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Impact of COVID – 19 Pandemic: Government Relief Package and Likely Misallocation of Loans in Pakistan

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Abstract

This study argues the likely misallocation of capital in Pakistan associated with the perverse incentives faced by banking institutions to provide additional loans to weak businesses and households. Businesses and households are more likely to receive additional bank financing if they are financially constrained because (a) financial intermediaries in Pakistan have an incentive to allocate funds to weaker borrowers to avoid the realization of non-performing loans on their financial statements, and (b) the financial regulator's relief package for commercial banks to sidestep deleveraging that will hamper economic growth arising from COVID-19 pandemic. This study hypothesizes that a potential 'ever-greening' behaviour would be more observable among financial institutions that have capital adequacy ratios close to the regulatory minimum requirement, and the policy of forbearance on extending funds by banks will be compounded due to the existence of deposit insurance scheme. However, the evidence suggests that the banking institutions in Pakistan have not adopted the policy of forbearance despite the announcement of incentives by State Bank of Pakistan (the central bank) - commercial banks preferred to park their excess liquidity in government securities in the face of global pandemic. Moreover, the findings of this study are not conclusive due to the availability of aggregate commercial banks data and short sample period.

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INTRODUCTION

The severe global pandemic represents one of the major economic events of the 2020.[2] This 'once in a century' event and oil price war between Riyadh and Moscow[3] resulted in the collapse of the Pakistan stock exchange. On the other hand, Pakistan's economy showing very little progress since 2016,[4] and even till writing of this paper, with most of the country under lockdown, the economy shows little evidence of returning to the robust health. This study primarily touches upon an important factor that might contribute further to this

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[2] The World Health Organization (WHO) declares coronavirus a global pandemic, urges aggressive action see https://apnews.com/52e12ca90c55b6e0c398d134a2cc286e
[3] See https://www.foxbusiness.com/energy/saudi-aramco-oil-capacity-russia-price-war
[4] See https://thediplomat.com/2019/04/pakistans-economic-woes-the-way-forward/

economic disorder: the misallocation of loans by commercial banks. Following the announcement of a comprehensive relief package by State Bank of Pakistan (SBP) to counter the impact of COVID-19 on March 26, 2020,[5] commercial banks in Pakistan have incentives to continue making funds available to households and businesses with poor financial health, shielding those borrowers from market forces which otherwise would face restructuring or insolvency.[6] Interestingly, a theoretical study by Kobayashi, Nakajima, & Takahashi (2020) derived the inefficiency of loans from the demand side; whereby due to series of economic shocks, the borrower's outstanding debt exceeds the maximum limit, he or she can repay. That is, it is the depressed demand for additional loans by the borrower that causes the misallocation. However, this study focuses on the supply of new or additional financing by banking institutions.

For households, bankruptcy is a conduit to remove financial pressure: the law can stop collection efforts and reduce or discharge debts in exchange for assets or future cash flows. For businesses, bankruptcy resets the negotiation table with lenders: Companies are given interval to renegotiate debts, restore operations, renegotiate agreements, and suggest a repayment schedule consistent with their ability to pay (Morrison & Saavedra, 2020). Extant literature documents ever-greening of loans in parts of the euro area during the crisis (Blattner, Farinha, & Rebelo, 2019). In contrast, during this ongoing crisis, the EU finance ministers were unable to develop consensus on further economic rescue aid and credit lines – a stand-off between financially ailing southern European states and fiscally conservative north; the northern block insisted Eurozone credit should come with conditions.[7]

In sharp contrast to the bank capital crunch experienced in the United States in the 2007-08 Global Financial Crisis, where the troubled banks chose to tighten their lending standards and reduce lending (i.e., credit crunch); this paper assumes that the domestic banks in Pakistan are more likely to increase loans.[8] This argument is straight forward, in part, because bank regulation in Pakistan (i.e., the announcement of relief package) provides banks that will potentially observe growth in nonperforming loans and reduction in the capital;[9] have little incentive to be strict with distressed borrowers. If the banks do not extend financing facilities to their distressed borrowers, those borrowers will not be able to make the interest payments required to keep their loans active and may even be forced into liquidation, in either case requiring banks to increase their reported problem loans.[10] Moreover, Correia, Luck, & Verner (2020) investigated the economic consequences of an influenza pandemic

[5] See http://www.sbp.org.pk/press/2020/Pr-26-Mar-20.pdf
[6] This short research paper analyzes the possible problems that may arise from relief package announced by SBP and policy of forbearance by commercial banks; that would subsequently short-circuit the economic recovery process.
[7] See https://www.kitco.com/news/2020-04-08/EU-ministers-fail-to-agree-coronavirus-economic-rescue-in-all-night-talks.html
[8] SBP relaxed the regulatory limit on extension of credit to SMEs from PKR 125 million to PKR 180 million per SME. This measure facilitates banks to provide more loans to SMEs, which might be losing money because of lockdown.
[9] SBP has reduced the Capital Conservation Buffer (CCB) from its existing level of 2.50% to 1.50%. This will enable banks to lend an additional amount of around PKR 800 billion.
[10] Banks are asked to defer the payment of principal on loans and advances by one year. The borrowers will, however, continue to service the mark-up amount.

by exploring non-pharmaceutical interventions (NPI). Using the topographical difference in mortality during the 1918 Spanish Flu Pandemic in the U.S., they find that more exposed cities experienced severe and persistent deterioration in economic activity. The estimates suggest that the pandemic reduced manufacturing output by 18%, and the recession is driven by both supply and demand-side channels. Hence, it will be in the self-interest of the banks to follow a policy of leniency with their problem borrowers to avoid the increase in their loan loss reserves and further weakening their capital.[11]

This leads to a strategy of banks' 'ever-greening' of loans, whereby a banking company provides additional funds to a distressed business and household so it will continue to service the mark-up amount on outstanding loans to postpone insolvency. By keeping the loan regular, the banks' balance sheet looks healthier, since the bank is not required to report such problem loans in its nonperforming bucket.[12] However, the chairman of Pakistan Banks' Association (PBA) is of the view that banks have no problem of liquidity crunch for six months amidst coronavirus outbreak[13] - a debatable claim. On the other hand, an association of small and medium enterprises (SMEs) in Islamabad called on the government to finalize a package for the coronavirus hit SMEs to save them from default.[14] The aforesaid statement suggests that highly leveraged businesses and SMEs have already started showing cracks.

Although banks have a reason to ever-green loans, their ability to follow such policies aggressively requires regulatory support. The government of Pakistan, faced with a growing budget and current account deficit and afraid of funding bank bailouts, has an incentive to allow, or even inspire, banking institutions to continue their policies of leniency to sidestep the alternative scenario of massive business, and perhaps bank failures, and especially the related financial and political costs.[15] For example, misallocation of funds in Japan as a result of perverse incentives encountered by banking institutions to extend additional loans to the weakest borrowers (Peek & Rosengren, 2005).

In contrast to the prior evidence, this study finds that financial intermediaries are not extending additional funds to their existing borrowers, at least in the short run. The non-adoption of the policy of leniency by financial lenders despite the government incentives, relatively low-interest rate scenario, and availability of deposit insurance suggests that, so far, banks are not facing any liquidity issues and prefer to invest in risk-free government securities rather than providing additional loans to their weaker clients. Moreover, we have analyzed the combined commercial banks' data to examine the hypotheses that comprise of large, medium and small banks. Hence, the documented evidence of this paper by utilizing aggregate data and small event window (i.e., four-month) cannot be generalizable. This study contributes in several ways; i.e., first, the study examines the impact of the relief package

[11] Due to steep decline in share prices, SBP reduced margin call requirement from 30% to 10% (vis-à-vis banks' financing against listed shares).
[12] On top of it, as per SBP relief package, loans that are res-scheduled/ restructured within 180 days from the due date of payment will not be treated as defaults. Banks are also not required to suspend the unrealized mark-up against such loans. In addition, the timeline for classification of 'Trade Bills' is also extended from 180 to 365 days.
[13] See https://www.dawn.com/news/1547365/banks-good-to-go-for-six-months-says-pba
[14] For example, see https://tribune.com.pk/story/2193764/2-small-medium-units-brink-default/
[15] The relief package announced by SBP clearly suggests such scenario.

announced by the central bank of Pakistan on the banking institutions. Second, this study is conducted at the height of the global outbreak, which has occurred after almost one-hundred years (i.e., Spanish flu of 1918-19); and third, this crisis is different from earlier crises, as it does not arise because of excessive risk-taking by financial markets and institutions. However, the only limitation of this study is the non-availability of bank-level data.

The rest of the study is structured as follows: Section 1 briefly talks about the banking sector of Pakistan. Section 2 discusses the perverse incentives that may trigger the banking crisis. Section 3 argues the role of the depositor protection scheme. Section 4 describes the data and empirical results, and Section 5 concludes this study.

The Banking Sector Performance in Pakistan

The central bank of Pakistan expressed satisfaction on the banking sector performance for the half-year ending June 2019. Despite challenging macroeconomic environment, the banking sector in Pakistan able to maintain its growth trajectory, largely, backed by decent growth in deposits. However, due to slowdown inflow of advances and tilt of the government borrowing to the central bank, most of the growth in assets is reflected in the increase of end period 'cash and balances' (i.e., excess liquidity). Among the advances, the flow of private-sector advances observed a broad-based slowdown owing to subdued economic activity and continued monetary tightening, while the flow of public sector advances declined due to lower utilization of commodity financing and retirement of energy sector advances. It is pertinent to mention that asset quality saw some deterioration, with increased volume and share of non-performing loans, particularly in agriculture and energy sectors. While investments observed a marginal rise, banks renewed their interest in long-term Pakistan Investment Bonds (PIBs) due to favourable interest rate dynamics.

Moreover, SBP suggests that the overall risk profile of the banking sector remained satisfactory until June 2019. The resilience of the banking sector remained robust as the Capital Adequacy Ratio (CAR) at 16.1 per cent was well above the local and international minimum benchmarks of 11.9 per cent and 10.5 per cent, respectively. Lastly, SBP hinted that with the approaching deadline, banks need to ensure effective implementation of their plans for meeting the enhanced capital requirement of 12.5 per cent by end December 2019.[16] Therefore, based on the aforementioned report, this study assumes that with enhanced capital requirement since January 2020, some banks will remain under immense pressure to maintain the required capital adequacy ratio due to ongoing pandemic crisis.

Perverse Incentives and Banking Crisis

The main hypothesis discussed in this paper is that it is in the best interest of financial intermediaries to follow a policy of leniency with their distressed borrowers to bypass reporting non-performing loans, as long as bank regulators allow relaxing loan quality standards. Thus banking institutions, following the announcement of relief package, can avoid a mandatory increase in loan loss provisions by extending additional financing to the businesses and households that enable them to make mark-up payments on the outstanding loans from the bank and to dodge declaring bankruptcy. Especially, in the past, businesses with trade channels are worst affected by the Asian flu and the Russian virus (Forbes, 2004);

[16] See http://www.sbp.org.pk/publications/HPR/H1CY19.pdf

since import and export of merchandise and services cause transmission of crises internationally. However, this Covid-19 pandemic is similar to the Spanish flu that adversely affected almost all the countries albeit with slight variations. Resultantly, a banking institution may continue lending to distressed businesses to keep otherwise financially insolvent companies buoyant. This ever-greening of loans aids the borrower because it can at least delay restructuring of business. Therefore, it also enables the financial intermediary to delay a further increase in its reported classified loans, which would deteriorate the bank's profits, and thus equity. Such practices, particularly during a time of reduced bank lending to the private sector and global pandemic, would appear as increases in loans to the weaker firms. Moreover, given the drastic reduction of 225 basis points in the policy rate by SBP on March 24, 2020; it does not require sizeable amounts of additional financing to enable distressed businesses and households to service their mark-up payments to remain solvent.

This discussion suggests several associated hypotheses about Pakistani banks' expected lending behaviour in the face of the pandemic. The ever-greening hypothesis says that banks may act in their own best interest by extending additional financing to weak borrowers to avoid loan losses (Peek & Rosengren, 2005). The 'balance sheet cosmetics hypothesizes that the motivation for a financial intermediary to extend additional financing to distressed businesses and households to which the banking institution has outstanding exposures increases as the bank's capital adequacy ratio approaches its minimum required level (Peek & Rosengren, 2005). That is, it is appearance rather than the genuineness of adequate capital that is critical, even though it is mentioned in the banking sector review (in the aforementioned Section) that capital ratios of banks in Pakistan are well above the local and international minimum benchmarks. However, capital ratios for some small and medium-sized banks are just adequate.

Deposit Protection Corporation – Government Safety Net

In June 2018, State Bank of Pakistan issued guidelines for deposit insurance. A robust financial stability framework is necessary for the growth of financial infrastructure and for enhancing public confidence in the system. Deposit protection schemes, globally, are cornerstones of such frameworks. In this context, the Deposit Protection Corporation (DPC) was established to protect small depositors of banks operating in Pakistan. An amount of PKR 250,000/- (Rupees two hundred fifty-thousand only) per depositor per bank was determined by DPC as the guarantee amount in case of bank failure.

Although a government safety net can help protect depositors and other creditors and prevent banking crises, the most serious drawback of the safety net stems from moral hazard, the incentives of one party in a transaction to engage in activities detrimental to the other party. Moral hazard is a major concern related to government arrangements to provide safety nets. With a safety net, depositors know they will not suffer losses if a bank fails, so they do not impose the discipline of the marketplace on these financial intermediaries by withdrawing funds when they suspect that the lender is taking on too much risk. Consequently, banks with a government safety net have an incentive to take on greater risks than they otherwise would, because taxpayers will foot the bill if the bank subsequently fails (Mishkin & Eakins, 2018). Moreover, due to declining capital base of banking institutions in the face of the severe pandemic with the time, banks will have 'less skin in the game'; which again give rise to moral hazard risk.

Therefore, the existence of explicit deposit insurance in Pakistan and depleting bank capital allows banks/bankers to continue with forbearance behaviour by extending additional funds to distressed businesses and households, and avoid booking loan losses on the balance sheet. Similarly, the central bank's role as the lender of last resort, although has the benefit of preventing bank and financial panics, but it does have a cost. If the banking institution knows that State Bank of Pakistan will provide it with discount loans when it gets into trouble, it will be willing to take on more risk knowing that the SBP will come to the rescue. Thus central bank's lender-of-last-resort role has hence created a moral hazard problem like the one created by deposit insurance. On the other hand, the moral hazard problem is severe for large-size commercial banks, which might believe that they will always receive loans from the central bank because SBP view them 'too big to fail'; since a failure of a single large financial intermediary would be likely to precipitate a bank panic. Therefore, the policy of forbearance can be equally applicable to large lenders. However, the principles discussed above depends on the actual data observed for all commercial banks (i.e., not bank-level) over a short period.

RESULTS AND DISCUSSION

The monthly data is obtained from State Bank of Pakistan (i.e., the central bank - SBP) from the week ending December 20, 2019, to April 17, 2020. We extracted data after a gap of every 4-weeks from the commercial bank balance sheet. In this study, we analyzed month to month data of three constituents of the asset side of all commercial banks' balance sheet data. That is, (a) Gross advances, (b) Loan loss provisions, and (c) Investments. Panel A of Table 1 shows that gross loans have not increased at the peak of the pandemic in Pakistan, i.e., following the decline of total 425 bps monetary policy rate in March, and the announcement of major relief package by SBP on March 26, 2020 (and series of few other relief measures in the first week of April 2020) The trend in gross advances is also shown in Figure 1. Perhaps, the gross advances decreased by 0.05% on April 17, 2020, from the previous month (i.e., March 20). Similarly, we document an increase in non-performing loans and thus increase in provisions by 1.08% as of April 17, 2020 (a growth in number since March 20, 2020) in Panel B of Table 1, which is obvious due to prolonged lockdown that constrained the operations of small and medium enterprises and cash flows of highly leveraged big firms. The monthly trend of loan loss provisions is depicted in Figure 2.

Table 1. All Commercial Banks – Domestic Operations (Rupees in Million)

Panel	Jan 17, 2020	Feb 21, 2020	Mar 20, 2020	Apr 17, 2020
Panel A				
Gross Advances	7,968,220	8,008,224	8,076,278	8,072,610
Growth in %	0.40%	0.50%	0.85%	-0.05%
Panel B				
Provisions	(488,284)	(498,332)	(498,982)	(504,400)
Growth in %	0.29%	2.04%	0.13%	1.08%
Panel C				
Investments	8,471,479	8,472,429	9,341,409	9,845,879
Growth in %	-3.10%	0.01%	9.76%	5.26%

Note: This table shows monthly data of all Commercial banks as at close of business on January 17, February 21, March 20, and April 17, 2020. Panel A shows gross advances and its growth in percentage. Panel B depicts loan loss provisions and its growth in percentage, and Panel C presents investments and its monthly growth in percentage.
Source: SBP Weekly Publication (Data were taken at an interval of 4-week to make it monthly)[17]

Based on the data, we conclude that banks in Pakistan, on average, are not taking an excessive risk by providing additional funds to already distressed businesses and households. The financial intermediaries are parking their excess liquidity in the risk-free government securities, which is depicted in Panel C of Table 1 where Investments for the period ending April 17, 2020, has increased by 5.26% from the corresponding previous month – the graph of Investments is shown in Figure 3. Overall, the evidence suggests that banks have not adopted the policy of forbearance by extending financing to weak borrowers, even though SBP announced a comprehensive relief package for commercial banks, availability of explicit deposit insurance scheme and existence of discount window by SBP as a lender-of-last-resort. However, the results need to be interpreted with caution due to a short event window and use of aggregate banks data.

[17] See http://www.sbp.org.pk/publications/press_comm/2020/index2.asp

Figure 1. Gross Advances (Rupees in Million)

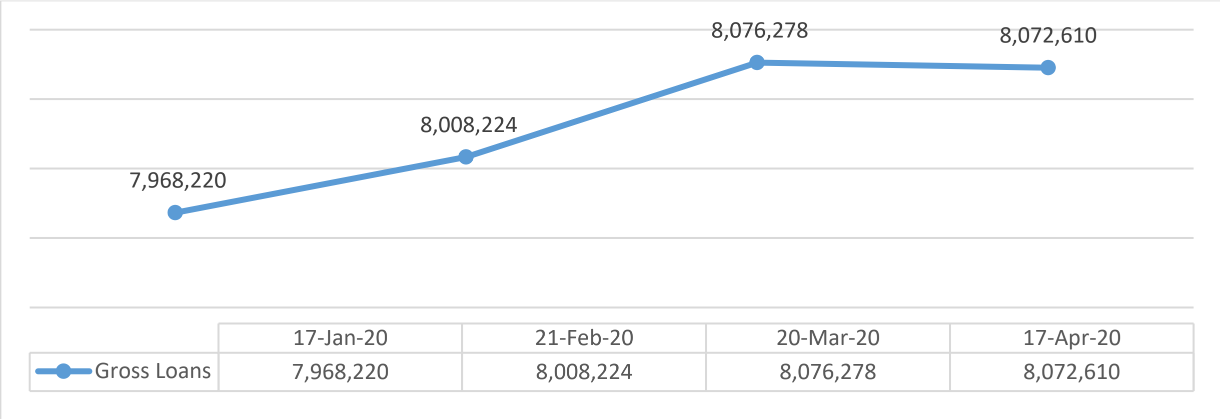


Figure 2. Provisions against NPLs (Rupees in Million)

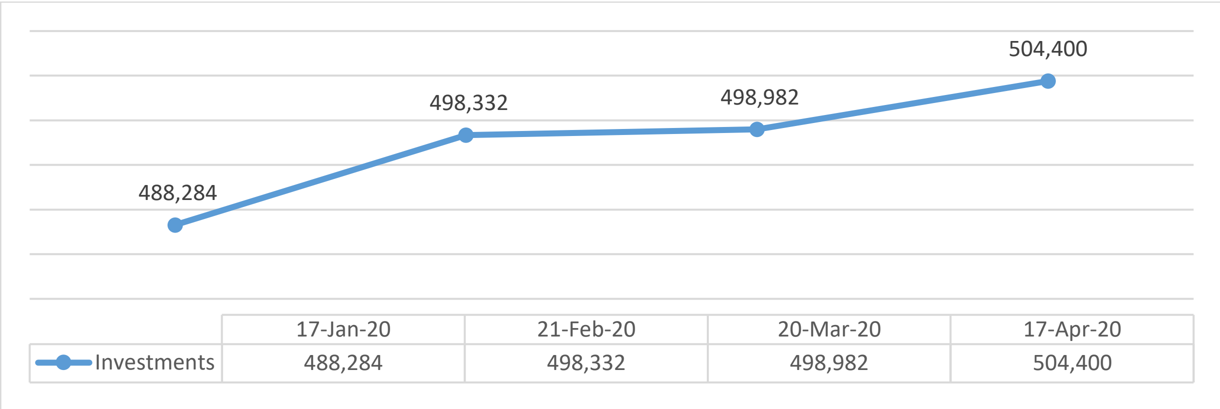
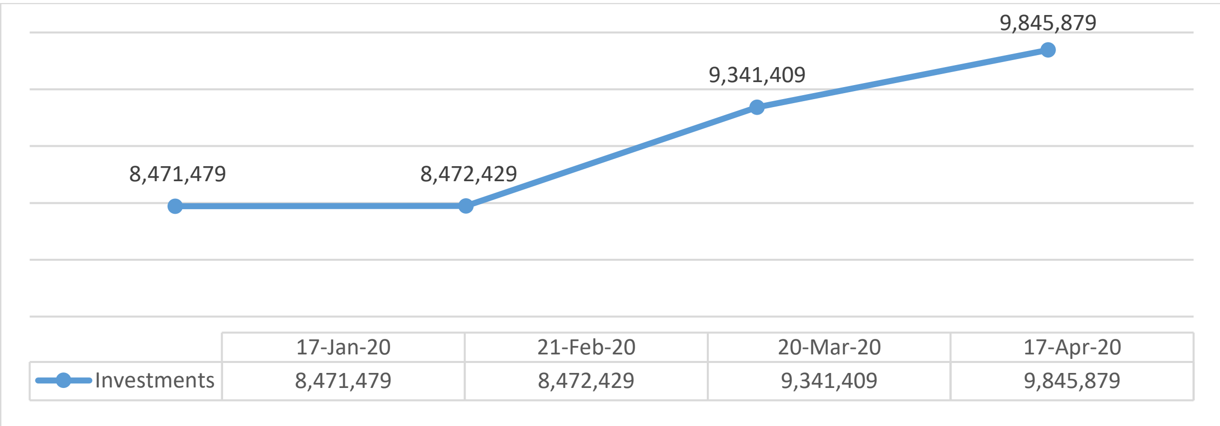


Figure 3. Investments (Rupees in Million)



CONCLUSION

This study investigates empirically (albeit with limited data) how commercial banks in Pakistan respond to relief package to increase loans to potentially distressed businesses and households, even if the borrowers might not be economically viable and the loans, on average, are unlikely to be profitable to the lender. Some of these incentives are internal to the lenders attempting to limit the growth in loan losses on their balance sheets to maintain the minimum required capital adequacy ratio. External incentives emanated from SBP relief package for the banking sector to supply additional loans to businesses and households, to avoid an even bigger surge in unemployment and borrower liquidations, as well as containing the financial costs that may arise from buying the toxic assets of especially public sector commercial banks. The political concern would be that the taxpayers have to foot the bill of bank bailouts that would undermine the credibility of the government. In particular, through the announced relief package, commercial banks are allowed to understate their loan loss provisions and not to suspend the unrealized mark-up against restructured loans, resulting in bank net income, and therefore capital ratio, is overstated.

Moreover, this study tests three specific hypotheses: (a) lenders are acting in their own best interest by ever-greening loans to the distressed businesses and households; (b) balance sheet cosmetics are important insofar as the motivation for commercial banks to ever-green loans increases as their reported capital adequacy ratio approaches their required minimum; and (c) existence of explicit social safety net, i.e., depositor protection scheme. With limited data and small sample period, the study finds no support for each of these three hypotheses. Banking institutions in Pakistan are not practicing the ever-greening, even if, on average, the reported capital ratio is close to its required level; which could be the case since the start of 2020 due to enhanced mandatory capital ratio requirements and growth in commercial banks' non-performing loans. Therefore, it appears that, by not extending additional financing to distressed borrowers, Pakistani banks might not be responding to government/regulator's relief package and just parking their excess liquidity in government securities, i.e., crowding out by public sector borrowers at the cost of the private sector, which could be considered a misallocation of capital from another aspect (i.e., governments excessive borrowing to meet fiscal deficits), whereby the consequences can be observed in the medium to long term.

The relief package announced by SBP has not allowed financial intermediaries to extend additional financing to distressed businesses and prevent the desired restructuring of non-financial companies. While the ever-greening of loans in Pakistan during pandemic could have insulated many distressed businesses from market forces and may have inhibited a bank capital crunch; that behaviour nonetheless has not been observed. Thus, financial intermediaries by not allocating funds to businesses and households with less-than-stellar prospects, will not short-circuit the economic recovery following the end of coronavirus outbreak. For example, Kwon, Narita, & Narita (2015) show that perverse incentives of banks could hinder the economic growth, due to misallocation, as funds are not diverted for productive purposes. Besides, the presence of social safety net and central bank's role of lender-of-last-resort, banks in Pakistan did not indulge in excessive risk-taking (i.e., heads I win, tails the taxpayer loses). Lastly, by limiting further financing to weak businesses and households, Pakistan economy might witness sustained growth trajectory in future.

AREA FOR FUTURE RESEARCH

In the next phase, the author has planned to do bank-level analysis for the Quarter ended December 2019; March 2020; and June 2020 to analyze noticeably each bank's allocation of capital behaviour before the arrival of pandemic (i.e., December 2019), during the pandemic (i.e., when major policy changes and relief package was announced) and following the application of unconventional monetary policy tools (i.e., as of June 2020). Moreover, the bank-level data help us to understand how different kind of banking institutions behave during the pandemic era; i.e., (a) what was the behaviour of big banks (too big to fail); (b) banks with low capital ratios; and (c) lending criteria of both public and private sector banks and / or conventional and Shariah-compliant banks.

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