BANKING REFORMS

1972

HIGHLIGHTS

The following are the highlights of the wide-ranging bank reforms, announced by the Finance Minister, Dr. Mubashir Hasan.

** *Control of the State Bank of Pakistan over the scheduled banks will be strengthened in order to end banking malpractices.*

** *The State Bank is empowered to disband board of directors of any bank, indulging in malpractices or misusing bank funds and credit for their own benefit.*

** *Steps have been taken to break the interlocking system prevailing among the big industrial business magnates and the banks.*

** *Collusion of banks with big business will be detected and made difficult.*

** *The capital base of the banks will progressively be enlarged to ten per cent of their deposits.*

** *To check banks' tendencies to give large advances to a select few, it has been decided to introduce a system of ceilings on borrowings from banks.*

** *The banks have been prohibited from making advances against stocks and shares to their directors and their family members, and from undertaking any transactions with them for sale and purchase of shares.*

** *Banks will not be allowed to write off big credits, without permission from the State Bank.*

** *A Credit Information Bureau will be established to collect information on indebtedness of individual parties.*

** *A National Credit Consultative Council will be created to ration credit for various sectors.*

** *The Agricultural Development Bank will be asked to expand and establish its branches at all tehsil headquarters.*

** *The Agricultural Development Bank and co-operative banks will be asked to provide large amount of credit to small farmers who will acquire land under the recently announced Land Reforms.*

BANKING REFORMS 1972

TEXT OF FINANCE MINISTER'S SPEECH

I am addressing you tonight to announce details of reforms in the banking system of Pakistan.

Before outlining the scheme of the reforms I would like to tell you that over the last 24 years, the banking system has undergone a phenomenal expansion. The number of branches of the scheduled banks in Pakistan have increased from 195 in 1948 to over 3,600 in 1972. The deposits have increased from Rs. 88 crores in 1948 to over Rs. 1,600 crores in 1972. The bank credit recorded an increase from Rs. 20 crores in 1948 to Rs. 1,250 crores in 1972. Seventy one branches of Pakistani banks are operating abroad.

While the banks flourished, the banking system became an instrument of aggravating inequalities of income and wealth in the country. The distribution of bank credit favoured those with large accounts. Concentration of economic power brought in its fold many evils that are known to all of us. Unbridled capitalism fed on it. In March 1971, over 30 per cent of the total scheduled bank advances were given in the account brackets of Rs. 50 lakhs and above. In December 1971, the two cities of Karachi and Lahore had 673 branches out of a total of 2,397 branches in West Pakistan. These two cities also accounted for 52 per cent of the total deposits and 69 per cent of the total advances of scheduled banks. Cruel distortions existed in the distribution of credit. It tended to concentrate in the manufacturing and commercial sector, though 43 per cent of the national income is contributed by agriculture it receives only 10 per cent of the total bank credit.

Large scale malpractices exist in the banking system. Underhand methods used by the banks to capture deposits took several forms, such as bestowing of undue favours on those in control through gifts—constructing houses for them and giving them unsecured advances and even financing holiday trips abroad. Malpractices include charging of commission by the bank managers on loans advanced. Banks also provided capital finance to their favoured customers without an unbiased appraisal of the project. In many cases, bank resources have been used by bank directors, executives and employees for personal ends. Banks are also known to have issued indiscriminate guarantees to their favoured customers without readily realisable security. While their business expanded very rapidly, adequate attention was not paid to the need for augmenting their capital and reserves commensurate with the expansion of their business. The banks have also been reluctant to step-up their deposit rates while they have steadily increased their advance rates, thereby widening their profit margin.

Another aspect of unhealthy development in the banking system is its ostentation in complete contrast to the poverty in the country. Banks are known to offer salaries and expansive perquisites to officials quite out of proportion with their qualifications and experience. In addition large sums of money that should benefit the bank customers are wasted on palatial buildings, lavish entertainment, ceremonial functions and maintaining a fleet of luxury cars.

The failure of the banking system in these areas has remained a cause of concern for the whole nation. Although State Bank of Pakistan was supposed to exercise a certain degree of control over the banking system, the efforts did not yield the desired results. The concentration of economic power in the hands of a few kept on growing. Banking in the country is characterised by the interlocking of ownership. A few big family groups own and control a large share not only of the industrial and commercial undertakings but also of financial assets in the country. It makes collusion of banks with big clients easy to occur and difficult to detect.

It is clear that far reaching changes are needed in the organisational and management systems of the banks in order to enable them to serve the needs of the economy better than in the past. Efficiency and soundness of the banking system badly needs improvement. The system must be purged of the malpractices. The powers currently available to the State Bank under the Banking Companies Ordinance to control the management of the banks are insufficient and do not lend themselves to effective use. It has, therefore, been decided that suitable amendments should be made in the Banking Companies Ordinance to strengthen the control of the State Bank on banks' management.

The State Bank would be empowered, under the new regulations, to remove, directors or other managerial persons and to supersede the Board of Directors of a banking company and appoint administrators during the period of such supersession. Action under this provision may be taken, in case of mismanagement, by the Governor on the report of a Standing Committee to be specially appointed by the State Bank for the purpose. Appeal against orders of the Governor will lie with the Board of Directors of the State Bank. The State Bank would also be empowered to nominate a director on the Board of Directors of every private bank. The nominated directors would not be having any connection with a banking company or a cooperative bank. It would also be specified that no person can serve as director of a bank for more than six years at a stretch, and any director of a bank who defaults in meeting his obligations to the bank would forfeit his directorship.

In some cases banks employ directors and other high executives on fat salaries and lavish perquisites. It has been decided to direct the banks not to employ their directors, except as chief executives. No payment should be made or perquisites provided to directors other than travelling and daily allowance for attending meetings.

It has been decided that banks should be required over a period of time to have a paid up capital of not less than 5 per cent of their deposits as against the present average ratio of less than 3 per cent. The aim would be progressively to bring up the capital base of all banks to 10 per cent of their deposits. At present the banks do not have any obligation to transfer profits to the reserve fund after the amount in the reserve fund has equalled the paid up capital. It would be made obligatory for the banks to transfer 10 per cent of the profits to their reserve funds every year after the reserves become equal to their paid up capital.

Banks are known to provide preferential credit facilities, both in respect of quantum and terms, to their directors and their business. The banks' resources have also been found to be misused by bank executives and employees. Some banks have also got excessively involved in wrongly financing individual projects and parties. To remedy this it has been decided to introduce a system of ceilings on borrowing from banks. It will be related to their paid up capital and reserves. It will cover individual borrowers, bank directors and their concerns and bank executives and employees. Officers and employees of banks will not be permitted to borrow in excess of the limits which are being prescribed. Unsecured loans to directors, their families, firms and companies would not be permissible.

To check excessive credit facilities against stock and shares and to reduce the concentration of economic power, it has been decided to prohibit the banks from making advances against stocks and shares to their directors and their family members and from undertaking any transactions with them for sale and purchase of shares. It is also being laid down that the " controlling groups " of shareholders, other than banks' directors and their families, of any company shall not be entitled to borrow against their shares beyond limits to be prescribed.

There are instances where private limited companies sponsored by the directors of the banks are given advances out of proportion to the credit worthiness of the companies. It is proposed to make the directors directly and personally responsible for such loans by directing the banks not to give advances without a personal guarantee of the directors of the companies. The guarantee will be in addition to other securities normally obtained.

The audit of banks at present serves a very limited purpose. It is proposed to widen the scope of the responsibility of the auditors by suitable amendments in the Banking Companies Ordinance. It will be laid down that auditors should be appointed by banks from a panel on the approved list of the State Bank. It will be further provided that the tenure of office of the auditors shall be for 3 years. No premature retirement of the auditors without the prior approval of the State Bank will be allowed.

Another form of malpractice indulged in by the banks is to give unsecured loans to favoured parties at concessional rates without ever expecting them to be repaid. It is proposed that the banks should be directed not to write off any loans exceeding certain limits due from a borrower without prior permission from the State Bank. The State Bank will also set up a Credit Information Bureau to collect information about the indebtedness of the individual parties. The Bureau will supply the information to the banks and other credit institutions, on request, in a consolidated form without disclosing the names of the lending institutions. On the basis of the information thus supplied by the Bureau it will be possible for the banks and other institutions to regulate their lendings to individual parties or groups in order to avoid excessive lending.

In order to bring about a more equitable and purposeful distribution of bank credit a number of measures are proposed. It has been decided to set up a National Credit Consultative Council with representatives from the Government and the private sector. At the commencement of each financial year the National Credit Consultative Council will draw up an integrated credit plan within the safe limits of monetary and credit expansion. After the Annual Plan has been approved by the National Economic Council, the National Credit Consultative Council will sub-allocate the available credit to the various sectors and regions in conformity with the priorities and targets set in the Annual Plan. Additional measures would be taken to improve the flow of credit into sectors such as (a) agriculture (b) small borrowers (c) non-traditional exports and (d) housing which do not at present enjoy adequate credit facilities. In particular, measures will be taken to bring greater participation by the commercial banks in agricultural finance. The Agricultural Development Bank would be required to embark on various expansion programmes to cover at least the tehsil headquarters within a reasonable period. The Agricultural Development Bank and co-operative banks would be required to make special arrangements to meet the credit requirements of the small farmers who will acquire the ownership of land under the land reforms recently announced by the Government.

Public Demand Recovery Act is being amended to allow banks the powers of having their agricultural loans recovered as arrears of land revenue. To enlarge the flow of credit to the small man the credit plan to be prepared by the National Credit Consultative Council would set a specific target for the purpose and this will be distributed amongst different banks. Any bank failing to fulfil the target will be required to deposit the amount of shortfall in an account with the State Bank free of interest. To cover the risks involved in small loans and agricultural loans the State Bank would introduce a guarantee scheme to provide guarantees to the commercial banks on 50—50 basis for which a Guarantee Fund would be created in the State Bank.

While the traditional exports get adequate credit facilities, there is a paucity of credit for the newly emerging exports. The scope and coverage of the Export Credit Guarantee Scheme being operated by the Pakistan Insurance Corporation is also being examined with a view to making necessary improvements to help the drive for increased exports. To provide for maximum coordination among various agencies connected with export credit a standing committee having representatives of the private and public sectors is being constituted.

It is expected that these reforms will go a long way in making the banking system serve the needs of the less privileged people of Pakistan.

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