Challenges Faced by Banking Industry of Pakistan during Global Financial Crisis (2008-12)

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Abstract:
This study aims at investigating the challenges faced by commercial banks of Pakistan especially five big well established banks during the period of global financial crisis. The key performance indicators for this purpose were liquidity, profitability and stability. This study covers a period of five years from 2008-2012 and the Year 2007 was taken as base year on the basis of that the impact and performance of selected five banks of country was gauged by using financial ratios as measuring tool .The financial ratios meant for Profitability, liquidity and capital structure were calculated and average of selected ratios of five big were used to avoid disparity in size. Also impact on performance of loans was evaluated to relate it with globalization. A survey was made by developing a close ended questionnaire; a five point Likert scale was used as a measuring tool to evaluate the response of Bankers, scholars & customers.

The main findings are (I) there seems significant impact on deposits, liquidity and profitability of banking system. (II) Non Performing Loans were accumulated significantly after multi year better performance of healthy loans due to increase of interest rates by central bank to maintain the liquidity in system (III) It was also revealed that the cost of deposits were increased to maintain the books and confidence of stakeholders which has adversely affected the profitability of well established five big banks of the country.
Key Words: Global Financial Crisis, Commercial Banks , Deposits , Liquidity, profitability, Non Performing Loans

Introduction:

The main objective of this paper is to evaluate the performance and growth of commercial banks of Pakistan during the recent global financial crisis which basically started in United States but engulfed the entire world. While the scale of economic loss varied from country to country, the renowned economists agree that the current downturn is more than that of Great Depression of 30s.These are basically credit crisis which are direct consequence of fall down of the mortgage market in United States.

The study is mainly aimed at to analyze & evaluate the performance of commercial banks of Pakistan for the period 2007-2012. Specifically, focus is on five well established big banks namely National Bank of Pakistan, Habib Bank Limited, United Bank Limited, MCB Bank Limited & Allied Bank Limited two banks. Banks were selected on the basis of their deposits, advances, Stability, profitability, products and services so provided and tenure of presence in the industry. Data were collected from their financial reports. In this age of sophisticated technology and competitive financial market it is very common to use this method of investigation for evaluating Banks performance.

Causes of Crisis

The foremost causes of crises were imprudent & careless lending for a long period of time, fair value of collateral so accepted was ignored, repayment capacity of borrowers was not checked in most cases even down payment was relaxed, improper rating was awarded by rating agencies against attractive incentives, relaxation of regulations by US government especially repeal of the Glass-Steagall Act of 1933.

Impact of Global Financial Crisis

The financial crises got unusual momentum during the period from 2004 -2007, stock markets of the world witnessed slow down. It caused collapse of Financial Institutions including giant financial & insurance institutions such as Lehman Brothers, American International Group Inc(AIG), Fannie Mae, Freddie Mac etc. Central Banks in weak economies such as Ice Land turned out as bankrupt, so many large banks applied for bailout to avoid collapse. Investors lost huge amount worldwide. This resulted into severe liquidity crunch and credit squeeze in the financial markets.

House prices sharply declined by 20% from its peak during 2006 and home equity reached at lowest level of $8.8 trillion in the mid of 2008 which was valued at $13 trillion in the Unites States. In 2009 global output dropped by 2.2 %, unemployment increased by 7% which resulted into more than 35 million people out of job.

Impact of Global Financial Crisis on Pakistan

A stressed global economic down turn has seized Foreign Direct Investment (FDI) which witnessed a decline by 47.5 % during the period of July 2008 to April 2009 Most of this decrease was in the shape of an out flow of private portfolio investment amounting to US$ 1 billion. However remittances made by overseas workers' remained stable which were approximately US $ 6.4 billion. During the period under review Pakistan could not raise funds from the capital markets abroad as entire world was already passing through such unprecedented and extraordinary crisis. In fact Pakistan's existence was literally very much restricted in the global capital markets during the said period particularly in 2008-09.

Overall tax revenues targets could not be achieved substantially as the economic slowdown reduced Pakistan's two main tax bases-manufacturing and imports.

Overall Impact on Banking Industry in Pakistan

In pursuance of demands for financial & economic globalization banking and financial sectors of Pakistan also started to be a part of global financial market. Hence the effects and shocks of global financial crisis were also felt though the scale of severity was not as much as observed in developed economies.

Immediate shocks were as under,

- Massive withdrawal of deposits from local as well as foreign currency accounts.
- Capital Flight in shape of foreign currencies
- Banking system experienced tight liquidity and credit crunch
- Crash of stock exchange to its lowest level after multi year growth & stability.
- Increase of interest rates for special objective of credit contraction.
- Banks were in panic to restore confidence of stake holders hence offered high rates to mobilize deposits for maintenance of books
- Profitability of banks was significantly affected
- Profitability of stock holders was also decreases considerably
- Accumulation of bad loans

Immediate Remedial Measures by Central Bank (State Bank of Pakistan)

To control and avoid further instability of the currency market he State Bank of Pakistan intervened and taken following steps,

- Injected around $20-100 million in the currency market.
- Lowered the Statutory Liquidity Requirements (SLR) & Cash Reserve Requirement(CRR) from 34 % to 30%.

Review of Literature

There is a lot of empirical literature available on the root causes of recent Global Financial Crisis & its direct impact on world economy & banking industry as well. A number of articles, research papers & reports were attempted to examine & explore the effects and implications of Global financial Crisis. But in case of under developed countries particularly for Pakistan very negligible empirical literature is available on the subject matter.

Hence an attempt has been made to analyze the consequences of Global financial Crisis on various dimensions & aspects of banking sector of Pakistan especially evaluation of performance of five big selected sample banks with respect to their liquidity, profitability & solvency. The existing literature explores the root causes globally are reviewed as under.

T Schuermnn & A.B.Ashcraft, et al, 2007, explores that the prime cause of the global financial crisis was the process of collateralization near about 75 per cent of subprime mortgage loans were directly linked with the securitization. Financial derivatives played an important role in securitization of the subprime loans in special compartment of CDOs (collateralized debt obligations) & CLOs (collateralized loan obligations).

Dr Umer Chapra -2008 in his research on the subject matter claimed that the recent global economic down turn is worse than the Great Depression of 1929. He further predicted that the growth of financial markets will experience slow down and effects of crisis will be long-lasting. He further analyzed that more revenue means more lending and high leverage is the only basis which adds in excessive lending and resultantly causes an artificial boom in assets prices. Consequently allows rise in speculative investment & consumption. Such type of high leverage is difficult to calm down and such vicious series of selling eventually ends to abrupt decline in prices which ultimately results in financial crisis.

Lowenstein (2008) investigated that central banks & the regulators have allowed the repetition of financial crisis who have failed to exhibit financial control even overlook the past experiences which is a clear warning signal and advise to display financial discipline to avoid recurrence of same blunders again and again but no lesson was learnt there from It was an immediate need to recognize such early warning signals for proper management of financial derivatives more carefully rather they allowed to promote such unsafe business.

Nicholson, 2008 explores that global financial crisis which initiated from United States has engulfed the entire globe. The severity and intensity of crisis was so much that it not only has affected financial industry of United States but severely stroked the stock exchanges of so many countries of Europe and Asia. Moreover he concluded that Global Financial crisis not only affected capitalist economies but have severe impact on Socialist economies, stock Market of Russia also dropped considerably in May 2008.

Bartlett (2008) expressed his view point that crises which were basically started with the collapse of US sub-prime mortgage industry; its intensity was so much severe that ultimately gripped the entire world. Losses on the Collateralized Debt Obligations, subprime mortgage securities and related assets were about $945 billion in March 2008.He also compared these losses with Japan’s banking crisis which were about US $ 780 billion in 1990 , Asian Crisis losses which accounted for US 420billion in 1990 & Saving And Loan Disaster of USA accounted for US $ 380 billion in 1986-1995.

Rasmus (2008) has the similar opinion; he, while narrating the causing of economic recession initiating from USA expressed that the US economy was affected from real ailments including a decades-long real pay freeze for 91 million blue collar labor resulting into sharply increasing income disparity accelerating collapse of systems of healthcare and retirement after US postwar.

Stijn Claessens, M. Ayhan Kose and Marco E. Terrones -2010 in their research has examined that the global financial crisis emerged due to the boom in asset prices ,rapid accumulation of debt ,dramatic expansion in variety of marginal loans especially in subprime mortgage with high level of systematic risk and last but not least lack of regulatory supervision.

Wim Naude has explored that there were various causes of crisis which include weak regulatory restrictions Easy & cheap money , imprudent lending and improper rating by rating agencies. Conflicts of interest and Moral Hazards were rife throughout the financial system.

Yilmaz (2008) has clearly concluded that U.S mortgage industry is solely responsible for extending mortgage finance facilities to subprime clients which otherwise not eligible for availing the home mortgage facilities thus caused the happening of such severe nature of global financial crisis.

Research Methodology

Ratio Analysis

In this study Banks’ performance have been measured by using ratio analysis technique, the main advantage of this method is to remove disparity based on their size of deposits ,advances& network and brings the banks at par. This method was also used by other researchers too such as Ahmed & Hassan (2007), Sabi(1996) and Chen & Shimerda (1981).

Financial Analysis by using Ratios

Profit before Tax Ratio %

Bank	**2007**	**2008**	**2009**	**2010**	**2011**	**2012**
NBP	55.49	37.74	28.61	27.6	27.29	23.24
HBL	27.08	26.75	28.11	33.25	34.82	29.88
UBL	31.68	26.29	22.82	29.52	34.38	36.77
MCB	67.03	54.61	44.86	47.89	46.2	46.89
ABL	28.08	20.02	25.62	27.44	29.16	32.06
Average	41.87	33.08	30	33.14	34.37	33.76

Profit before Tax ratio is clear indicator that the sample banks have been adversely affected in terms of profitability. Its Profit before Tax has decreased in terms of Gross Mark up Income due to maintenance of Advances Deposits Ratio which was fixed as 70 %.

Gross Spread Ratio %

Bank	**2007**	**2008**	**2009**	**2010**	**2011**	**2012**
NBP	66.5	60.81	49.34	48.85	49.11	43.63
HBL	62.06	58.1	56.09	57.79	57.12	49.46
UBL	58.74	54.04	53.94	57.68	55.96	52.46
MCB	75.26	71.13	69.31	67.19	65.34	59.77
ABL	52.39	45.83	45.47	50.15	48.58	37.09
Average	62.99	57.98	54.83	56.33	55.22	48.48

Gross Spread ratio also confirms that big established banks remained adversely affected during period under review. It tells that Net Markup income is decreased and Markup expense increased which also reflects from Weighted Cost of deposits.

Return on Equity %

Bank	**2007**	**2008**	**2009**	**2010**	**2011**	**2012**
NBP	27.48	19	19.21	16.93	15.93	13.93
HBL	17.01	23.87	16.1	17.92	20.61	16.96
UBL	19.81	19.25	15.57	16.11	19.58	19.75
MCB	37.66	30.31	27.35	25.91	26.23	25.07
ABL	22.14	19.98	27.51	26.39	26.95	27.2
Average	24.82	22.48	21.14	20.65	21.86	20.58

Return on equity also indicates that equity holders' profitability was reduced significantly. Efficiency can be measured through this ratio i.e. higher ratio means better performance and vice versa

Gross Profit Ratio %

Bank	**2007**	**2008**	**2009**	**2010**	**2011**	**2012**
NBP	45.09	33.72	27.62	31.34	32.68	28.79
HBL	38.39	34.63	38.49	41.89	43.7	38.42
UBL	35.35	32.46	27.49	37.5	38.64	37.98
MCB	55.18	53.37	49.69	54.41	53.6	52.09
ABL	33.7	31.26	30.17	36.48	37.31	27.98
Average	207.71	185.44	173.46	201.62	205.93	185.26

Gross Profit Ratio also confirms that performance was deteriorated to considerable extent. It means that Gross profit has been decreased as a result of decrease in Total revenue due to significant increase in cost of Funds/deposits.

Weighted Average Cost of Deposit %

Bank	2007	2008	2009	2010	2011	2012
NBP	2.91	3.69	5.53	5.53	5.19	5.33
HBL	3.39	4.05	4.78	4.31	4.46	4.72
UBL	2.79	3.64	5.63	6.18	4.07	4.32
MCB	2.15	3.03	3.97	3.96	4.35	4.45
ABL	3.71	4.98	5.73	4.76	5.23	5.04
Average	2.99	3.87	5.12	4.94	4.66	4.77

Weighted Average Cost of Deposits increased by 71 % in 2009 as compared to base figure of 2007 which clearly depicts that Banks were under pressure to maintain their books and restore confidence in the eyes of stake holders that's why they borne extra cost to mobilize costly deposits. Although their lending was restricted above 70% at any point of time in terms of Advances to Deposits Ratio this resultantly reduced their markup income and increased mark up expense.

Gross Advances to Deposits Ratio %

Bank	2007	2008	2009	2010	2011	2012
NBP	63.31	73.21	73	64.91	63.87	70.36
HBL	71.93	76.43	66.59	61.52	48.99	41.14
UBL	78.98	80.84	77.73	66.96	59.76	58.45
MCB	78.65	82.64	73.37	63.55	50.52	48.14
ABL	67.63	75.18	75.98	72.12	65.61	56.13
Average	72	77.66	73.32	65.81	57.75	54.84

Gross Advances and Deposits Ratio also confirms liquidity pressure on banks as the advances were increased in comparison to deposits. This ratio indicates that how a Bank utilizes its deposits by extending loans, relatively low ratio contributes higher liquidity and results in low profits and low ratio creates stress for managing liquidity but higher profits. To address the liquidity issue SBP reduced SLR+CRR from 34 % to 30%

Cash & Portfolio Inv to Deposit Ratio

Bank	2007	2008	2009	2010	2011	2012
NBP	51.7	44.41	45.95	50.08	48.65	48.36
HBL	43.42	31.21	43.4	45.03	55.91	78.55
UBL	43.27	36.19	41.05	54.98	62.55	62.77
MCB	52.3	41.27	56.01	59.92	75.28	84.3
ABL	43.09	36.4	36.33	40.4	57.53	59.39
Average	**46.75**	**37.89**	**45.54**	**50.08**	**59.98**	**66.67**

Cash & portfolio Investment to deposit ratio tells that there was decrease in cash & Portfolio investment and liquidity was relatively tight ,higher ratio is better for liquidity but inversely affect profitability on idle cash. It was suddenly decreased around 10%, a clear signal of tight liquidity prevailed in the market.

Non Performing Loans (NPL)

(Fig in Billion)

Bank	2002	2007	2008	2009	2010	2011	2012
NBP	26.32	374.73	457.83	530.86	538.61	592.37	730.14
HBL	26.5	403.48	435.71	432.28	473.41	460	545.8
UBL	23.79	325.67	390.91	343.38	368.7	366.31	409.1
MCB	14.13	4.67	6.7	8.62	8.95	10.74	9.74
ABL	33.78	6.36	6.16	6.51	6.96	7.8	7.15
Average	**124.52**	**34.21**	**40.59**	**49.67**	**55.12**	**58.52**	**54.43**

NPLs increased from the highest figure of 2002 which was managed to large extent as at 2007 that shows that counter party failed to meet its obligation (Credit Risk)

NPLs/Gross Advances Ratio

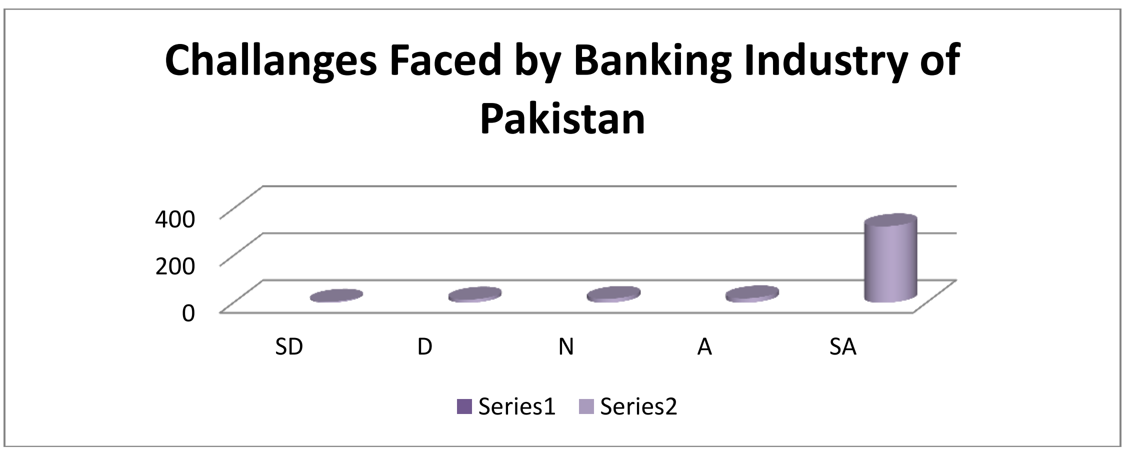
Bank	2002	2007	2008	2009	2010	2011	2012
NBP	26.32	10.23	12.33	13.36	16.09	14.88	12.6
HBL	26.5	6.09	8.28	9.79	9.86	11.15	10.92
UBL	23.79	6.86	7.12	11.39	13.26	13.95	14.02
MCB	14.13	4.67	6.7	8.62	8.95	10.74	9.74
ABL	33.78	6.36	6.16	6.51	6.96	7.8	7.15
Average	**24.9**	**6.84**	**8.11**	**9.93**	**11.02**	**11.7**	**10.88**

NPLs to Gross advances ratio also confirms credit risk position prevailed during the period under review it was only due to rise in interest rates, borrowers were unable to meet their obligations.

Primary Data

Primary Data was collected from management and senior bankers of commercial banks and from of central bank s and customers of banks. A five point Likert scale was used as measurement tool (1 for strongly disagree & 5 for strongly agree).A closed ended questionnaire was developed to record and analyzing the response of respondents.

Overall Response –By 380/400 respondents



Results

From survey it is evident that Global Financial crises have negatively impacted the performance of Banking Industry in Pakistan, Cash Reserve Requirement & Statutory Requirements were relaxed to enable the banks to meet day to day cash requirements, capital flight was occurred, and few banks stopped bonuses and annual increments. Banks diverted from funded income to non funded income by introducing a non core banking product namely Banca assurance etc.

Conclusion

While going through the performance of Banks so far it has been concluded that the sample banks have been adversely affected in terms of profitability. Its Profit before Tax has decreased in terms of Gross Mark up Income due to maintenance of Advances Deposits Ratio which was fixed as 70 %.Net Markup income is decreased and Markup expense increased which also reflects from Weighted Cost of deposits. Return on equity also indicates that equity holders' profitability was reduced significantly. Gross Profit Ratio also confirms Gross profit has been decreased as a result of decrease in Total revenue due to significant increase in cost of Funds/deposits

Weighted Average Cost of Deposits increased by 71 % in 2009 as compared to base figure of 2007 which clearly depicts that Banks were under pressure to maintain their books and restore confidence in the eyes of stake holders that's why they borne extra cost to mobilize costly deposits. Gross Advances and Deposits Ratio also confirms liquidity pressure on banks as the advances were increased in comparison to deposits. This ratio also indicates that how a Bank utilizes its deposits by extending loans, relatively low ratio contributes higher liquidity and results in low profits and low ratio creates stress for managing liquidity but higher profits.

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