

POLITICAL MOTIVATIONS: THE NATIONALIZATION OF THE PAKISTANI BANKING SECTOR

*Hussain Gulzar Rammal**

Abstract

The sixth most populated country in the world, Pakistan has faced political instability since her independence. The Pakistani banking sector, which had experienced rapid growth, faced an unexpected move in 1974 when through a parliamentary act; the Government of Pakistan nationalized the industry and seized control of all assets. The purpose of this paper is to highlight the events leading to the nationalization and the impact of the decision on the banking sector in Pakistan. The findings of the paper reveal that the decision to take control of the banking sector was a politically motivated one which failed to achieve the objectives that were set out during the nationalization.

Keywords: nationalization; privatization; Pakistan; banking.

**The University of Adelaide Business School, Australia
hussain.rammal@adelaide.edu.au*

1. Introduction

Since her independence in 1947, the Pakistani Banking sector has faced numerous challenges. From laying the foundations of a financial regulatory system to establishing indigenous banks to compete with foreign owned entities, Pakistani banks worked hard to make their presence felt both nationally and globally. But these efforts received a jolt in 1974 when the Pakistani Government nationalized the banking industry and took over control of the operations and assets of Pakistani banks both at home and abroad. This paper provides a critical account of the events that led to the nationalization and subsequent privatization of the Pakistani banking sector.

This paper is divided into six sections. The following section provides a brief profile of Pakistan and its economy. Section three provides the history of the Pakistani banking sector from the time before the partition from India till the end of the 1960s. Section four details the events that led to the nationalization of the Pakistani banking sector, followed by section five which discusses the steps taken by the government in 1980s and 1990s to privatize the banking industry and the current market situation. The final section provides core findings and conclusions of this paper.

2. Profile of Pakistan

With a population of more than 172 million people (2008 estimate), Pakistan is the sixth most populated country in the world (Population Reference Bureau 2008). Situated in South Asia, Pakistan borders the Middle East via Iran, Central Asia via Afghanistan and Tajikistan, East Asia via China and other South Asian

countries via its Eastern border with India (Dunung 1999).

The demand for a new country in South Asia called Pakistan was first put forth in a resolution in Lahore by the All India Muslim League on 23 March 1940 (Ahmad 1997). This new proposed country would be the homeland for the Muslims of South Asia and on 14 August 1947 Pakistan was created. Pakistan's population consists of people from different ethnic backgrounds such as Punjabis, Sindhis, Balochs, Pathans, Bengalis and Mohajirs (those who migrated to the newly independent state of Pakistan after the partition) who came together as a nation on the basis of the common religious belief of Islam (Khan 2007). The differences in the ethnic background were exposed in 1970-1971, when the then Eastern part of Pakistan broke away from the Western part to form the independent nation of Bangladesh (Memon 1996; Ziring 1971).

Pakistan was the first country in the world to declare herself an Islamic Republic on 23 March 1956 (Constitution of Pakistan 2008). More than 97 per cent of Pakistan's population belongs to the Islamic faith, making it the second most populated nation in the Muslim world after Indonesia. As such, religious beliefs heavily influence the national and business culture of Pakistan (Karim 2008). For the majority of Pakistan's existence, the military has ruled the country (Dunung 1999) and many of the state owned enterprises, and a few financial institutions, are managed by active and retired military personnel.

3. The banking sector (pre-partition – 1974)

Prior to the partition of India, the financial sector was in the hands of foreign banks some of which were

British by origin. Commencing their operations in 1883, the oldest banks operating in India were the Chartered Bank and the Grindlays Banks (Baig 1999; Baig 2000; Khalid and Hanif 2005). Among the indigenous banks, the Imperial Bank of India was the largest Indian Bank and performed the dual roles of a commercial bank as well as the Central Bank for India. In 1935 the Reserve Bank of India was established as the independent central bank. However, due to its large network, the Imperial Bank continued to play the role of a subsidiary of the Reserve Bank of India (Khalid and Hanif 2005).

The role of the Muslim population in the banking sector prior to the independence of Pakistan was limited. The only bank in pre-partition India that was owned by Muslims was the Habib Bank, which was established in 1941 (Khalid and Hanif 2005). To improve and strengthen the banking sector for the future Muslim State of Pakistan, the leader of the Muslim League, Muhammad Ali Jinnah, expressed his desire that another Muslim bank be established before partition. In 1947, a few months before the creation of Pakistan, the Muslim Commercial Bank was established (Baig 1999). After the creation of Pakistan, both Habib Bank and Muslim Commercial Bank shifted their headquarters to Karachi, the then capital city of Pakistan. Pakistan did not have its own central bank until 1948, a year after independence (Khalid and Hanif 2005). In May 1948, the founder of Pakistan, Muhammad Ali Jinnah, took steps for the establishment of a central bank. These steps were implemented in June 1948, and the State Bank of Pakistan commenced operation on 1 July 1948. Under the State Bank of Pakistan Order 1948, the Bank of Pakistan was charged with the duty to regulate the issue of bank notes and keeping of reserves with a view to securing monetary stability in Pakistan and generally to operate the currency and credit system of the country to its advantage (State Bank of Pakistan 2008).

From 1947 the banking sector grew rapidly. The private sector invested in the establishment of commercial banks with a network of branches across the country. At the same time, the State Bank of Pakistan granted licenses to certain foreign banks to operate in Pakistan. But in 1974, the banking industry fell into chaos when the government decided to nationalize the banking sector (Husain 2004).

4. The banks (nationalization) ordinance, 1974

The growth of the banking sector was accompanied by rapid growth of the Pakistani economy. This is evident from the fact that in 1969 the exports of Pakistan were higher than the combined exports of Indonesia, Malaysia, Philippines and Thailand (Husain 2004). But in Pakistan a perception had developed that income and regional disparities had widened resulting in concentration of wealth in a few hands. Many critics blame this inequality is the core

reason for the separation of Eastern wing of Pakistan which came to be known as Bangladesh. Politically this economic disparity saw the increase in popularity of the alternative socialist system. Pakistan had since independence allied herself politically to the United States and followed a relatively liberal capitalist economic system. In 1971, the elected Government led by Zulfikar Ali Bhutto came to power on a platform of promotion of socialist economy in the country (Karim 2008). The new government motto was to provide food, shelter and clothing to the masses. The role of the government increased sharply with both direct as well as indirect controls over the economy. Direct controls took the form of price regulation; restriction to entry and exit; allocation of resources, services and credit; issuing licenses for new investment; and regulation of monopolies to prevent inefficiencies in economic transactions. Indirectly, the Government intervened in the economy through taxation, provision of subsidies and incentives in the form of protection, tax exemptions, infrastructure and social services (Baig 1999). The Bhutto-led government decided that the best way for achieving equitable growth in Pakistan was by nationalizing banks, insurance, educational institutions, utilities and other industries. Thus, the public sector became responsible for the provision of all infrastructures including energy and communications and financial services but it also participated in the manufacturing activities as well.

The action to nationalize the banking sector was first promulgated as an Ordinance on 1 January 1974 by the President of Pakistan as 'The Banks (Nationalization) Ordinance, 1974'. The Bill of the Act was introduced in the National Assembly on 23 January 1974 with the following statement of objects and reasons:

"In order to provide the directing banking activities towards national socio-economic objectives, co-ordinating banking policy and co-operation in various areas of feasible joint activity without eliminating healthy competition in various fields of operation, and ensuring complete security of depositors' funds, the Banks (Nationalization) Ordinance, 1974 (1 of 1974), was promulgated on the 1 January, 1974. This Bill, which contains certain additional provisions relating to the management and administration of the banks, seeks to replace the said Ordinance by an Act of Parliament".
(State Bank of Pakistan 1974, p.2)

Pursuant to the Rules of Procedure and conduct of business in the National Assembly, 1973, the Bill was referred to the Standing Committee on Finance, Planning and Development, Economic Affairs and Statistics. The Committee considered the Bill at its meeting held on the 28th January, 1974 unanimously recommended introduction of the Bill in the National

Assembly. On 29 January 1974 the Bill was introduced in the National Assembly and received the assent of the President of Pakistan on 7 March 1974 (State Bank of Pakistan 1974).

Though foreign banks were not affected under the policy of nationalization, all life insurance companies, both Pakistani and foreign were taken over by the government under its policy of nationalization. The business operations, assets and properties of the sequestered insurance companies were merged under the patronage of State Life Insurance Corporation. In the banking sector, the government decided to retain only five major banks and the remaining banks were merged into them. The nationalization resulted in Habib (overseas) Bank and Standard Bank being merged into Habib Bank Limited, while Bank of Bahawalpur, Eastern Merchantile Bank and Easter Bank Corporation were handed over to the National Bank of Pakistan. The Commerce Bank and Union Banks were amalgamated with the United Bank Ltd and the Premier Bank was merged into Muslim Commercial Bank. Over half a dozen small banks operating in Punjab and NWFP were merged with Australasia Bank under a new title of Allied Bank of Pakistan. The Government of Pakistan also decided to establish the Pakistan Banking Council which acted as a holding a holding company of nationalised commercial banks and exercised supervisory control over them. It therefore played the role of a coordinator between the nationalized banks and the government (Baig 1999; Khalid and Hanif 2005).

In accordance with the Banks Nationalization Act, all deposits in the nationalized commercial banks were fully insured by the government. But despite this assurance, the high and increasing rate of inflation resulted in reduced deposits by 20 per cent and in real terms deposits were reduced by about 23 per cent. At the same time there was rapid expansion in staffing, which grew by 55 per cent, and number of branches, which grew by 82 per cent in a few years (Khalid and Hanif 2005). Subsequent to the process of amalgamation, serious problems were developed in the personnel adjustments in different banks. Before the merger of banks, the smaller banks were run by comparatively low paid and less qualified staff but with high ranks and designations. Their adjustment with the high cadre staff of larger banks created problems for the banks in the early days of nationalization. In order to solve this problem, identical new grades, pay scales and positions were introduced by the finance minister (Baig 1999).

The operations of the nationalised banks were gradually becoming focussed on satisfying the requirements of the Banking Council which defeated the main principle of the Nationalisation Act: serving the people. The appointment of Presidents and Senior Executives of the nationalized banks was made by the government while finance minister or senior bureaucrats in the finance ministry had the powers for transfers and postings of the bank staff. The Pakistan Banking Council became a strong body and was

accused by many of nepotism when it came to promotions. The bankers in order to get promotions or postings at desirable locations had to win favour with the Banking Council by appeasing them through gifts. On average, the chief executives or presidents of the banks were allowed to remain in a position not for more than two and half years (Husain 2004). As these chiefs of the banks were not sure about their term of service their efforts were directed towards ensuring that they maintained a healthy working relationship with the Banking Council. The nepotism and uncertainty in the banking industry resulted in a large exodus of talented bankers from Pakistan to North America, Europe and the Far East. Thus, the Pakistani banking sector along with facing the challenges of reorganization of the industry also faced a brain drain in the area of talented managers and financial experts.

5. Privatization of the Pakistani banking sector

Bhutto's reign ended in 1977 and the new military government of Zia-ul-Haq started focussing on converting the banking system into one that relied mainly on Islamic financing. The efforts to Islamize the economy did not receive the response that was expected and conventional financing continued to be the principal form of banking. By the end of the 1980s, it was becoming clear that the national socio-economic objectives, sought under the nationalization process, were not being met. Instead, the economy was facing financial inefficiency, crowding out of the private sector, and the deterioration of the quality of assets, in addition to the rising vulnerability of financial institutions (Zahid 2000). The role of the State Bank of Pakistan as the central bank had also been considerably weakened due to the presence of the Pakistan Banking Council, which also exercised supervisory control over banks. The duplication of the supervisory role was diluting the State Bank of Pakistan's enforcement of its regulations over the nationalized commercial banks.

In April 1989, the Pakistani government appointed a British firm M/s N.M. Rothschild as consultants to undertake a study on the privatization strategy the government should pursue. In May 1989, the consultants submitted a report titled "Privatization and Public Participation in Pakistan", which recommended privatization on widespread ownership basis as an appropriate strategy for Pakistan (Husain 2004; International Monetary Fund 2005; Zahid 2000). By "Widespread Ownership" the consultants intended development of Pakistan's capital markets by bringing hundreds of thousands of small savers into share ownership for the first time. The report, however, warned that the participation strategy should be carefully structured so as to avoid over ambition on price or size, inadequate preparation, inappropriate regulation, insufficient marketing and lack of communication with the workers.

The consultants also suggested that a new department should be established under the Ministry of Finance to co-ordinate the complex transactions involved in wide spread offers. The establishment of the new department was also recommended on the grounds that it would be helpful in implementing future privatization programme of the Government. The report also indicated the need of financial restructuring of the units identified for privatization, in order to make them an attractive proposition. It further suggested the need of adopting special techniques, new procedures and incentives to attain wide dispersal of offers both within the country as well as abroad (Zahid 2000).

In 1990, a Committee on Disinvestment and De-regulation was formed. The Committee in its preliminary report, submitted to the government in January 1991, recommended the disinvestment of 118 industrial units, which included 45 nationalized units taken over during the period 1972-74 (Husain 2004). The government approved this disinvestment plan and announced the creation of a Privatization Commission to implement the disinvestment programme within the shortest possible time. At the same time, a Cabinet Committee on Privatization, with the Minister for Finance and Economic Affairs as its Chairman, was constituted to approve the recommendations of the Privatization Commission.

The dominance of public sector banks at the beginning of the nineties was apparent with a share of 92.2 per cent of the total assets of the banking sector. The remainder belonged to foreign banks, as domestic private banks did not exist at that time. By 30 June 1990, a total of 24 commercial banks (7 domestic and 17 foreign) were operating in Pakistan. Domestic banks, with absolute public sector ownership and a broad branch network, were catering to most of the commercial banking needs of the economy (Zahid 2000). But despite the dominance, the nationalized commercial banks were characterized by high intermediation costs; over-staffing and over-branching; huge portfolio of non-performing loans, poor customer services; poor management; narrow product range; and undue interference in lending (Baig 2000). The weakness in the supervisory system and the impact of political favours came to light further with the collapse of the Bank of Credit and Commerce International (BCCI), which had received support from the Pakistani government and was allowed to operate without much scrutiny of its operations.

To prepare the public sector banks for privatization, the government took a number of steps. The government made amendments in the Banks (Nationalization) Act of 1974 paving the way for privatization of the nationalized commercial banks and allowing entry of foreign banks in the country. The Pakistan Banking Council was abolished in January 1997, handing over supervisory powers to the State Bank of Pakistan. Other steps included equity injection of Rs46 billion in some of the public sector

banks and write offs equivalent to Rs51 billion, lay off of close to 35,000 employees in two phases from public sector banks and closing of over 2000 unbanked branches (Husain 2004). To reduce the level of non-performing loans, the Government and the State Bank of Pakistan coordinated to establish the 'Committee for Revival of Sick Industrial Units' and the 'Corporate and Industrial Restructuring Corporation' which enabled debt recovery of over Rs15 billion.

The then Governor of State Bank Dr. Ishrat Husain (Husain 2004) underlined the uniqueness of Pakistan's political influence in economic matters. The implementation of the privatisation was undertaken during the regime of General Musharraf, who took over control of the government in 1999 in a military coup and subsequently was elected as the President of Pakistan. Addressing a conference in Washington, Husain (2004, pp.9-10) stated:

"It is illustrative to understand the political economy considerations also. All of the above tough measures were taken during the military regime headed by General Musharraf. It must be recognized that these were not easy decisions that could be carried out under an elected representative government and a well functioning parliament. There would be all kinds of pressures on the elected leaders not to close the branches or shed off the redundant workers or to transfer the NPLs at a discount or issue the tax refund bonds. These were the tough measures that the President was convinced were necessary to prepare the banks for privatization and secure a decent buyer at a reasonable price. It is not therefore obvious that this experience would be amenable to replication under a different set of political regime".

By March 2004, the share of the assets owned by nationalized commercial banks had declined to 18.6 per cent while those of the private sector banks jumped to 76 per cent. This included the share of foreign banks, which had increased from 7.8 per cent in 1990 to 10 per cent (Husain 2004).

6. Summary and conclusion

The nationalization of the Pakistani banking sector in the 1970s was undertaken with the aim of ensuring the spread of wealth, away from a select few to the majority of the people. The decision was politically motivated and matched the political platform of the new government of Zulfikar Ali Bhutto and was made without evaluating the impact of such an action. Prior to the nationalization, the banking sector in Pakistan had been successful and the economy was strong. The separation of Bangladesh from the country was blamed partially on the economic disparities between

the rich and the poor. The nationalization process left the banking sector with five main nationalized banks and a new regulatory body called the Pakistan Banking Council. A change in government and priority meant that the banking sector was left to deal with the new structure without any checks and balances. The inefficiencies in the banking sector were fast becoming obvious and the government in the 1990s decided to privatize the banking sector and open it up to competition from foreign banks. The sector is now more efficient with more choices available for consumers. The Pakistani experience highlights the folly of politically motivated decisions. The banking sector in Pakistan experienced decades of uncertainty, a huge fall in performance and reputation, and brain drain due to nationalization. The privatization of the banking sector has helped restore some of the consumer confidence and introduced much needed competition. The experience of this sector should act as a lesson for Pakistan and other countries contemplating nationalization of efficient industries and other economic sectors.

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