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DOES PRIVATIZATION REALLY WORK? STUDY OF PAKISTAN'S BANKING SECTOR

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Abstract

Nationalization and de-nationalization are the processes adopted by economists for the betterment of state-owned and private institutions. Aim of these steps is mainly overall growth of economic pillars for tremendous growth. This paper is drafted with an aim to conduct institutional development and financial growth of privatized banks. Sample of 3 banks is observed in financial industry of Pakistan. Quantitative methodology is adopted through financial growth of the institutions, data collection of which is conducted through annualized financial reports of these institutions. Our findings include stable growth in financial institutions through better risk management practices, assets utilization and good corporate governance. Practical implication of this paper for policy division related to controlled nationalization or privatization implementation in the economy.

Key words: *Nationalize, De-nationalize, Privatize, banks*

1. Introduction

Privatization was considered as symbol of economic transformation from state-owned socialism to private-centric capitalism. Last two decades lead privatization in more than 100 transition economies of worth more than US$100 trillion. History of privatization initiated in 1960s from Germany as postwar economic reforms (Magginson, 2000).

Banking sector in Pakistan comprised of 54 banks including big-5. Big-5 comprises of National Bank of Pakistan (NBP), Habib Bank Limited (HBL), United Bank Limited (UBL) MCB Bank Limited (MCB) and Allied Bank Limited (ABL). All of these except NBP are privatized. Big-5 banks contribute more than 51% banking share of the country in assets, deposits and finances (SBP, 2010). Thus, these banks contribute major share in Pakistani banking sector.

1.1.Background: History of Pakistan banking sector evolved since country independence from British ruled India in 1947. Considering the importance of banks in economical framework, Habib Bank was established in 1946 with motive of supporting the infant economy of new republic of Pakistan. Karachi, then capital of Pakistan was also an economic hub due to seaport, and already had branches of some of the foreign banks like ABN AMRO Bank, Grindlays, etc. Later in 1950s, Pakistan welcomed various foreign financial institutions from US and Europe, which evolved Pakistan banking sector to a considerable shape. Domestic banks like Muslim Commercial Bank were also evolved to advantage the situation. Later couple of decades got real boom in Pakistan banking sector with establishment of United Bank and Allied Bank. Nationalization plan was implemented by government with an ideology of establishing Islamic republic, and to eliminate concentration of wealth in few hands. The major aim for nationalization of banking and financial sector was to publicize the loans system to each individual, and to raise employment level in country. Scheme based on the amalgamation of all banks into six commercial banks through Bank Nationalization Act 1974, into namely National Bank of Pakistan, Habib Bank, United Bank, Muslim Commercial Bank and Allied Bank (SBP, Annual Report , 1999). Plan got popularity by opening of branches in every corner of Pakistan including underdeveloped and rural areas benefitting every individual in the country through loans-disbursement, depository schemes, raising national savings, supporting industrial base and multiplying employment level of country. Thus benefitting from charter, these institutions were ruined through corruption, mismanagement and lack of controls, over-employed corporations, poor service quality and burdens of financial losses. So, last decade of 20th century forced government of Pakistan to denationalize these financial institutions to compete with global banking and financial system, thus improving regulatory environment in country.

As briefed above, Pakistan banking sector has major contribution by Big-5 comprising of 51% shares of which 4 are privatized banks (SBP, 4th Quarterly report, 2010).

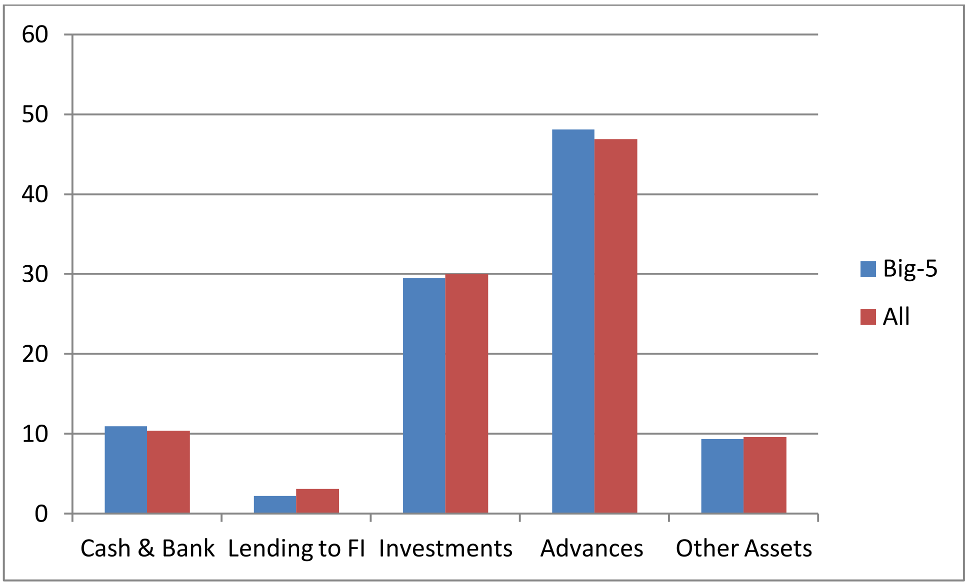

Figure 1: Assets composition of Big-5 banks with industry (as of Dec 31, 2010)

(SBP, 4th Quarterly report, 2010)

Figure-I depicts the assets composition of big-5 banks in Pakistan banking sector as of Dec 31, 2010. This data portrays the reliance of assets base by these banks which is mainly on advances followed by investments. Cash & bank share mere 11% which reflects efficient asset management by these banks.

1.2.Research Aims: This paper is designed to analyze the improvement in privatized financial institutions due to denationalization. Thus, research aims listed are:

- Adoption of denationalization model in Pakistan banking sector
- Growth analysis of privatized banking institutions with respect to privatization
- Growth relationship of privatized banking institutions with economic growth
- Risk management in privatized financial institutions
- Bankers' perspective of improvement in privatized banks post-denationalization.
- Customers' preference of privatized financial institutions

1.3.Research Rationale: this research creates a comprehensive study of Pakistan banking sector and role of big-5 banks in economic growth. This study is different from its kind due to application of multi-methodologies including financial variables, growth with macroeconomic variables and two-fold survey from bankers and customers.

1.4.Practical implication: this study is helpful to economies considering denationalization of banking sector to adopt Pakistani model with controlled detriments. Moreover, this study is helpful to policymakers of big banks and regulators for improvement of banking sector with perspective of positive growth. This paper evaluates the performance growth of each privatized bank before and after its privatization process.

2. Literature review

Positive financial performance of privatized banks in Pakistan is observed (Bokhari, 1998). However, literature highlights various other aspects of privatization on global picture.

2.1. Factors Of Nationalization

Some of the factors are listed here which determine the nationalization of private institutions by government.

2.1.1. General Welfare: government foresees welfare of general public by acquiring controlling stake of private institutions. Thus, core purpose rises when government wants to implement economic reforms with an idea of improved welfare belongings to general public. Sub-aims include rising employment opportunities, industrial revolution, improved economic desires.

2.1.2. Elimination Of Cartels: financial institutions, sometimes, make cartels to rebel against regulators directives for sake of own interests. Therefore, government decides to acquire controlling assets of such institutions with perspective of elimination of such cartels and spread the benefits to common man.

2.1.3. Willful Crash Down: regulators and central bank perform the function of last resort. So, in case of willful crash down of financial institution, regulator or central bank acquires controlling assets in such financial institution and runs it further. Different myths are followed to run such institutions like handing over to some other industrial group, run through executive panel committee, merged into some financial institution, implementation of employees-ownership scheme, etc.

2.1.4. Monetary Policy: regulators and central banks in country feel hurdles to the implementation of monetary policy, thus they acquire controlling assets in banking and financial institutions to drive economy by their own (Beck, Cull, & Jerome, 2005).

2.2. Detriments Of Nationalization

Global experience of nationalization highlighted detriments at micro and macro levels. Major of which may be listed as:

2.2.1. Lack Of Ownership: Since nationalized institution belongs to public and is not profit driven so ownership lack the visibility of improvement and stagnant growth (Dharwadkar, George, & Brandes, 2000).

2.2.2. Risks Exposure: State-owned banks represent higher proportion of nonperforming loans in their pockets comparatively (Saha & Sensarma, 2004). These banks enjoy government organizational deposits and sanction finances on political grounds. Such deposits and finances are not considered with intention of asset-liability management (ALM), thus resulting in booking of financial losses.

2.2.3. Cost-Benefit: state-owned institutions are not run on cost-benefit analysis. Core objective of such institutions is to spread financial services to every corner of the country so cost-benefit analysis is not the main priority of the business. Thus, such institutions bear financial losses to the books, and additional burden on fiscal deficits (Berger, Klapper, Peria, & Zaidi, 2006).

2.2.4. *Stagnant Products And Services:* state-run institutions indebted with slow pace of growth, thus resulting in stagnant products and services offering to general public. Innovative financial services are not designed to compete with other economic rivals.

2.2.5. *Banking Performance:* State-owned banks run in unfavorable results in developing economies, however developed economies portray a mirror image (Baumol, 1996) (Boycko, Shleifer, & Vishny, 1994) (Brada, 1996). Developing economies are lead by foreign-owned banks who introduce innovative products in the industry.

2.2.6. *Political Suppress:* State-owned banks are run by politicians statesmen due to political linking, thus resulting in unfair use of means and mismanagement (Braun & Raddatz, 2010).

2.2.7. *Fiscal Loss:* Nationalized institutions performance result in financial losses which have to be settled by government through capital injection, thus resulting in fiscal losses to the government. Various such incidents in study of nationalization and then privatization process of Pakistan (Shahid-ur-Rehman, 2006).

2.3. Modes Of Denationalization

Analysis of privatization process reveals that denationalization comes in different shapes. Some of the major forms are listed as:

2.3.1. *Public Offering:* public stake in institutions is denationalized by offering controlling shares to general public through stock exchange. Thus general public nominates the management for institutions after privatization. Sometimes, an investment group takes controlling stake in institution through stock exchange and claims controlling rights.

2.3.2. *Direct Full Bid:* Government arranges a bidding process for denationalization of state-owned institution to corporate sector. Thus, corporate sector takes over controlling stake fully or partially through this process and runs organization by its own.

2.3.3. *Partial Stake:* Government disowns its controlling stake to public or corporate and retain partial stake in institution with perspective to investment and controlling the performance of privatized institution (Beck, Cull, & Jerome, 2005).

2.3.4. *Employees Stock Option:* Government off-loads its institutional stake through Employees stock option scheme, and hands over institution to employees' representative management. Employees own its shares and runs institution with its best management.

2.3.5. *Inviting Multi-Nationals:* larger units are sometimes targeted for sale to multinational firms considering the reduced potential of local buyers and intention of growth of specific firm to international standards (Dharwadkar, George, & Brandes, 2000).

2.3.6. *Industrial Groups:* industrial groups are welcomed as targeted buyers of privatized units which are also likely to takeover such businesses as forward or backward integration (Ramamurti, 2000).

2.3.7. *Split-Off To Small Units:* Since intention of privatization combines with battling with cartels and oligopoly so (Yosha, 1995) suggested that privatization plan should include the split-off of larger banks into smaller units and then sell-off. It will not only help in controlling economy in a better way and also improve banking competition resulting in growth with more pace.

2.3.8. *Split-Off Varied Business:* Considering the same essence of privatization, (Yosha, 1995) suggested another plan of privatization through split-off varied business from banks, like managing funds, pension funds, etc. and privatize the commercial bank only. This will help in implementing better control over social-controlled activities and privatized banks could devote their growth to pure commercial activities.

Privatization process of banking institutions in Pakistan has been run through thrice of these modes. ABL was first privatized through employees-ownership but later its controlling stake was later privatized through bidding process to interested corporate parties.

2.4. Impacts of denationalization

Different outcomes are experienced in varied experiences of denationalization. For example, Polish (in 1990s) and Mexican (in 2005) experiences of privatization met with disastrous results (Bonin & Wachtel, 2002) (Bonin, Hasan, & Wachtel, Ownership structure and bank performance in the transition economies of Central and Eastern Europe: a preliminary report, 2002) (Nakane & Weintraub, 2005).

2.4.1. *Growth In National Productivity:* Positive approach of privatized banks under better risk management practices help in economic growth and improved national productivity (D'Souza & Megginson, 1999) (Magginson, 2000) (Boehmer, Nash, & Netter, 2003) (Nakane & Weintraub, 2005).

2.4.2. *Compensation Of Inflation:* Privatization is processed in developing countries under stressed economic depression. Inflation is compensated by privatized commercial banks by issuing more credit to industrial sector, which generates employment. This practice is onwards controlled by central banks through open market operations (Nakane & Weintraub, 2005).

2.5. Privatization Process In Pakistan:

Privatization process of Pakistan started from suggested simplicity turned into complexity due to legal implications through changes in political climates over period. Experience of privatization resulted into varied conclusions, some of them reflected better performance by new management and some resulted into disaster of untrained management (Bokhari, 1998).

Rs (in million)

Sr. No	Unit Name	Sale Price	Date of Transfer	Buyer Name
Banking and Finance				
1	Allied Bank Limited (51%)	971.6	Feb-91	EMG
2	Muslim Commercial Bank (75%)	2,420.0	Apr-91	National Group
3	Bankers Equity (51%)	618.7	Jun-96	LTV Group
4	Habib Credit & Exchange (70 %) (52,500,000)	1,633.9	Jul-97	Sh. Nahyan bin Mubarik Al-Nahyan
5	United Bank Ltd. (51%) (1,549,465,680)	12,350.0	Oct-02	Consortium of Bestway & Abu Dhabi Group
6	Bank Alfalah (30%)(22,500,000)	620.0	Dec-02	Abu Dhabi Group
7	Habib Bank (51%)	22,409.0	Dec-03	Agha Khan Fund for Economic Development
	Total	41,023.2		
Capital Market Transaction				
8	Muslim Commercial Bank (6.8%)	563.2	Jan-01	MCB Employees-PF & Pension Fund
9	Muslim Commercial Bank (4.4%)	364.0	Nov-01	MCB Employees-PF & Pension Fund
10	NBP 10% shares IPO (37.3 million shares)	373.0	Feb-02	General Public Thru Stock Exchange
11	Muslim Commercial Bank (CDC)(24,024,560 shares)	664.0	Oct-02	Sale Thru CDC
12	National Bank of Pakistan 10% SPO (37,303,932 shares)	782.0	Nov-02	Sale Thru CDC
13	NBP 3.52% 3rd offer (13,131,000 shares)	604.0	Nov-03	General Public thru Stock Exchange
14	UBL 4.2% IPO (21,867,000 shares)	1,087.2	Aug-05	General Public thru Stock Exchange
15	UBL 25% GDR (202,343,752 shares)	39,450.7	Jun-07	GDR offering to international & domestic institutions
16	HBL 7.5% thru IPO (51,750,000 shares)	12,161.0	Oct-07	General Public thru Stock Exchange

Table 1: Banks' privatization in Pakistan (Pakistan, 1998, 1999, 2000, 2001)

3. Methodology

Umer Khalid (2006) is his study of privatization prospects over Pakistan banking sector for 1990-2002 concluded that financial health of all of the privatized banks have been improved, except one bank which was privatized under Employee-Ownership scheme (Abid, 2003). Change of firm's management is not the only key to firm's improved post-privatization performance, however, industry structure, regulations and macroeconomic variables are also of equal importance (Ramamurti, 2000). Some of the researchers work is summarized below.

Researcher	Year	Method	Data	Findings
Berger et al.	2006	Banking relationships with respect to ownership	4,382 Indian firms relationships are studied with 26 banks	State-owned banks enjoy more share in industry and multiple relationships with firms
Cull et al.	2005	Financial analysis of privatized banks to assess performance growth	Annualized data of 69 Nigerian banks for 1990-2001	Positive performance observed post-privatization of banks
Weintraub	2005	Cobb-Douglas production function	Time series data of 242 Brazilian commercial banks for 1990-2001	Banks privatization reflects into improved economy
Saha	2003	Divestment impact on deposits and prices of public banks	Cross-sectional study	Divestment impact on both sides of growth in competition among banks for deposits and pricing
Catarina	2005	Comparative study of private-owned and state-owned banks	Cross sectional data of 340 banks of 40 African countries for 2001-02	Privately owned banks perform better than state owned banks
Umer Khalid	2006	CAMELS analysis	Pakistan banking sector 1990 - 2002	Post-privatization performance of banks is improved in terms of financial health except ABL which was run under Employee-Ownership scheme

Table 2: Methodologies by researchers (source: study of various articles)

Bank competition is studied by (Saha & Sensarma, Divestment and bank competition, 2004) for divested public banks through deposits, liquidity and interest rates. It was concluded that divestment in public banks impact on both sides of financials.

However, we have adopted methodology of financial analysis over privatized banks. Despite of different financial years of privatization, we have compared the key financial figures of three stages.

First stage based on last three years prior to privatization (depicted by BP), second stage based on immediate three years after privatization (depicted by AP) and third stage comprises of recent three financial years (i.e. 2009, 2010 and 2011).

4. Analysis And Findings

We have compared key financial figures of three privatized banks i.e. Allied Bank Limited (ABL) privatized in 2003, MCB Bank (MCB) privatized in 1996 and United Bank Limited (UBL) privatized in 2002. Three years financial key figures prior to privatization are compared with three years post privatization and recent three years financials. Comparison is made in total assets, total deposits, total finances, net profit before tax (NPBT) and return on assets (ROA).

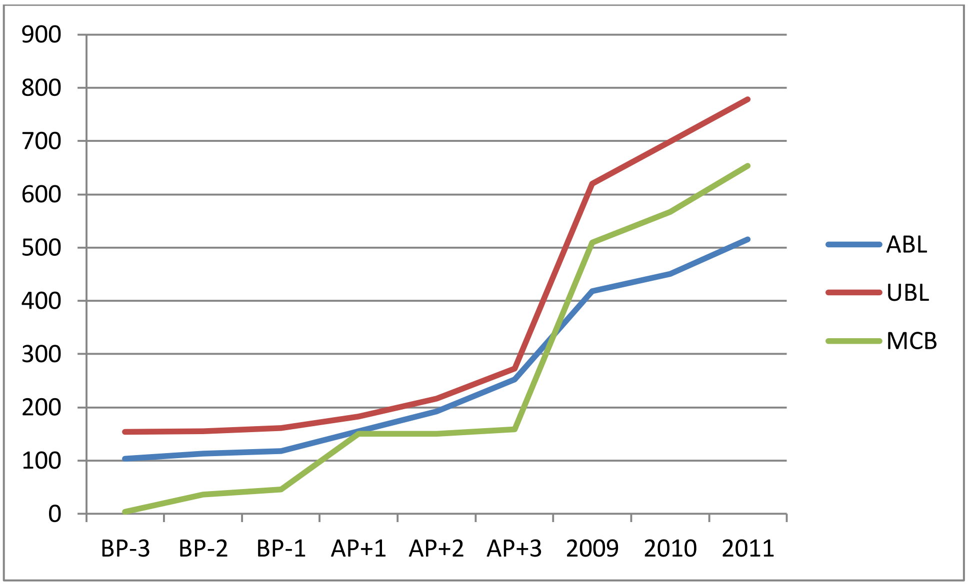

Figure 2: Comparison of Assets of Privatized banks (BP: Before Privatization; AP: After Privatization)

Figure-II depicts the comparison of three major privatized banks. This comparison reflects similar trend of banks' growth. Total assets of the banks have improved constantly in identical growth ratios. ABL and UBL are reflecting steady growth in six years of privatization while MCB is reflecting stagnant position post-privatization but sudden growth later over ABL.

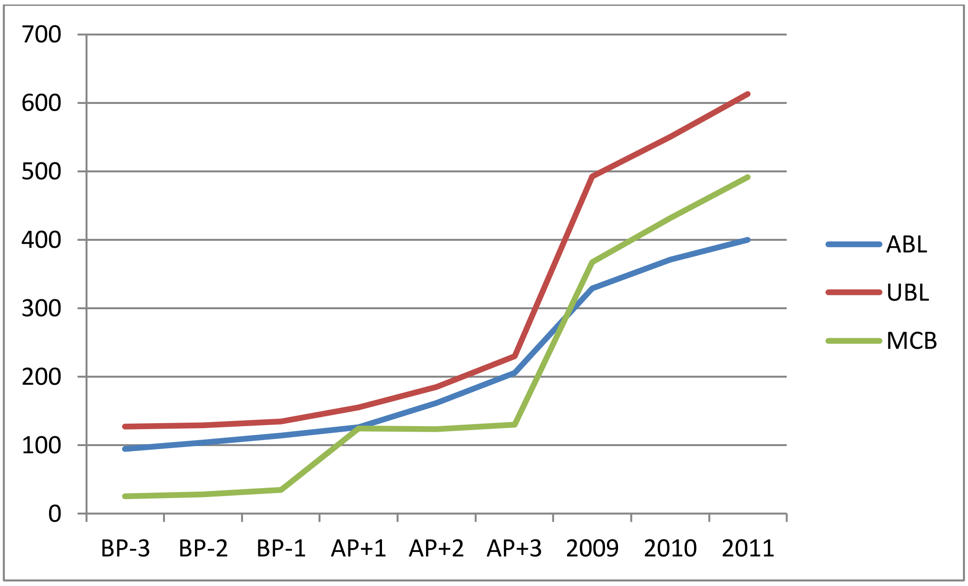

Figure 3: Comparison of Deposits of Privatized banks (BP: Before Privatization; AP: After Privatization)

Figure-III depicts the growth trend of total deposits among thrice of the privatized banks. This trend also reflects similar trend as observed in illustration-2 of total assets. ABL and UBL have shown similar steady growth while MCB reflected very stagnant position in six years around privatization but shown sudden growth in recent years over ABL.

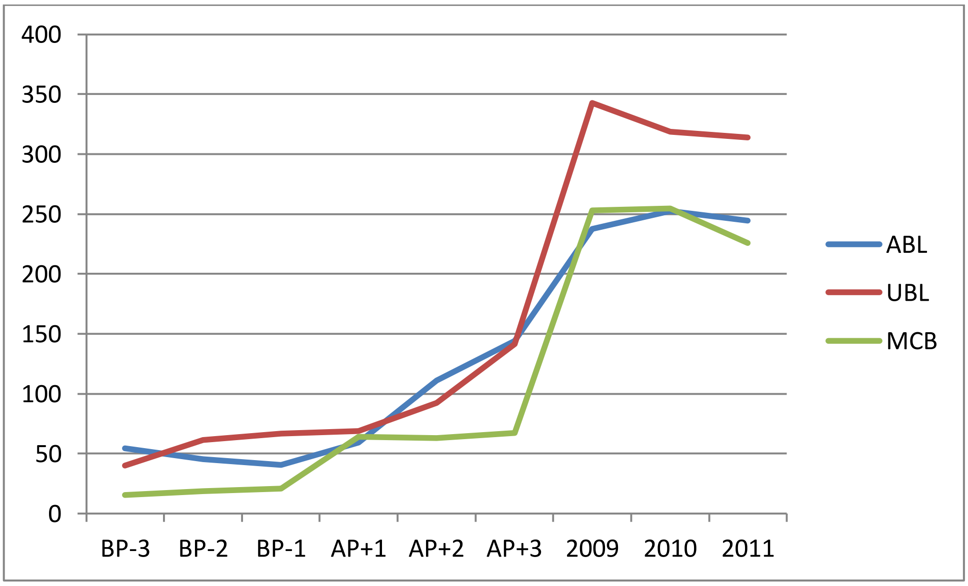

Figure 4: Comparison of Finances of Privatized banks (BP: Before Privatization; AP: After Privatization)

Figure-IV is reflection of growth trend of total finances of three privatized banks. In this analysis, ABL has shown a declining trend prior-privatization but good growth after privatization. Comparatively, UBL showed rocketing growth after privatization, whereas MCB remained identical to its two previous financials. Recent global financial crisis reflected drowning trend in statistics of thrice of banks.

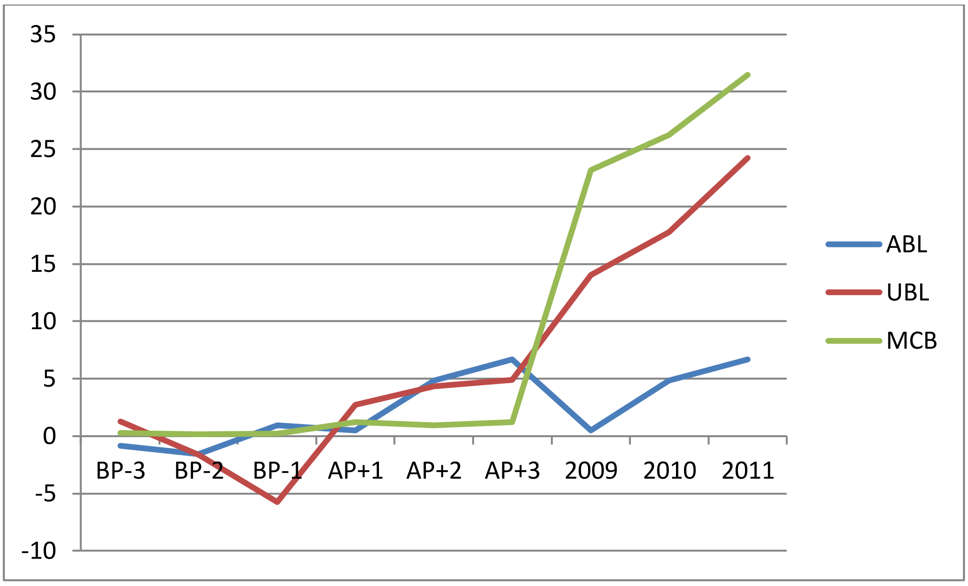

Figure 5: Comparison of NPBT of Privatized banks (BP: Before Privatization; AP: After Privatization)

Figure-V is the reflection of net profit before tax (NPBT) for thrice of the sample banks. ABL has resulted slow pace in growth of profits around privatization and later declined till 2009 after which it gained its pace again. UBL has been declining prior to privatization but gained post privatization to rocketing profits till date. MCB, which was standing at even stage, lead the way comparatively till date.

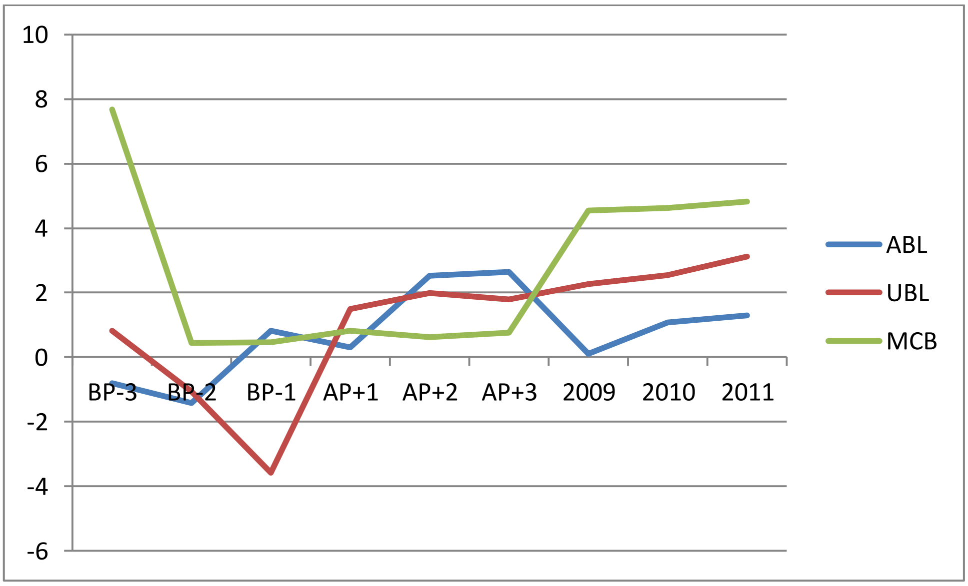

Figure 6: Comparison of ROA of Privatized banks (BP: Before Privatization; AP: After Privatization)

Return on Assets has always been a test for reflection of financial growth. ROA was observed for the sample banks which are reflected in Figure-VI. Analysis reflected ABL in an earthworm route curve bearing enjoying highest returns immediate after privatization. UBL touched lowest return just before privatization and enjoying growth since then. MCB bore lowest returns in phase of privatization but enjoyed good returns afterwards.

5. Conclusion

Public banks are usually caused with disinterest, divested focus, political influence and non-focal growth. Stakeholders are worst influenced with mismanaged concern due to ill corporate governance. Privatization, though a source of funds for public funds and resulted in focal growth of the organization resulting in general economic growth. Some of the institutions might wait some time to adopt a new vision after privatization but resulted in healthy results afterwards. The medium of privatization has a major impact over the results of this economic activity and its micro and macro results.

- ***5.1.Privatization Benefits:*** Improved work efficiency, better financial results, focus financial tasks, etc.
- ***5.2.*****Adverse Impacts Of Privatization:** Privatization adversely affect on job security of employees, interest raise rise for loans, less jobs (since privatized banks use less workers for same tasks), nepotism of owners, non-preference of sector-wise growth,

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