IMPACT OF PRIVATIZATION ON NON-PERFORMING LOANS OF CONVENTIONAL COMMERCIAL BANKS IN PAKISTAN

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ABSTRACT

Current study describes the effect of privatization on non-performing loans of conventional commercial banks in Pakistan to some extent. Process of privatization started from 1988 due to non-satisfactory performance of banks, as there was lack of lenders plans, weak credit operations, increased loans sizes and many other similar factors. Studies revealed the better performance of private banks as compared to government owned banks. Most important factor is about handling of non-performing loans which may be through early risk assessment, better law and order situations, regular monitoring and other similar factors. MCB, ABL, UBL and HBL banks were privatized in order to attain efficiencies and all of these banks showed significant improvement after the privatization. Values of non-performing loans is divided in to pre-privatization and post-privatization period and collected from Banking Surveillance Department (BSD) and from the official website of SBP. Graphical as well as analytical analysis is performed to judge the impact of privatization. Average values of non-performing loans showed a significant fall in the values of non-performing loans after the privatization. There are also some other forces for this improvement like the Banking Reforms. Due to these reforms the concept of corporate governance, risk assessment and loan portfolio management and some others were introduced. A very small proportion of people denied the importance of these reforms. A prominent improvement showed that privatization has reduced the values of non-performing loans.

Keywords: Privatization, Pakistani banks, Loans

INTRODUCTION

Privatization is the transfer of ownership of government owned institutions to the private sector. It may be share issue privatization, asset sale privatization, voucher privatization.

Privatization efforts in Pakistan began in Pakistan in 1988, when the banks were treated as the employment exchanges. Employers were hired on the political bases instead of on the merit bases. More and more branches were opened causing over employment. There were no trained professionals, less customer royalty, budget deficit, foreign debt burden, trade deficit, disequilibrium in the balance of payments, increasing non-performing loans.

The performance of Government owned banks were at alarming level, there was lack of the financial disciplines. Privatization has been an important aspect all over the world especially the developing countries of the world like Pakistan. Two banks ABL and MCB were privatized in the decade of 1990 to 2002.

A privatization commission was establish in 1991. The main purpose of privatization is to improve the performance of banking sector like asset quality, capital adequacy, earning profitability and liquidity.

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In 1991 Allied bank and MCB bank were privatized and the ownership of ABL was transferred to consortium comprising Ibrahim Leasing Limited and Ibrahim group. Ownership of MCB was transferred to Nishat Group lead consortium in 1991. HBL was privatized in 2003 when government of Pakistan firmly handover the management control to Agha Khan Fund for Economic Development (AKFED). In 2002 UBL was privatized with the ownership transferred to Best Way Abu Dhabi group.

The main purpose of our study is to check the impact of privatization on non-performing loans of banks in Pakistan. Non-performing loan is the defaulted loan which is the sum of borrowed money upon which the debtor has not made the scheduled payment for at least 90 days. Non-performing loan is either default or closed to being in default. If debtor starts making payment again on a non-performing loan, it becomes a re-performing loan even if the debtor has not caught up on all the missed payments. When loan goes default maximum three months then that loan is consider to be a non-performing loan.

Non-performing loans are classified by State bank of Pakistan into different categories according to their recovery. If the amount received is less than 75% of receivable and overdue by more than 180 days, it treated under the head of "Other Assets specially mentioned". If the amount recovered is less than 60% and over due by more than 1 year is treated as "substandard". If the amount recovered is less than 10% and overdue by more than 2 years is treated as "doubtful". Similarly if the amount recovered is less than 2% and overdue by more than 3 years, treated as "loss".

The main reasons behind the occurrence of non-performing loans are due to the lenders lack plan to deal with risk, reduced intention to borrowers, moving along with the risk curve, weak credit operations, increased loan size increased the risk. In 1980 Italian market faced an increase in the non-performing loans due to high speculation in real estate market. The investors were more interested to invest their money in real estate markets as the economic condition of Italian markets at that time was so good. Investors were taking more and more loans from banks to earn from speculated prices in real estate markets but as the bubble of speculation burst in real estate, the investors faced a huge loss and become unable to pay back the loan to banks. The percentage of non-performing loans in Italy was contributed by real estate. Another reason of increase in non-performing loans in Italian markets was the poor policies of loans recovery. The government laws contradicted the banking policies for loans recovery. The banker borrower relationships also contributed to increase in non-performing loans. This relationship weakened the credit control policies, as there was no detailed investigation process before the sanction of loans. The same problem was observed in Swedish financial markets where the non-performing loans caused the financial crises. They were focusing only on increasing the loan volumes and did not pay attention to cash flow processes. Our study is based on the four banks which were privatized in Pakistan and aimed to observe whether the privatization has reduced the amount of non-performing loans or not.

LITERATURE REVIEW

Privatization is considered to be a tool to improve the values of non-performing loans of banks. Caribean development and cooperation committee (2001) conducted a study to observe the impact of privatization on the banking sector in Caribean. A significant improvement in the performance of banks was observed. Innovations, services and increased growth in the broad money to GDP was seen but it also increased the operating cost and interest rate spread.

Megginson,W.L (2003) compared the performance of state owned banks with the private banks and found a significant difference in the performance of private owned banks. The empirical evidences showed that the state owned banks are less efficient than the private owned banks.

Hussain,I (2004) observed that improvement can be achieved by privatizing the banks to some private investor instead of employees of that bank, as in the case of Allied Bank Limited who's ownership was transferred to its employees but it was a bad experience as the post-privatization performance was less than pre-privatization performance. Instead of this MCB's ownership was transferred to a group of private strategic investor that results in an efficient way.

One study conducted by Jessica and Isac (2004) on the market of Italy and Sweeden and described the two ways for securing non-performing loans in small markets like Sweeden, it is better to handle by banks himself, while in vast markets like Italy, the auction in public to asset management companies (AMC's) is better. After further investigation it was seen that historic actions of government, credit culture and management decisions crucially caused the spread of non-performing loans. Both methods of handling non-performing loans are important and they are to be used according to specific national conditions.

Bonin, J.P, Hassan, I & Wachtel, P (2005) studied the comparison of foreign-owned banks and government-owned banks in six relatively advanced countries, Bulgaria, the Czech Republic, Croatia, Hungary, Poland and Romania. It was found the foreign-owned banks more efficient than government-owned banks. Two important factors that affect the efficiency of banks are the timing of privatization and the methods of privatization. Beck, T, Cull, R & Jerome, A (2005) the Nigerian banks performance for the period of 1990-2001 was observed to know the effect of privatization. The banks that were privatized showed improved performance while the government owned banks were in bad condition.

Islam, S, M (2005) conducted a study to find the causes and consequences of non-performing loans and described that non-performing loan cannot be avoided but can handle in a wise able way. Loans are defaulted due to poor plans to deal with risk, reduce attentions to borrowers, moving along the risk curve and lack of good models. The non-performing loans can be recovered timely by early risk assessments, motivation, and law and order situation, helped from recovery agency, reducing relaxation, developing situation specific models, real time training, regular monitoring and trade off.

Khalid, U (2006) the impact of privatization and liberalization was observed which showed an improvement in the banking indicators of Pakistan. Khan, B (2006) Pre and Post privatization impact was observed on banks in Pakistan. It was concluded that there was a significant improvement in liquidity ratios, profitability, deposits and non-performing loans after privatization.

Umer (2006) used CAMELS framework of financial indicators to describe the effect of privatization and liberalization on the performance of banking sector of Pakistan. Privatization resulted in improved most of financial indicators in particular the performance of privatized banks has been less than satisfactory mainly due to poor showing of ABL whose ownership was transferred to its employees group.

Imran and Tariq (2009) did a secondary data based result to see whether the privatization reduced the proportion of non-performing loans and increased the performance of banks or not. They studied the period of 1990 to 2004 during which MCB and ABL were privatized under the artificial environment, exploratory as well descriptive research was done by the use of SPSS software and found a positive impact of privatization on non-performing loans and improved performance.

Takashi observed the Japan's experience of non-performing loans, that how they affect the real economy. A relationship between the increase in non-performing loans and effects on economy was considered. They concluded the two main reasons of increase in non-performing loans i.e. the collapse of land prices, credit crunch and forbearance lending. It affected the economy indicators to fall below.

Bakhtiar studied the two banks MCB and ABL to understand the impact of privatization on the banking sector Pakistan. The privatization effected on the efficiency, economy, employment, new product services and also effected legal environment. Improvement in liquidity ratios, deposits, profitability, new products and services showed the improved efficiency of banking sector, mobilization of savings increased loans, advances and investment showed improved economy. The impact was also observed on employees as salary and remuneration increased number of employees decreased but not at the alarming level. After studying the impact of privatization on economy, banking sector and effect on non-performing loans by using different models and techniques i.e CAMELS or CLSA, an effort is made to observe the impact of privatization on the non-performing loans of banks in Pakistan.

PRIVATIZATION OF BANKS

In 1977 it was observed that the economic situation of many industries especially banks is not satisfactory and they are suffering loss. There was lack of decision making, efficiency and investment was also limited. In order to overcome this situation the government of Pakistan has decided to privatize the banks. The study is based on the privatization of four banks i.e. Allied bank Limited, United bank Limited, MCB, and Habib bank Limited before and after privatization.

Muslim Commercial Bank Limited (MCB)

The bank has more than 60 years of experience as a leading bank in Pakistan. It was incorporated by Adamjee group on july9, 1947. The bank received prestigious recognition and award by Euro money, MMT, Asia Money, SAFA (SAARC), The Assets and the Asian Banker.

Pre-Privatization

Before the privatization the non-performing loans and other indicators of MCB showed that in the period of 1980-1990 the non-performing loans were in the range of 25% to 18%. The percentage of income to assets was 0.381. MCB was performing only traditional services like deposits mobilization and credit extension, project financing of industries. There were no services like personal financings, credit cards, ATM, online banking, phone banking and even housing finances.

Privatization

MCB was privatized on 6 April, 1991 with 26% share sold to national group at price of Rs.56 per share that amounts for total Rs.2.4 billion. There was a sales agreement between government of Pakistan and national group. According to that agreement further 25% shares were offered for subscription to public on Feb 19, 1992.

Post-Privatization

The growth of MCB after privatization can be observed by some indicators as total assets of MCB which were 18% in 1994 increased to 28% in 2003. A 10% increase in upward trend was seen. Total deposits were 17.6 in 1994 and grew to 26.5% in 2003 thus 9% increase in upward trend. Total advances in 1990 were 17.7% which increased to 26.7% in 2003. Non-performing loans to total loans percentage was 18.6% in 1993 which decreased to 11% in 2004 which is a great improvement in recovery of loans. Earning assets to total assets percentage for five years average is 81.20% which is higher than industry average.

Allied Bank Limited (ABL)

Allied Bank was the first Muslim bank which established in Pakistan as the Australian bank in Lahore with a paid up share capital of Rs.0.12 Million under the chairman ship of Khuwaja Bashir Bux. ABL has a history of more than sixty years of banking operation and having750 branches. Allied bank is leading the industry with the largest network of ATM's countrywide.

Pre-Privatization

As ABL was the only Muslim bank and formed on Aug 14, 1947, it faced many riots in East Punjab. Many of its branches in India were closed down and new branches in Karachi, Rawalpindi, Peshawar, Sialkot, Sargodha, Jhang, Gujranwala and Kasur. In 1974 the bank was renamed Allied Bank Limited due to the resolution of Board of directors of Australasia Bank. The profit in the first year exceeds Rs.10 Million. Deposits increased by 50% and reached Rs.1460 Million. Investment increased by 72% and advances exceeds Rs.1080 million and it was for the first time in the history of bank.

The seventeen years of the Bank saw a rapid growth. Branches increased from 353 in 1974 to 748 in 1991. Deposits rose from Rs.1.46 billion, and Advances and investments from Rs.1.34 billion to Rs.22 billion during this period. It also opened three branches in the UK.

Privatization

After MCB, Allied Bank was the second bank in the public sector to be privatized. In September 1991 ABL was privatized through an Employee Stock Ownership Plan (ESOP). On September 9, 1991, 26% shares were sold to the Allied Management Group, which represented the employees of ABL at a price of Rs.70 per share. On August 23, 1993, another 25% shares were sold to AMG at a price of

Rs.70 per share. This resulted in transfer of ownership from the Government of Pakistan to AMG so the ownership transfer from public to private.

Post-Privatization

After privatization, Allied Bank registered an unprecedented growth to become one of the premier financial institutions of Pakistan. Allied Bank's capital and reserves were Rs.1.525 Billion and assets amounted to Rs.87.536 Billion and deposits were Rs.76.038 Billion. Allied Bank enjoyed an enviable position in the financial sector of Pakistan and was recognized as one of the best amongst the major banks of the country. In 1999, it transpired that one of ABL's major defaulters had purchased about 35-40% of ABL shares from employees but in July 1999, the State Bank imposed restrictions on the transfer of shares from employees to non-employees. On August 3, 2001, the SBP removed the Chairman and three Directors from the Board of ABL, who were also employees of ABL, as they were found to be working against the interests of ABL and its depositors and appointed a new Board to look after the affairs of the bank. In April 2003 the State Bank initiated the process of reconstruction of the bank and transfer of its ownership to one of the existing financial institutions in the private sector that will acquire strategic shareholding. In August 2004 as a result of capital reconstruction, the Bank's ownership was transferred to a consortium comprising Ibrahim Leasing Limited and Ibrahim Group.

United Bank Limited (UBL)

UBL formed in 1959 and now one of the major banks in Pakistan in terms of deposits and advances with a huge domestic and international network. UBL is a Banking Company, which is engaged in Commercial & Retail Banking and related services domestically and overseas. A professional team was appointed in the mid of 1997 for the purpose of restructure the bank and to commence rightsizing. The management is also in the process of rationalizing the branch network and identifying and recovering the doubtful and classified portfolio. It has planned to institute major improvements in customer services and internal systems to improve efficiency of bank. It also intends to launch innovative products. The bank is increasing resource mobilization through regular deposit campaigns and accelerating the process of recovery of outstanding advances and non-performing assets.

Pre-privatization

Tracking the history backward, after it was proposed that UBL privatized has recorded the heaviest fall in profitability in 1994. The pretax profit reduced from Rs.275 million in 1993 to Rs.59 million in 1994 - an alarming decline of 79%. Since nationalization, around two decades ago, successive governments appointed management had doled out around Rs.17 billion (25% of all advances) worth of non-recoverable loans in the form of politically influenced advances. This is essentially Rs.17 billion of depositor's funds given out to favorites who are now either unwilling or unable to pay them back. The bank, as a result, is now being run with an estimated negative net worth of more than Rs.12 billion The Bank's 28 foreign branches were profitable but a large number of its local branches continue to incur heavy losses. On top of it the influence of Union and political pressures, to the level of rendering the management helpless, has resulted in 40% of its loans being termed "non-performing". The bank was also suffering a surplus staff of nearly eight thousand in its total strength of 22,500, whose future hangs in uncertainty. Besides over-staffing the bank also suffers from non-professionalism, deliberate violation of rules, wasteful expenditures and lack of accountability.

Privatization

In 2002, the Government of Pakistan sold it in an open auction to a consortium of Abu Dhabi Group and Best way Group. Abu Dhabi Group has given Rs.12.3 billion each acquiring 25.5% shares and management control in the bank. In 2002 the bank merged its operations in the UK with those belonging to National Bank of Pakistan to form United National Bank Limited. United Bank owns 55% of the joint-venture and National Bank of Pakistan owning the remainder.

Post-Privatization

The performance of bank after the privatization improved as many banking indicators are showing. The Paid-up capital of United Bank Limited was increased by way of bonus during 2006, deposit base increased by 16% and that was Rs.335.1 billion. Due to the international growth of bank almost 19%

of total deposits base is mobilized from the overseas branches and it contributed almost 52% of total growth in 2006. Net advances increased from Rs.204.b billion to Rs.247.3 billion during 2006 both the corporate and consumer lending contributed to the growth achieved during 2006. Although there has been growth in NPLs overall portfolio quality indicators have improved with net infection reducing to 1.1%. UBL has also grown to the international markets as 15 branches are created in various foreign countries. Profit before tax from these international operations increased by 31% to Rs.2.48 billion during 2006. Total assets of UBL also increased by 22% that is Rs.423.3 billion in 2006 from Rs.347.1 billion at the end of previous year.

Habib Bank Limited (HBL)

Habib bank limited is the first commercial bank that was formed in 1947. It remained a successful bank in Pakistan and it was ranked as a largest private bank in Pakistan with 1450 branches across the nation. HBL is enjoy a good ranking for long term as well as for short term i.e. AA for long term and A1+ for short term.. Habib bank Limited was nationalized in Zulfiqar Ali Bhutto regime and after that the performance showed a positive indicator. The commercial banking market share reached to 55% by inward remittances and also the loan scheme for farmers and small businesses. It that times the profit of HBL was doubled from all other commercial banks like MCB, ABL, NBP and UBL.

Pre-Privatization

Habib bank was enjoying a good performance after its nationalization. In in the regime of Ayub Khan a new scheme for loans was introduced whose purpose was to boost the agriculture sector. That scheme was named “Green revolution”. In the government of Junejo a new strategy was formulated in order to cut down the expenses and for the profit maximization and that strategy provided fruitful results. In the government of Shoukat Aziz, another strategy was formulated which aimed to retire old employees by golden shake hand packages and to hire young, and energetic employees to gain the efficiency in workings. It boosts the bank performance as bank was enjoying huge profits, huge salary increment, bonuses and other compensative incentives.

Privatization

Privatization of HBL was done by Dr. Abdul Hafiz on 29th Dec 2003 and as a result of that biding the management was given to Agha Khan Funds for Economic Development by 51% shares for Rs.22.409billion.

Post-Privatization

A significant improvement in the performance of bank was seen. The management of the bank was handed over to chairman of the bank. HBL first time introduced the concept of corporate governance as per SBP’s requirement due to which only the CEO was the executive body of the bank. It was decided to have meeting of board after every 3 months. If we observe the financial indicator of the bank after privatization, the impact of privatization can be viewed. The total deposits of the bank increased by 12% during the years of 2003-2004. The total assets also increased which reduces the risk of liquidity. Loan and advances grown by 41% and liquid assets were decreased which were due to the investments in different portfolios and it was resulted by the decrease in the non-performing loans. The net income also increased by 10%. Total expenditure of the bank was increased by 42 % which was the result of increase in deposits. The non-performing loans were decreased by 56%. Almost 46 branches were closed that were non-profitable.

METHODOLOGY

The main purpose of our study is to search out the impact of privatization on the non-performing loans of commercial banks in Pakistan. The study can be divided into two aspects of pre-privatization and post-privatization impact on non-performing loans. For this purpose the non-performing loans to totals loans percentage has been taken. The data collected from the years 1981-1990 for pre privatization period and 1993-2010 for post privatization of MCB & ABL similarly for HBL from 1996-2003 and 2004-2010 for pre and post privatization respectively. For the UBL the data has been taken for the period 1997-2001 of pre-privatization and for the period of 2003-2010 of post-privatization. The data has been collected from Banking Surveillance Department (BSD) & official website of State Bank of Pakistan. The data analysis is divided in two parts graphical analysis and analytical analysis.

GRAPHICAL ANALYSIS

Muslim Commercial Bank Limited

The PR-P line is representing the pre-privatization non-performing loans of MCB Bank. In 1988 the non-performing loans reached to 29% which was very high and it may be due to the placement of new government. PO-P line is representing the non-performing loans after the privatization. During 2004 to 2008 NPLs reduced to one digit figure this was the period of new government of Parvez Musharaf. This was the booming period of economy. MCB has also been awarded as a Euro money Award 2008 for the Best Bank in Asia but unfortunately NPLs again begins to rise in 2010 because of the political crises.

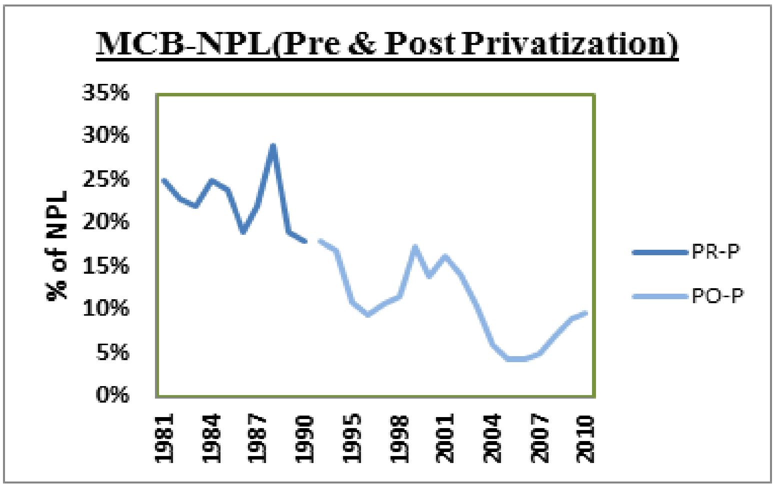

Figure 1: Muslim Commercial Bank Limited-

Allied Bank Limited

In 1981-84 board of directors of bank was dissolved and new management took over the bank so there we find a large figure of NPLs. In the starting period after privatization in NPLs were increasing continuously till 2003 because of the continuous change in management and policies of banks. Bank saw a rapid growth in 2007-2010 as well as saw a decline in NPLs.

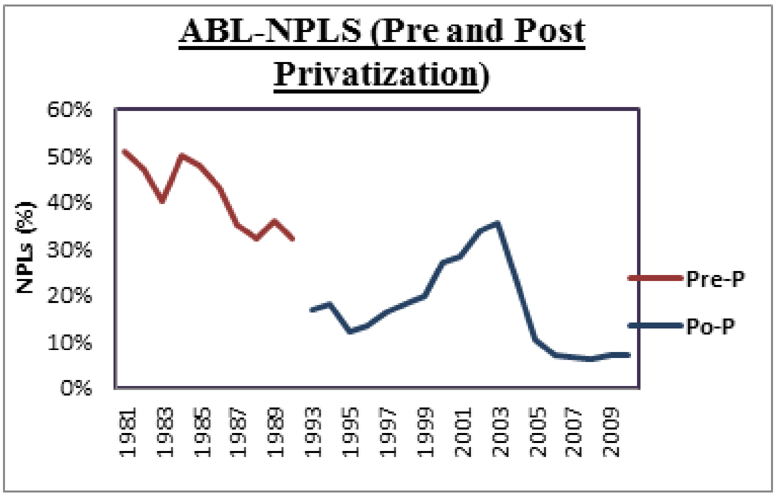

Figure 2: Allied Bank Limited

United Bank Limited

In 1998 due to influence of union and political pressure, the management became helpless which results the 40% increment in NPLs. During 2001 the Bank merged their operations with National bank of Pakistan in UK which made decrease in NPLs. After privatization NPLs shows one digit figures because of his rapid growth in banking sector.

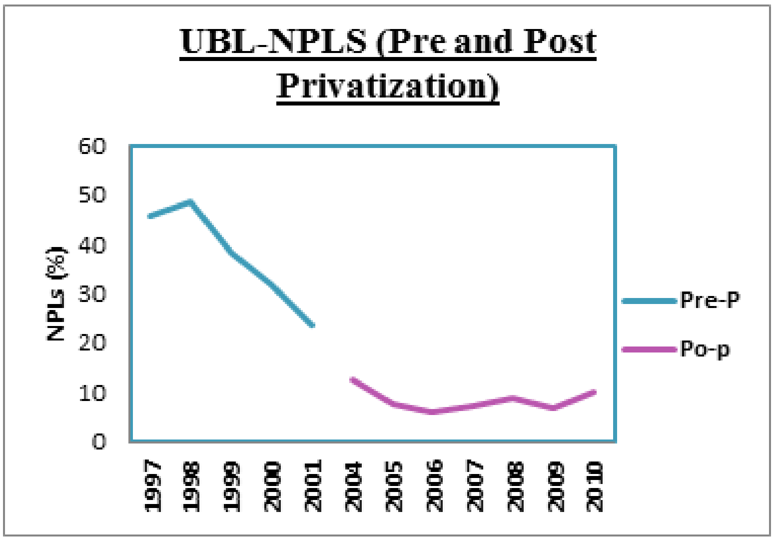

Figure 3: United Bank Limited

Habib Bank Limited

HBL had a problem of over staffing which shrinkage the profits. During pre-privatization period HBL was highly influenced by the government policies which cause the lack of consistency. After privatization HBL had considerable growth. They changed their management style from traditional to corporate. On the other hand, the provisions provided by HBL to its NPLs are decreased by 56% as compare to pre-privatization period.

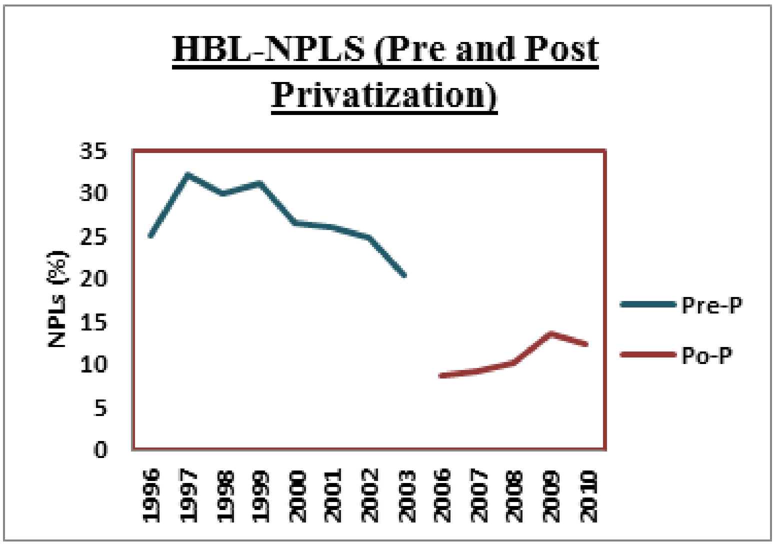

Figure 4: Habib Bank Limited

ANALYTICAL ANALYSIS

In order to observe the impact of privatization, analytical analysis is performed whose purpose is to check whether the privatization has impact on non-performing loans or not.

Hypothesis

Ho: There is no significant impact of privatization

H1: There is significant impact of privatization

Level of Significance: 0.05

Table 1: Analytical Analysis of Bank Privatization

Banks	Year of Privatization	Average NPLs (%)		Standard Deviation		T-Stat
		Pre-Privatization	Post-Privatization	Pre-Privatization	Post-Privatization	
MCB	1991	23	11	0.034	0.045	7.18*
ABL	1991	41.4	17	0.074	0.094	7.071*
UBL	2002	35.73	7.92	10.53	1.41	6.58*
HBL	2004	27.23	11.31	4.11	1.92	7.19*

* shows that t-stats values are greater than t-tabulated

So, reject Ho, which means there is a significant impact of privatization.

CONCLUSION

From the graphical and analytical analysis it has been cleared that there is a significant impact of privatization on the non-performing loans as the privatization has reduced the value of non-performing loans. The most important is the Banking Reform by State Bank of Pakistan. From 1990s the effort was started to improve the banking performances, also with the non-performing aspect. A number of reforms were introduced for the restructuring regulations and policies. Due to banking reform, Corporate governance standards were first time introduced, risk assessment and loan portfolio management, supervision and improvement in credit decision by removing political influence was done. Human resource recruitments at all levels were made on merit. Information technology was improved to introduce e-banking. Almost 75% of banking employees and 90% of banking customers represented that these banking reforms has positively effected on the performance of banks. And only 20% banking employees, 4% banking customers showed dissatisfaction as it has increased the cost too. Minimum capital requirement was also set up in these reforms that are Rs.1.0billion to Rs.2.0billion. So, there are many other factors along with privatization that positively impacted on banking performance in Pakistan.

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