, for expecting such an outcome.

Recommendations

The first principle of safeguarding the public interest in banking must be to protect the depositors against bank failure and not vice versa. Yet, the State policy of providing a safe exit to the inefficient and failing banking firms is tantamount to protecting the banks rather than the interests of the borrowers.

Insuring deposits

The former Governor of the State Bank, Shamshad Akhtar, had proposed a deposit insurance scheme to effectively reverse this protection mechanism so that it could work in the public interest and not that of the banks. This proposal envisaged the setting up of an insurance fund to protect deposits below Rs 100,000 per depositor per bank. Such insurance would cover 77% of the number of depositors, but only 22% of the value of deposits--- – a natural reflection of the skewed deposit distribution. Business accounts, interbank deposits, government accounts would not be covered in order to avoid moral hazard.

Shamshad Akhtar proposed the limit of Rs 100,000 insurance coverage on the basis that it was three-times the per capita GDP (Rs 34,294) of Pakistan and because this extent of coverage (3 times GDP) was in line with the international standard of such available coverage, which was 2 – 4 times GDP. There is however another market-related reason for restricting the insurance coverage to this limit. As Chapter 6 showed, the most dynamic segment of the deposit market during the past 10 years has been that of current account deposits ranging from Rs 20,000 to Rs 100,000. At the same time, the savings deposits grew most significantly in this size of account. From the point of view of competitive activity, it would therefore be logic to focus on this segment.

Legal protection to depositors was in fact made available under the Banks (Nationalization) act of 1974, However, after denationalization, this protection appear to have lapsed. An explicit depositor protection scheme (DPS) has therefore been proposed in the new draft Banking Act that has reportedly been finalized by the State Bank. *The Competition Commission should support this proposal, and the Government should enact it.*

Tenet of consolidation

The Government must be well aware of the fact that the implicit moratorium on new entry that had been placed on new entry by the State Bank, is meant to protect the incumbent bank against further competition. The State Bank admits that the increased capital adequacy ratio and minimum capital requirements are meant to promote consolidation within existing banks and deter further entry. It is for the Government to determine, on the basis of objective criteria, whether these restrictions on competition and the on-going consolidation operation are in the public interest.

The State Bank has always advocated that bank consolidation is in the public interest. During 1950s and the 1960s, when a large number of malpractices crept into the banking system, when corruption became rampant, when price fixing and collusion became the norm --- for instance, through the Inter-bank Agreement of 1959 to fix deposit rates and the State Bank's fine-tuning of the cartel --- the State Bank's policy prescription was that of consolidating the banking system in order to "reduce the chances of competition hitting the weak units" (see Chapter 4). It has continued with this policy ever since.

In 1995, four years after relaxation of entry restrictions and State-divestiture, it imposed a moratorium on further investment. During the decade of 2000s, the process of consolidation through mergers and acquisitions became the official doctrine that has continued to be adhered to.

The adherence to this doctrine has not been questioned in Pakistan, not even by the Competition Commission. The Competition Commission has in fact endorsed it.[177] Consequently, the belief in "too big to fail", which implies that the larger the bank the safer it is, and that consolidation promotes stability as well as efficiency, has gone unchallenged. The rigid belief in this doctrine, which has now become State policy, has not, however, been validated by international experience. The post Second World War wave of conglomerate mergers and acquisitions started to recede in the 1970s when it became evident that economies of scale did not necessarily follow

[177] See The Business Recorder, December, 2008, and also ff. 19 in Chapter 5

large- size acquisitions and might even result in diminishing returns. "Small is beautiful" emerged as a contrary maxim, and the virtues of diversification and consolidation began to be questioned. However, in the banking sector, the thinking that large size was preferable, continued to hold sway. Thus, it would be only fair to add that the official doctrine, held throughout in Pakistan, was not at variance with the official tenets of banking elsewhere --- with the exception of the United States, which has had a very strong anti-trust tradition, a large number of small-sized regional banks (which had a history of failure, and no government support) and hardly any State-protection until 2008.

The recent experience of the spectacular failure of big banks world-wide, necessitating expensive bail-outs at the public expense, serves to highlight the fallacy in the belief of 'too big to fail." Additionally, there is no empirical basis for the argument that the larger the size of operation the greater the efficiency. Even the economies of scale that were supposed to result from the induction of IT technology in banking have remained elusive. The State Bank's own study on efficiency (see M&A effects in Chapter 5) has not shown any positive findings.

M&A impact assessment

Under these circumstances, a review of the philosophy of consolidation is warranted. Specifically, this implies review of the current policy restrictions on new bank entry and of the effects of mergers and assessments. No attempt has been made so far to evaluate the effects of the recent spate of mergers. Nor is there any procedure for an ex- ante assessment of the possible effects of mergers. The Competition law of the Competition Commission envisages such an ex-ante assessment, but none has been made in the case of bank mergers because this has remained within the jurisdiction of the banking regulator. In other competition jurisdictions (e.g. South Africa) it has been recommended that proposed bank mergers should automatically proceed to Stage II consideration (less perfunctory than routine disposal of merger applications) by the Competition Commission. In the case of Pakistan, the State Bank is not likely to assess the impact of M&A on competition, since anti-trust action or promotion of competition is not a part of its mandate. Consequently, *it is up to the Competition Commission to put together a mechanism for merger assessment benchmarking.*

This is a technically complex matter, not devoid of controversy and ambiguity. Simple market share calculations and reliance on accounting data will not suffice, and may in fact lead to wrong or misleading conclusions.[178] It is therefore advisable to proceed with caution and circumspection. Yet, an analysis of efficiency and competitiveness is imperative.

Re-classification of product-market data

An alternative route (and a more efficacious one, in fact) to analyzing the effect on competition is to look within product markets rather than the banking 'industry'. This approach has been suggested throughout this Report. For further analysis, of the kind recommended here, it would of course be necessary, as a first step, to identify the product market segments as well as the relevant geographical markets. Without that there can be no meaningful view of competition that is actually taking place. However, this analysis requires primary data on product markets. In the

[178] See Cetorelli (1999) for an appraisal of methodologies of competition analysis for the banking sector that address the problems of M&A impact assessment.

case of the banking sector, the State Bank reports and publishes Statistics on 85 categories of borrowers and depositors under 7 main heads of account. It also reports on 5 types of accounts that are further broken down under 36 rates of interest. The reporting schema also has 31 classifications of size of accounts. Identifying relevant market segment from these matrices is much-too complicated a task, and one that cannot be performed without re-classification of data, which can only be done by the State Bank.

Strategic group analysis

However, if such re-specification of data is possible, it would be feasible, indeed desirable, to look at competition within each of the significant product markets. The important question here is to determine the entry and exit barriers and cost conditions surrounding different segments within the banking industry. In other words, one has to identify intra-industry 'mobility' barriers rather than inter-industry 'entry' barriers. This identification is implicit in an analysis of strategic groups. The concept of strategic groups and its application to the banking sector was reviewed in the European Perspective, in the context of the Polish study discussed in Chapter 3. The applicability of this concept in analyzing the deposit markets in Pakistan was also pointed out in Chapter 6. For a proper study of the mobility barriers surrounding product markets and the strategic differences between economic enterprises operating in the markets of deposit-taking and loan extension, one would need a much more careful analysis not only of the incumbent banks' strategies but also of potential entrants. For instance, one would need to look not only at deposits of banks but also at all other forms of deposits, especially CDNS deposits under different savings schemes and other investment opportunities. For the market of borrowers, one would need to analyze informal credit markets and lending by non-banking institutions. *The resultant strategic group analysis would possibly be the most wholesome and useful one for the Competition Commission. It should be the methodology of choice.*

This leads to the final, and possibly the most far-reaching, recommendation for the banking sector.

Artificiality of industry boundaries

Banking firms throughout the world have enjoyed a special status, owing to the existence of what the UK Review described as the informal contract between banks and successive governments. Nowhere has this contract been more evident than in Pakistan. As in several other countries, the banking regulator has promoted the interest of commercial banks at the expense of other financial institutions lying outside the banking industry and outside its own regulatory control. The CDNS, which lies outside the State Bank's regulatory control, is not viewed too kindly. It is denied access to the payment system and cannot perform any banking function. Even though a savings account can be maintained with the CDNS, profits accruing on NSS cannot be transferred automatically into this account. Profit can only be withdrawn first (through a 'withdrawal slip') and deposited as a cash transaction by the account holder, not credited by the Savings Centre. Nor can a depositor write out a cheque on his own account in favour of a third party--- because that would tantamount to a banking transaction. In other words, even though the CDNS performs the basic functions of banking (deposit taking, making payments and giving profit) it is allowed no intermediation and no access to the payment system. Other 'non-banking' financial institutions are similarly disadvantaged--- the difference between them and 'scheduled

banks' being one of nomenclature, classification and regulatory control, not one of substance or functionality.

The artificiality of industry boundaries is again a universal problem. An economic definition of a "bank", as being different from a "fund" or a "non-bank" financial institution, is hard to give, which is probably why the standard, and more convenient, answer that is usually given is that a bank is a bank when it is called a bank.[179] This may sound facetious, but it actually underscores the absence of an economic rationale for classification. How one defines a bank, and the banking industry, determines where its boundaries are drawn, and who is included and who gets excluded from privileged consideration under the 'informal contract'. It results in an arbitrary denial of access to (a product market) to a supplier that does not happen to be classified (by the regulator) to belong to that particular industry.

In India and Pakistan it is convenient to call a bank a bank when it is so "scheduled". An even simpler, and legally correct, answer is that a bank is that institution which falls under the regulatory control of the central bank.

Removing artificial boundary barriers

No meaningful analysis of competition in product markets can possibly be restricted to an analysis of the "industry" as defined by regulators, by governments or by Standard Industrial Classifications (SIC). Yet, that is what most industry analyses do, and that is precisely why they have such an unsatisfying property. In real life, firms do not conform to SIC. They cross industry boundaries with insouciance – unless disallowed legally from doing so. If they are prohibited from entering an adjacent industry, it is the most restrictive form of restraint on competition. Unfortunately, in the banking sector this is a universal restraint that is placed on non-banking firms. If a firm is not classified as a bank it cannot enter the banking industry. Cruickshank gave the example of Sainsbury's and Tesco that had to acquire non-English banks in order to enter UK banking. They could not enter the banking system in their own right or have any access to the payment system. The same situation prevails in other countries because of the inordinately high level of legal and economic barriers surrounding the banking industry.

In every competition jurisdiction this appears to be a very special problem that requires tackling. In the case of Pakistan, the problem is especially acute because of high profitability and high interest spreads that are an invitation to entry. Yet, fresh entry has effectively been foreclosed to any new entrant from outside the "industry". This ultimate barrier to entry, buttressed by ancillary fortifications that have been pointed out in this report, strengthens the banks' position and prevents other potential service-providers from competing down the monopoly rents of commercial banks. It weakens the bargaining position of customers and limits consumer choice. *In the final analysis, the Government will have to take the decision whether the payment system and the banking system need to be opened up in the public interest or whether they must remain closed in the interest of the bankers' oligarchy.*

[179] One cannot but help agree with Keynes' famous observation on the two greatest misnomers-- that the "Fund" (IMF) was actually a bank, while the "Bank" (World Bank) was actually a fund.

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