

Consolidation In Pakistani Banking Sector

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Abstract

Pakistan's banking sector has progressed rapidly in the last few years. The trend of consolidation in the industry, which began in the US and spread to Europe, Middle East, and South East Asia, has now reached the subcontinent.

A process of consolidation as a viable solution has followed each crisis in the banking sector. In the aftermath of the crisis in South East Asia in 1997, when capital outflow plunged the banking sector, central banks of the states found consolidation as one of the crucial remedies. Since Pakistan was following the South East Asian model of financial liberalization, it also adopted consolidation under the supervision of the International Monetary Fund. After the collapse of Asian tigers, weak banks were asked to increase their paid up capital from PKR 500 million to PKR 1 billion. As a result, banks had to take the consolidation route. State Bank of Pakistan became powerful regulator after an amendment in 1997 Act. The following study is an attempt to find the reasons of consolidation in the banking sector of Pakistan.

1. INTRODUCTION

Pakistan's banking sector has undergone a major reshuffle in the past few years. As part of this process, more than 10 bank mergers have been completed, three banks have disappeared from the portfolio, and privatization of Nationalized Commercial Banks (NCBs) have become the top priority of the State Bank of Pakistan (SBP). The trend of consolidation has its roots in the US banking sector. This slowly progressed elsewhere and is now seen in the subcontinent.

However, the common factor is that consolidation has emerged as the viable solution after every crisis.

The last decade of the 20th century was the era of Merger and Acquisitions (M&A) all over the world. The following graph shows M&A in the last 23 years [1]. It

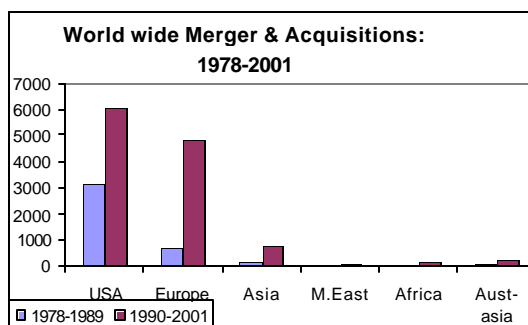


Fig 1: Worldwide Mergers and Acquisitions: 1978-2000
Source: Thomson Financial Securities Data (2001)

shows that 75 percent of the bank M&A took place between 1990-2001

Asia followed the trend and so did Europe. After the South East Asian crisis in 1997, Central Banks (CBs) resorted to consolidation as a remedy.

The trickling down effect was also felt in Pakistan despite the fact that it was a comparatively small economic unit. Since capital inflow was less than South East Asian economies, Pakistan did not suffer the collapse of banking structure of the same dimension. It also adopted measures under the supervision of IMF to strengthen the sector.

The following discussion examines the reasons of consolidation in the banking sector of Pakistan. The study comprises four sections. The first enumerates major theories of M&A, the second analyses the banking crisis in South East Asia (SEA) and the remedial steps taken by their governments. Section three focuses on the banking sector of Pakistan after 1990. The concluding chapter includes recommendations to probe usefulness of M&A in the banking sector of the country .

2. THEORIES OF M&A: [2]

Given below are some theories, which have been briefly defined:

a) Differential Managerial Efficiency Theory:

It states that when efficient firm acquires inefficient firm, the efficiency of acquired firm increases.

b) Operating Synergy:

It stresses on economies of scale and improvement in performance due to synergy.

c) Pure Diversification:

It refers to diversifying firms to avoid risk and reliance on few products.

d) Agency Problem:

It suggests that M&A can be used as a tool to control management actions. The threat of hostile takeover would force managers to work efficiently.

e) Hubris Hypothesis:

It states that management takes expansion decisions to increase the size of their firm and increase their power and perquisites. They might commit mistakes in taking such decisions and feel compelled to stick with them due to pride.

f) Tax Considerations:

To defer tax liabilities a firm acquires another. This could be a reason favoring M&A.

g) Methods of Testing the Effect of M&A:

Following are the three methods by which one can measure the effects of M&A.

Accounting Performance:

Measures differences between financial statements of pre merger and post merger periods.

Stock Market Reaction:

Refers to price fluctuation in share price on acquiring and acquired firm share before and after declaration of merger.

Correlation between Accounting and Market Reaction:

This method combines both the above methods and relies on statistical tool of correlation.

3. FINANCIAL CRISIS IN ASIA PACIFIC REGION.

As mentioned earlier, M&A stemmed from the US and spread all over the world. South East Asian region was blessed with the economic boom in the early 90s. But unfortunately, the region could not enjoy the fruits of labor as the financial sector of the region collapsed. Several factors were attributed to the collapse. Some of them are discussed here:

a) Globalization & Liberalization:

In late 80s, SEA opened their economy to attract foreign investment. The huge capital inflow led to the hike in prices, especially in the real estate sector. Properties were mortgaged with banks against advances. The reversal of this cash flow led to a drop in inflated prices and left banks with liquidity crunch.

b) Weak Legal and Statutory Framework:

SEA countries may have succeeded in attracting foreign investments but they could not handle the capacity properly. The legal framework and monitoring capacity was not strong enough to absorb the huge capital inflow and its utility prudentially.

c) Short-term Capital Inflow:

A large portion of foreign capital flew into the region through stock market investment instead of Foreign Direct Investment (FDI). Also in the absence of prudent rules and regulations, investors withdrew their capital easily and left the economy in a crisis.

d) Asset Bubble:

Due to huge capital inflow, prices of every commodity rose, which created an asset bubble. With the bursting of this bubble, situation became even worse. Banks were left with only properties as collateral and faced bankruptcy and liquidity crunch. Banking risk increased due to 50 percent, 35 percent and 23 percent investment in property sector by Thailand, Indonesia and Korea respectively.

e) Maturity Mismatch:

Banks borrowed short-term deposits from investors and landed on long-term basis, creating a maturity mismatch. This caused a collapse in the system. STD/TD ratio touched 50.2 percent in Korea, 41.4 percent in Thailand, 24.9 percent in Indonesia and 19.3 percent in Philippines.

f) Small Weak Banks:

Due to outflow of capital from the banking sector, weak banks did not survive the shock and soon declared bankruptcy. Hence financial crisis got worsened.

g) Subsidized loans to priority sector:

The government asked banks to advance loans to the priority sectors and state-owned enterprises on subsidized interest rates. This was against the commercial aptitude of banks.

h) Non-performing Loans:

Financial crisis worsened the banking performance. Due to mismatch in maturities and depression in the economy businesses were unable to payoff loans. Due to this, stuck-up loans increased. For instance, NPL/Loans ratio in Thailand rose from 19.8 percent in 1997 to 45 percent in 1998.

Let us now assess some of the remedial steps taken to revive the economy in South East Asia:

Balanced Developmental Role & Commercial Orientation of Banks:

Central Banks (CBs) of SEA countries established separate financial institutions to cater to priority sector necessities. Such steps gave leverage to the commercial banks to operate as commercially viable business units.

Resolution of Non-performing Loans:

The CBs of SEA countries also established the separate asset management companies to collect non-performing loans. Establishment of Korea Asset Management Corporation, Thai Financial Sector Restructuring Authority, Thai Asset Management and Property Loan Management Authority, and Indonesia Bank Restructuring Agency were some of the examples.

Restructuring the Banking Sector: [3]

Two solutions were devised for bank restructuring. First was known as Flow Solution, which was used in mild problematic situation. It prevented banks from incurring current period losses. Examples of this solution are change of management, improvement in prudential rules and regulations. Next was Stock Solution. It assisted the banks in reducing historical losses and using in critical situations. Capital injection, M&A and privatization are few examples of Stock Solution. Thus to implement above solutions financial policy, operational policy and structural policy instruments were used.

Enhancement of Prudential Regulations and Supervision:

SEA countries took proper measures to enhance prudential rules and regulations and adopted standards formulated by Bank of International Settlement (BIS). It was made mandatory for banks to maintain eight percent Capital Adequacy Ratio (CAR). Central bank's powers were enhanced and more independence was given to handle their affairs.

Strengthening the Infrastructure of Financial Sector and Human Resources:

Disclosure requirements were made mandatory for all banks in SEA countries. CBs conducted training sessions for their staff to improve their analytical skills. Capital requirements were raised, which forced weak banks to merge or close their operations. In Thailand 46 out of 91 financial institution merged or closed, 39 financial institutions became 8 in Malaysia and in Korea mergers reduced the number of banks from 30 to 14.

4. BANKING SECTOR IN PAKISTAN

Pakistan had its own minor banking crisis in May 1998 when Foreign Exchange accounts (FC\$) were frozen. The situation did not worsen, as much, because Pakistan was a smaller country with poor infrastructure and had not received the same amount of capital inflow as SEA countries did. It had a trickling down effect. When the capital outflow started, it did not affect Pakistan much.

Banking Reforms in the 1990s:

The objective of the reforms in the 1990s was to establish a more market-based system of monetary management. The government took the following steps to strengthen the market-based system:

- i) The government partially privatized the NCBs (Muslim Commercial Bank and Allied Bank Limited) in order to increase the competition and efficiency in the banking system.
- ii) The introduction of an auction system for government securities was a step towards interest rate liberalization, which enabled the SBP to exercise indirect monetary control through open market operations.
- iii) The government withdrew subsidy to credit schemes, and autonomy to SBP.

Reasons of Low Efficiency in NCBs in Pakistan:

- **Weak Leadership:**

Weak governance has contributed to the loss of control over banking sector in Pakistan, as can be seen in case of non-profit loans. Also worsening macroeconomic imbalances have led to a growing dependence on foreign currency deposits and increasing market intervention to contain the cost of financing a large fiscal deficit. Consequently, insolvency of the banking sector rose and two large NCBs (United Bank Limited and Habib Bank Limited) and the older direct foreign investments (BEL, NDFC) faced liquidity problems. Potentially volatile and expensive foreign currency deposits boosted foreign exchange reserves. Similarly, access to the credit by the private sector was increasingly curtailed.

- **Social Burden on Banks:**

Banks had to give away loans to the priority sectors, as was the case with SEA countries. These include agriculture loans, export finance loans, yellow cab loans etc.
- **Labor Unions:**

Labor unions were a major hurdle to the implementation of new development schemes in financial institutions.
- **Job Security Factor:**

There was no threat to job for managers and very few motivating factors. They were aware that the SBP would come to their rescue in adverse circumstances.
- **Political Influence:**

Political influence gave rise to the non-performing loans (NPL). 70 percent of these loans were allocated to 250 customers. Total NPL went up from PKR25 billion in 1989 to PKR128 billion in 1998.
- **Dollarization:**

As depositors lost confidence in Pak rupee, a majority of them invested in US dollar accounts. Hence, foreign banks were relying upon their business only on their foreign currency accounts. When these accounts were frozen, they lost huge business. Further, due to non-diversification in products, few were able to survive and others lost interest.
- **Poor Legal System:**

A poor legal framework increased the defaulters. Islamic bank defaulters' interest cannot be accrued more than 210 days as per Sharia (Islamic Courts). Legal proceedings used to take much time to issue decrees in favor of banks. Pakistan hence became a heaven for defaulters.
- **Weak Central Bank:**

There were three regulators in Pakistan: Ministry for Finance, Pakistan Banking Council and State Bank of Pakistan. This caused confusion about the real authority. On the other hand, SBP had limited powers to monitor financial institutions.

1997–1998 Banking Reforms

It is evident that after the Asian crisis there was a sweeping change in the policy structure in most of the Asian countries. The idea of free flow liberalization was transformed into a managed liberalization. Caution and prudence became the main focus for CBs. Professionalism among the bankers assumed maximum importance for the CEOs and the board of directors. Following are the proactive measures the government has taken to avoid crisis in the banking industry of Pakistan:

- **Privatization:**

It decided to privatize Nationalized Commercial Banks (NCB) in order to improve their performance.
- **Management:**

It replaced the old management of NCBs with young professional bankers. They were appointed by SBP for three years and were given full authority. Labor unions were also banned.

- **Legal Framework:**
Judiciary was made more effective. Directives were given to decide cases against defaulters within 90 days. Arrangement was made to decide cases up to PKR 30 million in banking court and for amounts exceeding this limit; the cases were referred to the High Courts.
- **State Bank of Pakistan:**
SBP were given more powers. Pakistan Banking Council was abolished and SBP was declared as the only regulator. SBP appointed professional consultants and started training programs to enhance the skills of its employees. CEOs of banks were appointed with the approval of SBP. Prudent rules and regulations were devised and implemented. SBP made it clear that if a bank does not compete in the market, it will not come for rescue.
- **Resolution on Non-Performing Loans:**
Efforts were made to reduce the stock of bad loans through vigorous recovery system and enforcement of laws.
In the first phase of amnesty program from June 5 to September 5 1997, incentives were given to the defaulters and “sick units” to settle their overdue amounts. Cash settlement was typically 10 percent down payment with the 90 percent balance due by December 5 1997. According to this, some 34,000 defaulters and 770 sick units with loans amounting to PKR28.5 billion and PKR34.4 billion, respectively, were covered.
The second phase was the mandatory legal action against those who didn’t come forward to settle their affairs in the first phase. By June 30 1998, PKR16.3 billion were recovered in cash, while PKR14.7 billion in loans were restructured or rescheduled.
- **Restructuring of Banking Sector:**
Following in the footsteps of CBs of SEA countries, Pakistan also took similar steps to restructure its financial sector. [4] Both Flow and Stock solutions were used through Financial, Operational and Structural policy instruments. Staff was retrenched and loss-making branches were closed down. Equity was injected in two NCBs to make them viable for privatization. Out of three NCBs, United Bank Limited was sold to Abu Dhabi group. Stock Exchange is privatizing National Bank of Pakistan and Habib Bank Limited is up for privatization soon. Reporting standards have been introduced and all banks have been asked to get themselves ranked according to their financial position. CAMEL standards have been implemented to gauge the adequacy of banks at all times. [5].

5. CONCLUSION

Banking sector is one of the most sensitive sectors in a country’s economy. Any mishap can destabilize the entire economy.

Restructuring is a tool by which any economy can be revived provided steps are taken in proper sequence.

Financial crisis gives birth to mergers. M&A rescued US economy when it was in deep recession. It helped Europe survive. And when Asian countries were in deep financial trouble; M&A activity salvaged the financial sector under the supervision of the IMF.

In the early 1990s, Asian countries opened their financial markets for foreign investors. Lots of western entrepreneurs brought capital into Thailand, Malaysia, Indonesia, the Philippines, People’s Republic of China (PRC) and Korea. Due to huge capital inflow, there was a boost in the economy. Stock markets saw bullish trends and attracted more investors from all over the world. In order to avail developmental opportunities, governments issued more banking licenses to investors. This led to a hike in the number of financial institutions. Owing to a high capital inflow, prices rose and inflation touched its peak. Real estate prices and interest rates went up. Inflation caused an asset bubble. Banks gave advances to local investors and accepted real estate as collateral.

At that time, it looked as if everything was moving smoothly, but when the trend reversed capital outflow touched its peak. The whole development cycle took a U-turn and economies of Asian countries tumbled one by one making the region the most dangerous from investment point of view.

The biggest reason behind the disaster was inadequate monitoring process of financial markets by respective governments and central banks. Financial sector of these countries were not equipped to absorb such huge capital inflow. Banks gave long-term loans against short-term deposits leading to mismatch of maturities resulting into bankruptcy. Consequently, IMF the donor agency intervened and suggested the following steps.

- i) Denationalization
- ii) Improved monitoring system
- iii) Increase capital base of banks according to BASLE Standards
- iv) Restructure financial sector by closure of imprudent banks and merge weak banks to reduce number of banks etc.

The South East Asian crisis shook regional economy and made it fragile. The trickling down effect was also felt in the subcontinent. Pakistan was lucky not to be affected at large. On the other hand, SBP took timely proactive measures to strengthen it by following IMF directions.

Following are some of the major reasons for the decline in the banking sector of Pakistan:

- NCBs owned most of the financial assets and deposits. They were overstaffed, had highly bureaucratic approach, a large number of unprofitable branches and poor customer services.
- They gave a lot of mandatory and concessional loans
- Banks were influenced by political pressure, which caused hike in non-performing loan (NPL) portfolio. NPL increased from PRs.25 billion in 1989 to 128 billion in 1998.
- Inefficiency had become common in bank management.

- SBP was not monitoring them well.
- There were three regulators - SBP, Ministry of Finance and Pakistan Banking Council. This created a lot of confusion of authority.
- There was a narrow range of products due to small size of domestic banks. They had a non-diversified portfolio.
- There was an over reliance on Foreign Currency (FC) accounts by foreign banks. Forward cover premium was the main source of their income and this exposed them to risk in the event of FC accounts freeze.
- There was a high tax on banking sector.
- There was a lack of transparency and rating requirements were not mandatory.

NCBs were making huge losses and their management was least bothered, as they were sure that SBP would rescue them. Similarly, in case of liquidity crunch the perceived confidence of SBP injecting capital proved hazardous.

In 1997, under an ordinance, SBP was given more powers and liberty to work independently. Pakistan Banking Council was dissolved. SBP forced banks to improve their efficiency and increased capital requirements from PKR 500 million to PKR 1 billion. This prompted banks to opt for mergers. The privatization process of nationalized commercial banks began and the legal process improved. New rules and regulations were implemented and the closure of banks such as Prudential Bank, Mehran Bank and NDFC established transparency in the banking system.

Given below is a list of the number of ways in which banks can be restructured:

- Selling of nationalized banks to one bidder at one go. The price fetched may be low in this case. Example is privatization of United Bank Limited.
- Selling government shares to the general public through stock exchange. Example is the floating of NBP shares in the market, which fetched Rs. 10 and Rs. 22 respectively in two offerings.
- Due to increase in capital requirement as per BASLE standards, small banks would merge. This would cut down the number of banks.
- Bank mergers due to increase in product line. Example PICIC acquired Gulf Commercial Bank.
- Bank mergers provide a safe exit to weak banks that cannot compete and are incurring losses due to one failed product. Example is ANZ merger with Standard Chartered.
- No more guarantees/ support from SBP given to weak banks. This led to the closure of its operations. Examples are NDFC, BEL, Indus Bank etc.

Due to reforms, banks merged into large units to achieve economies of scale, diversification of products, low transactions costs and efficient use of resources by avoiding duplication. After reforms and independence of SBP, few banks were forced to close their operations due to imprudent practices. Indus Bank, Mehran Bank, NDFC and Bankers Equity are few of them. Few banks injected

more capital to meet SBP requirements as per BASLE standards. About 10 bank mergers took place in the last two years. Doha Bank merged into Trust Bank; the Crescent Group acquired Mashreq Bank and PICIC acquired Gulf Commercial Bank. Emirates and American Express (card division) merged with Union bank. Faysal Bank merged with Alfaysal Investment Bank. NDFC merged with the National Bank. Prudential merged with Saudi Pak. And Standard Chartered Bank in Pakistan acquired ANZ. NCBs are in the process of privatization. Recently United Bank Limited was sold to Abu Dhabi Group, National Bank of Pakistan's shares have been off loaded through stock exchange and Habib Bank Limited is in the process of privatization.

It is evident that the government of Pakistan and the SBP are continuously taking concrete steps with the help of IMF to tackle the problems facing banking industry in Pakistan. The process has begun with major restructuring campaigns leading to the privatization of Nationalized Commercial Banks (NCBs) and mergers of smaller and weaker banks into a more viable banking sector industry.

REFERENCES

[1] Worldwide Banking M&A 1978-2001

| | USA | Europe | Asia | M. East | Africa | Aust -asia |
|-----------|------|--------|------|---------|--------|------------|
| 1978-1989 | 3105 | 716 | 129 | 11 | 16 | 68 |
| 1990-2001 | 6035 | 4801 | 829 | 107 | 145 | 236 |

Source: Thomson Financial Securities Data (2001)

[2] Mergers, Restructuring, And Corporate Control, by Weston, Chung, Hoag: Chapter 8: Theories of Mergers and Tender Offers

[3] Estimated Cost of Bank Restructuring

| Item | Local Currency Cost | US\$ bn (30Nov 1998 exch. Rate) | % of GDP |
|-----------------------------------|---------------------|---------------------------------|-----------|
| Interest Costs | | 17.0 | |
| Indonesia | Rp40 trillion | 5.4 | 3.5 |
| Korea | W8 trillion | 6.4 | 2.0 |
| Malaysia | RM 3.5 billion | 0.9 | 1.25 |
| Philippines | P11.9 billion | 0.3 (assume 10% int.rate) | 0.25-0.50 |
| Thailand | B143 billion | 4.0 | 3.0 |
| Total Cost (stock of debt issued) | | 159.0 | |
| Indonesia | Rp300 trillion | 40.0 | 29.0 |
| Korea | W74.7 trillion | 60.0 | 17.5 |
| Malaysia | RM48.4 trillion | 13.0 | 18.0 |
| Philippines | P100 billion | 3.0 | 4.0 |
| Thailand | B1.583 billion | 43.0 | 32.0 |

Source: IMF, World Economic Outlook and International Capital Markets, December 1998.

[4] EBR, DAWN; August 12, 2002

[5] Ramos, Roy. 1997a. "Prudential Norms and CAMELOT: How Real are Reported Earnings and Book Values." Mimeo. Banking research, Goldman Sachs, Hong Kong. 997b. "Asian Banks at Risk: Solidity, Fragility." Mimeo. Banking Research, Goldman Sachs, Hong Kong.