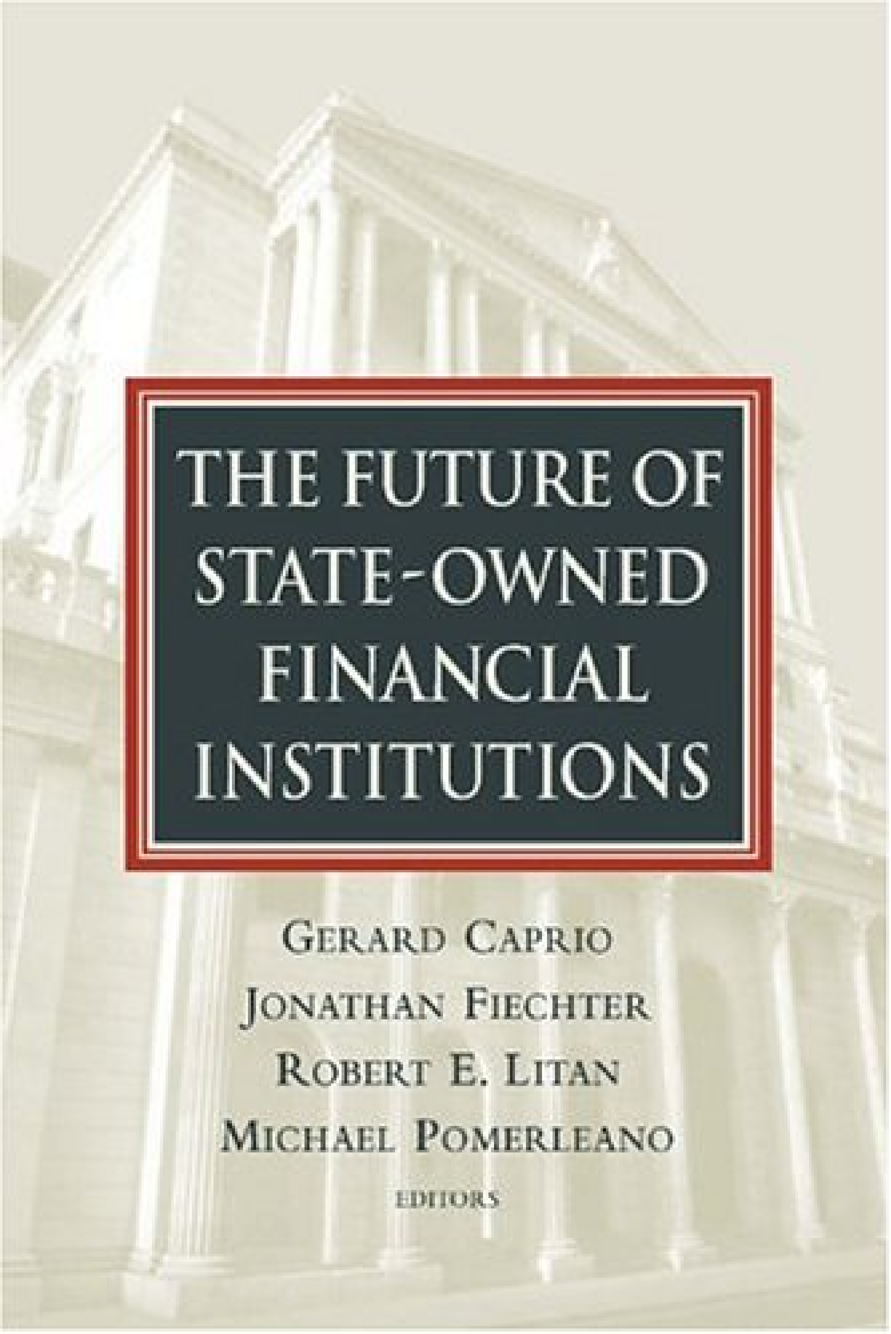

THE FUTURE OF STATE-OWNED FINANCIAL INSTITUTIONS

GERARD CAPRIO
JONATHAN FIECHTER
ROBERT E. LITAN
MICHAEL POMERLEANO
EDITORS

THE FUTURE OF STATE-OWNED FINANCIAL INSTITUTIONS

THE WORLD BANK GROUP
THE INTERNATIONAL MONETARY FUND
THE BROOKINGS INSTITUTION

This book is based on the sixth annual financial markets and development conference held April 26–27, 2004, in Washington, D.C. The conference was jointly sponsored by the World Bank Group, the International Monetary Fund, and the Brookings Institution.

The previous volumes in this series are available from the Brookings Institution Press:

Financial Markets and Development: The Crisis in Emerging Markets (1999)

Managing Financial and Corporate Distress: Lessons from Asia (2000)

Open Doors: Foreign Participation in Financial Systems in Developing Countries (2001)

Financial Sector Governance: The Roles of the Public and Private Sectors (2002)

The Future of Domestic Capital Markets in Development Countries (2003)

GERARD CAPRIO
JONATHAN L. FIECHTER
ROBERT E. LITAN
MICHAEL POMERLEANO
Editors

THE FUTURE OF STATE-OWNED FINANCIAL INSTITUTIONS

BROOKINGS INSTITUTION PRESS
Washington, D.C.

ABOUT BROOKINGS

The Brookings Institution is a private nonprofit organization devoted to research, education, and publication on important issues of domestic and foreign policy. Its principal purpose is to bring knowledge to bear on current and emerging policy problems. The Institution maintains a position of neutrality on issues of public policy. Interpretations or conclusions in Brookings publications should be understood to be solely those of the authors.

THE BROOKINGS INSTITUTION
1775 Massachusetts Avenue, N.W., Washington, D.C. 20036
www.brookings.edu

Library of Congress Cataloging-in-Publication data
The future of state-owned financial institutions / Gerard Caprio . . . [et al.], editors.
p. cm.
Conference proceedings.
Summary: "Focuses on the rationale and performance of state-owned financial institutions in emerging markets, as well as on possible government policies for either privatizing or managing them"—Provided by publisher.
Includes bibliographical references and index.
ISBN 0-8157-1335-5 (pbk. : alk. paper)
1. Banks and banking—Government ownership. 2. Financial institutions—Government ownership.
3. Privatization. I. Caprio, Gerard. II. Title.
HG1725.F88 2005
332.1—dc22 2004027181

9 8 7 6 5 4 3 2 1

The paper used in this publication meets minimum requirements of the American National Standard for Information Sciences—Permanence of Paper for Printed Library Materials: ANSI Z39.48-1992.

Typeset in Adobe Garamond

Composition by Lynn Rivenbark
Macon, Georgia

Printed by Victor Graphics
Baltimore, Maryland

Contents

PART V

Preparing for Privatization

ISHRAT HUSAIN

11

Lessons from Pakistan

Pakistan's financial sector privatization, which began in the early 1990s and continues today, offers valuable lessons for policymakers in other emerging economies. Pakistan successfully reduced state ownership in the banking sector from 92 percent of assets in 1990 to 18.6 percent in 2004. The government also pushed through a number of very tough policies dealing with overstaffing, overbranching, and nonperforming loans and managed to attract top managers from international banks to bring an infusion of new skills to the sector. This chapter lays out the hurdles Pakistan faced and the measures taken to privatize the banking system.

Nationalization of Pakistan's Financial Sector

In 1974, when the world was being swept by socialism, the Pakistani government decided that the best way to achieve economic development and equitable growth was to nationalize everything: industries, banks, insurance companies, educational institutions, and so forth. Policymakers embraced socialization because they perceived that there was a strong concentration of wealth. But nationalization resulted in a huge economic setback for Pakistan, compared to growth levels under its previous, market-driven, policies. In 1969, for example, exports were higher than the combined exports of Indonesia, Thailand, Philippines, and Malaysia; these were drastically reduced by the nationalization efforts of the 1970s.

Table 11-1. *Preprivatization Structure of the Banking Sector, Pakistan, 1990*

		Assets		*Deposits*		*Equity*	
Type of bank	*Number*	*Amount (billions of rupees)*	*Share (percent)*	*Amount (billions of rupees)*	*Share (percent)*	*Amount (billions of rupees)*	*Share (percent)*
State owned	7	392.3	92.2	329.7	93.0	14.9	85.6
Private	. . .	. . .	. . .	. . .	. . .	. . .	. . .
Foreign	17	33.4	7.8	24.9	7.0	2.5	14.4
Total	24	425.7	100.0	354.6	100.0	17.4	100.0

Source: State Bank of Pakistan, "Financial Sector Assessment, 1990–2000."

By the 1980s the banking sector was dominated by public institutions. The government exerted direct monetary control, controlled credit, directed credit, and determined pricing for financial institutions. Most of the borrowing was done by the government for fiscal deficit financing or meeting the losses of public sector corporations. The relationship between government and the financial sector was incestuous, which led to financial repression, financial sector inefficiency, crowding out of the private sector, and deterioration of asset quality. Further, the central bank could not effectively play any role in the growth of financial institutions or in cleaning up the mess because the Pakistan Banking Council had clipped its wings: The central bank was now directly controlled by the government of Pakistan.

By 1990, 92 percent of the assets, 93 percent of deposits, and 86 percent of the equity in Pakistan's financial sector was in the hands of state-owned financial institutions (table 11-1). There were no private sector banks (except some foreign banks, which played a marginal role because of the restrictions and directed credit controls in place). Pakistan's banks were characterized by high intermediation costs, overstaffing, overbranching, a huge portfolio of nonperforming loans, poor customer service, undercapitalization, and a poorly managed and very narrow product range. The banks' primary business was to serve government organizations, subsidize the fiscal deficit, serve a few large corporations, and engage in trade financing. There was no lending to small- and medium-size enterprises, to the housing sector, or to the agricultural sector, which create most of the growth and employment in Pakistan. Most important, the financial system suffered from political interference in lending decisions and also in the appointment of managers.

Rationale for Financial Sector Privatization

In the early 1990s the government introduced policies to liberalize the economy. At the same time, the World Bank was reporting on financial sector weaknesses in Pakistan and urging liberalization. Pakistan welcomed the Bank's advice and accepted the suggested reform package.

At first the government focused on lowering the fiscal deficit, state-owned enterprises representing the greatest burden. These enterprises' efficiency levels were low, and their production seemed unresponsive to market demand. They were producing goods and services that nobody wanted, and the cost of their continuing losses was being borne completely by the government.

To stem the losses and begin the privatization process, the government established the Privatization Commission in 1991. Its mission was to foster competition and to ensure greater capital investment, competitiveness, and modernization, thereby enhancing employment, improving the quality of products and services to consumers, and reducing the fiscal burden on the state.

The government also aimed to broaden the base of equity capital by divesting the shares of public enterprises through stock exchanges. It was hoped that, as the government's burden lessened, public resources for physical and social infrastructure would be released. These are the reasons that every government since 1991 proceeded with the privatization of public enterprises, including public sector banks.

Pakistan's Approach to Privatization

The Policy of 1998 laid the framework for privatization in the financial sector. Four methods of privatization were described in the law: total disinvestment through competitive bidding, partial disinvestment with management control, partial disinvestment without management control, and the sale and lease of assets and property. The law also required total transparency in the process, because it would be critical to win the support of the political officials as well as the general public, and there could be no hint of insider manipulation. The identification of transactions is also described by the law: A financial adviser is hired through a competitive bidding process and is responsible for the exercise of due diligence.

A number of regulatory and sectoral reforms have facilitated privatization transactions. There are two standard processes, one for the valuation of property and one for prebidding and bidding. Postbidding matters also are sorted out through a well-defined procedure.

In the case of banks, many hurdles had to be passed before they could privatize. The banks certainly were in no condition to be privatized as they were. The first challenge was legal empowerment. The Bank Nationalization Act had created a lot of obstacles to the sale of assets, so disposing of these assets first required amending the act.

Second, banks were burdened with excess staff. No private sector investor interested in profit maximization under a competitive environment would be prepared to accept an overstaffed bank. Nor would an investor be able to get rid of the excess labor, because of the political difficulties the new owner would face. So it was the government's challenge to get rid of the excess labor: It cut almost one-third of the labor force in the three top banks.

A third problem was the unprofitable branches of state banks; almost one-third of the branches (1,646) were closed.

Fourth, the state banks had accumulated losses for over twenty years, which the government had to recapitalize through equity injections in order to make the banks attractive to buyers. To deal with the large stock of nonperforming loans, the Corporate and Industrial Restructuring Corporation, an asset management company, was created in 2000. The CIRC bought some of the nonperforming loans at a discount and auctioned them to third parties. Nonperforming loans worth Rs 47 billion (at that time close to $800 million) were transferred to the CIRC for disposal. Then tax refund bonds were issued.[1]

A fifth problem was the human capital at the state banks. Many in the management teams were political appointees of the government party, lacking professionalism and incapable of running these institutions. Similarly, the boards of directors consisted of government representatives and, as such, not only lacked financial expertise but also were indifferent to the banks' need for both oversight and policymaking. The boards of directors were disbanded and many of the management teams were replaced. Fortunately, Pakistan has a pool of highly skilled international bankers at Citibank, ABN-Amro, and Bank of America. These international managers were brought in and induced to take over the management of the three big state banks. It was also important to attract private sector specialists in chartered accountancy, business, economics, and law who could make significant contributions to the leadership and oversight of the banks. With new boards of directors in place, the quality of the oversight did improve.

1. These measures were undertaken during the Musharraf period at a time when there was no elected government in Pakistan. Although these were tough decisions for the president and his cabinet to make, they would have been harder to make by an elected representative government because of the pressure not to close branches, cut jobs, transfer nonperforming loans, or create tax refund bonds.

Transparency was the sixth challenge. To further improve the transparency of the bank privatizations, a new law was promulgated in 2000, with more stringent information disclosure rules.

Finally—seventh—the repayment ethic among borrowers from state banks was terribly weak. Many borrowers had defaulted on their loans years before; some were enterprises that had ceased operation, but the banks continued to accumulate interest on the books. To encourage loan payments and to promote efficient loan write-offs, the government created an incentive scheme whereby, if loan defaulters could pay the principal amount with a certain percentage of the accumulated interest, the rest of the loan value would be written off.

Role of the State Bank of Pakistan

Fortunately, when the privatization effort got under way in 1997, the government of Pakistan decided to disband the Pakistan Banking Council and provided autonomy and powers to the State Bank of Pakistan as the single supervisor and regulator. The SBP got involved in the sale of state banks because, from the regulatory point of view, it wanted to make sure that the banks would end up in the right hands and not create any subsequent problems for the regulator. The SBP handled the analytic and diagnostic work and participated in the design, monitoring, and implementation of the bank restructuring plan, including reduction of excess labor, removal of incompetent management, reconstitution of boards of directors, injection of capital, and closure of branches.

The World Bank provided financial assistance for a massive voluntary employee separation scheme. Through these efforts, the SBP further reduced the number of state bank employees to levels acceptable to private sector buyers.

The SBP also created fit-and-proper criteria for the appointment of chief executives and boards of directors at state banks. These criteria have become part of the corporate code, so there are no longer subjective, and politically influenced, assessments of managers. If during supervision or inspection the SBP finds a deviation from these criteria, it is empowered to take action. The deviation is exposed rather than permitted.

The SBP also provided important inputs in the documentation for privatization: statements of qualifications, agreements of sale, share transfers, and so forth. Before 2000 every transaction carried out by the Privatization Commission ended up in a court of law because laws were not clear and documentation was ambiguous. The SBP was determined not to expose itself or the banks to litigation risk, which could abort the privatization process.

In addition, the SBP played a key role in the screening and evaluation of strategic investors. According to the fit-and-proper criteria, any investor buying more than 5 percent of the shares in a bank had to be cleared by the central bank. The SBP also handled issues raised by potential investors during the prebidding process. Finally, the SBP took part in the evaluation of bids.

Bank Privatizations, 1991–2004

Since the privatization program began, six large state banks have been privatized: Muslim Commercial Bank, the third largest bank; Allied Bank Limited, the fifth largest bank; Bankers Equity, which was disbanded after privatization because of its fraudulent activities; Bank AlFalah Limited, the former BCCI; United Bank, the third largest bank; and Habib Bank, the largest bank. The National Bank of Pakistan, which is the remaining bank in the public sector, is moving out of state hands; 23.2 percent of its shares have been divested through initial public offerings and the stock market.

Pakistan has now sold off seven state-owned banks, worth Rs 40.9 billion, or $710 million. (Between 1991 and June 2002, four banks were sold, with assets of Rs 5.6 billion; from July 2002 to June 2003, another two banks were sold, with assets of Rs 12.9 billion; between July 2003 and January 2004, another bank, with assets of Rs 22.4, was sold.) Table 11-2 provides a picture of Pakistan's banking sector in 2004. The share of assets held by state-owned banks has been reduced from 92 percent in 1990 to 19 percent. So more than 80 percent of banking assets, deposits, and equity is now in the private sector—probably a rare circumstance among developing countries.

Pakistan's financial sector and economy has benefited greatly from bank privatizations. Competition in the banking sector has intensified so much that the average lending rate has come down from 21 percent to 5 percent. Intermediation costs have come down so significantly that individuals, the prime borrowers, can get loans at a 3–4 percent interest rate. Since inflation is also 3–4 percent, the bank loan interest rate actually equals zero.

Pakistan's experience shows that privatization can be beneficial to the banking sector and to the economy, but it must be handled carefully, and many tough steps need to be taken along the way. Some of the key lessons that have emerged from Pakistan's experience are as follows:

—The legal framework is critical: Central bank independence, the ability to dispose of state-bank assets, and fit-and-proper criteria are a few of the essential legal underpinnings for a successful privatization program.

Table 11-2. *Postprivatization Structure of the Banking Sector, Pakistan, March 2004*

		Assets		*Deposits*		*Equity*	
Type of bank	*Number*	*Amount (billions of rupees)*	*Share (percent)*	*Amount (billions of rupees)*	*Share (percent)*	*Amount (billions of rupees)*	*Share (percent)*
State owned[a]	4	518.8	18.6	379.3	20.1	22.5	17.2
Private	20	1,840.3	66.0	1,292.3	68.5	92.8	70.9
Foreign	13	278.4	10.0	198.0	10.5	26.7	20.4
Specialized[b]	3	149.8	5.4	16.1	0.9	–11.1	–8.5
Total	40	2,787.3	100.0	1,885.7	100.0	130.9	100.0

Source: State Bank of Pakistan, Banking Supervision Department.

a. Three small new banks were set up in the public sector during the 1990s. These included the First Women Bank, set up to provide credit to women entrepreneurs; and two provincial banks: the Bank of Punjab and the Bank of Khyber.

b. These include Zarai Tarqiati Bank Ltd., Industrial Development Bank of Pakistan, and Punjab Provincial Co-operative Bank Limited.

—The government must take tough measures to eliminate excess staff and branches before attempting to sell unprofitable state banks; to accomplish this, political pressure must be overcome.

—International expertise should be welcomed and actively sought; international bank managers and professional specialists will prove an asset to the privatized banks.

—Governments need to deal swiftly and decisively with nonperforming loans and to reverse the weak repayment ethic among borrowers from state banks. This works best when fitted into a broad privatization program for state-owned enterprises and when the repayment ethic is addressed along with government efforts to deepen capital markets as alternative sources of financing for large enterprises.

It is useful to analyze the privatization effects of two representative banks: Muslim Commercial Bank and Allied Bank Limited.

Muslim Commercial Bank was sold to strategic investors, who purchased shares in three successive rounds. In 1991 investors purchased 26 percent of its shares at Rs 56 a share. In February 1992 investors purchased a further 25 percent of its shares. More shares were purchased in 2001. By 2002 Muslim Commercial Bank was fully privatized, and there is no longer any government holding.

The assets, deposits, and advances of Muslim Commercial Bank all show improvement over their performance when the bank was state owned. The bank's

Box 11-1. *Muslim Commercial Bank, Impact of Privatization*

—Assets as a percentage of total assets of nationalized banks grew from 18 percent in 1994 to over 28 percent in 2003.
—Deposits as a percentage of total deposits of nationalized banks grew from 18 percent in 1994 to 27 percent in 2003.
—Advances as a percentage of total advances of nationalized banks grew from 18 percent in 1990 to 27 percent in 2003.
—Nonperforming loans as a percentage of total loans varied between a low of 11 percent in 1997 to a high of 19 percent in 1993.

net nonperforming loan ratio is close to 2 percent. (In the system overall the net nonperforming loan ratio is 5.5 percent.) In addition, returns on assets grew from almost zero to 0.8 percent. The bank therefore appears to be in a much healthier condition now than under state ownership (see box 11-1).

Allied Bank Limited was the second bank to privatize. On September 9, 1991, the government sold 26 percent of the bank's shares to the bank employees' group, the Allied Management Group, at Rs 70 a share. On August 23, 1993, the government sold another 25 percent of the shares to the same group and at the same share price, resulting in the transfer of majority ownership from the government of Pakistan to the bank's employees.

By 1999 one of the major defaulters of Allied Bank Limited had purchased 35–40 percent of the bank's shares from employees. De facto, the bank's defaulter had become its manager! This was obviously a moral hazard and a potential regulatory problem, so in July 1999 the SBP imposed a restriction on the transfer of shares from employees to nonemployees except with the SBP's prior approval. Unfortunately, the damage had already been done, and the SBP found that the chairman and managers were working against the interest of Allied Bank Limited and its depositors. On August 3, 2001, the SBP removed the chairman and the three directors on the board of Allied Bank Limited and replaced the whole board.

As a result of this scandal, the Privatization Commission directed the SBP not to privatize Allied Bank Limited but to merge it with existing financial institutions. By February 2004 six parties had prequalified. But the defaulters, who were affected by this decision, went to a court of law and challenged the merger. The SBP and Allied Bank Limited appealed a high court order to the supreme court. The bank has now been sold to a private investor through an open bidding process.

Box 11-2. *Allied Bank Limited of Pakistan, Impact of Privatization*

—Assets as a percentage of total assets of nationalized banks grew from 10 percent in 1995 to 12 percent by 2002.
—Deposits as a percentage of total deposits of nationalized banks grew from 10 percent in 1995 to 14 percent in 2003.
—Advances as a percentage of total advances of nationalized banks peaked at 16 percent in 1999 but declined to 11 percent in 2003.
—Nonperforming loans as a percentage of total loans jumped from 16 percent in 1993 to 44 percent in 2003.

The impact of privatization of Allied Bank Limited is shown in box 11-2. Assets and deposits, though somewhat higher, have changed very little. Advances have actually gone down, and nonperforming loans have risen to more than 40 percent of the total loan portfolio. Return on assets declined from near zero to –5 percent. Once the SBP removed the board of directors, bank performance started improving. Allied Bank Limited was not transferred to a specific investor but rather to employees, an approach that proved to be even worse than public sector ownership. The 2004 sale to a private sector financial institution through competitive bidding has once again helped reconstitute the bank's capital, raising capital adequacy ratio to 25 percent.

Clearly, the two bank privatization experiences demonstrate that it is critically important that a government privatize state-owned financial institutions in the right way. Otherwise, it will make the situation worse than it was before. And those opposed to privatization will use a particular failure or scandal to try to abort or defeat the whole privatization effort.