

The impact of privatization on the financial performance of banking industry: a comparison of privatized and public banks in Pakistan

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Abstract

This study makes an attempt to compare the financial performance of privatized and public sector banks of Pakistan during the time period of 2005-2012. Using the sample size of 4 privatized banks and 4 public sector banks and implementing the methodology of Kader, Asarpota and Al-Maghaireh (2007), this study measures financial performance by calculating different categories' of ratios and compared the mean differences of privatized banks with public sector banks. The findings of the study indicate that privatized banks are more profitable than the banks which are still in public sector. Secondly privatized banks are better in operating efficiency as all three ratios of operating efficiency provide a significant positive means for privatized banks. Privatized banks provide significantly more advances, have low cash & cash equivalents (liquidity) and have higher debt to assets, debt to equity and equity multiplier ratios than the public sector banks. The findings of this study are consistent with the notion that privatization improves the efficiency of firms.

Keywords: privatization, privatized & public sector banks, financial ratios, financial performance.

1. Introduction

It is necessary to improve the efficiency of every firm operating in an economy. There may be a number of different ways to achieve this objective but one of the popular ways to achieve this objective is privatization. Privatization is done to properly allocate assets and financial resources of firms and is generally considered to increase performance of state owned or public sector firms. Privatization refers to the sale of assets of public sector firms to the general public. As noted by Gabel (1987) the term privatization has two meanings the first: is a financial transaction-the sale of a publicly owned asset to the private sector. The second is the transfer of the authority to make resource allocation decision from the government to the market place. Moyo & Kinuthia-Njenga (1998) define privatization as the entire process of expanding the sphere of the market through a host of regulations that create an enabling environment for free enterprise to operate as a strategy for sustainable economic development. Prior studies support that if there is change in ownership then it will result in greater efficiency. As in case of British Airways ownership change resulted in higher efficiency and due to change in ownership stock prices of their competitors fell compared to British Airways (Eckel, Eckel and Singal, 1997).

The process of privatization was started in 1970s all over the world. At start there were very small numbers of transactions of privatization but very soon it spread all around the world. Privatization became very common and valid because it has great impact on performance and efficiency of firms. Based on this notion, numerous European governments like U.K. Italy, Germany and Spain started privatization programs in the 1990s. Similarly, the Asian countries like China, India and Pakistan also started the privatization process at a small scale. Privatization is becoming more important to reform the structure of firms of developing countries. Majority of countries embarked on privatization process by selling full or partial government stakes and control of public sector firms to general public or private owners.

1.1 Privatization in Pakistan

In Pakistan in 1970s private industries were put under the government ownership. Soon after the nationalization, the financial performance and management of such firms start deteriorating. A need for privatization and reformation of industries was felt because of the loss making of majority of the firms. In Pakistan privatization began in 1988 by partially privatizing PIA. A commission was formed by the then president Zia-ul-Haq but the privatization plan was launched on January, 22, 1991 by the then Prime Minister Nawaz Sharif to support free market and private ownership.

Hardy and Bonaccorsi di Patti (2001) conduct a study on Pakistani banking sector and find a significant improvement in all banks, specially privatized banks, but also note a rise in cost for these banks as well. It was expected that privatization has positive impact in all conditions but there is contradiction in results in some cases. As in 1993-1997 liberalization, reform and privatization of major banks lead superior performance but due to regulatory changes and strict loan policies reform does not resulted positive in 1998-2002 (Bonaccorsi di Patti and Hardy, 2005). For the enhancement of Pakistani banking sector reform was intended to make stronger foundations of governance and financial discipline.

This study aims to compare financial performance of privatized banks with the public sector banks of Pakistan. This study comprises of 4 banks which are currently under private ownership and 4 banks which are still in public sector banks. This study made an effort to differentiate the financial performance of privatized banks and public sector banks. This study compares the financial performance of privatized and state owned banks by a thorough analysis of their financial statements. The financial performance of these banks is measured by calculating different categories of ratios i.e. profitability, liquidity, activity/assets

management, and solvency/debt management. This study is helpful for government to make decisions regarding privatization of state owned enterprises.

1.2 Significance of the study

Privatization is one of the major challenges that are faced by government all over the world. This study will be helpful to analyze the impact of privatization on financial performance of banking industry. This study will be helpful for customers and investors to compare the performance of private and public sector banks regarding their decision to deposits and investments in banks. It is helpful for government to privatize their firms in future and to see its impact on economic growth of country. This study revolves around the comparison of financial performance of privatized and state owned banks. This study is different from the previous studies as this study compares the performance of privatized banks (which were previously in public sector) with banks which still in public sector. It is different from those studies which compares the pre and post privatization performance of the same banks. Such studies have a limitation as the pre and post privatization economic performance cannot be controlled effectively. It is different from the second group of studies which compare the performance of public and private sector banks. Here one cannot associate the difference in performance to privatization as the private sector banks are never been in public sector. The current study aims to address both the issues by comparing the performance of those private banks, which were previously in public sector, with banks which still in the public sector over the same time period. So both groups of banks will be exposed to the same economic and financial conditions. Any differences in the performance of these banks can directly be associated to privatization.

2. Literature Review

The number of privatized firms is increasing day by day. A large body of empirical studies in favor of privatization and a number of opponents are there as well. Arguments in favor of privatization show a positive impact of privatization on financial performance of firms as compare to state owned firms. Sathye (2005) studied the impact of privatization on the performance and efficiency of Indian banks. Results of the study, using mean differences analysis, express that partially privatized banks show constantly enhanced efficiency and performance throughout after privatization.

Public sector ownership is more valuable in case of incomplete contracts as state ownership is capable to enact socially necessary adjustments on enterprises. Adding to this, sometimes in private enterprise conflict of interest between shareholders and regulators may be less beneficial (Laffont & Triole, 1993). Frydman, Gray, Hessel & Rapaczynski (1999) compare the performance of firms under the ownership of government and private firms of central Europe using survey data consist of 506 medium size firms of Czech Republic and Poland. Findings of the study indicate that ownership or possession matters and according to the type of ownership privatization gives different effects. Furthermore the outcome of privatization on revenue performance is noticeable. Kikeri & Nellis (2004) provide evidence from a study, an assessment of privatization, that privatization has a deep achievement in acquiring performance of firms, via properly privatizing and struggle to encourage competition and clearness of sales processes, performance of firms can be improved. Burki & Niazi (2003) analyze cost efficiency due to financial liberalization for the period of 1991-2000. Results of the study suggest that reform enhanced competition and private banks and foreign banks perform batter as compared to public sector banks.

Fries and Taci (2005) investigate cost efficiency of banks. Using data of 15 East European countries which show alliance of smaller banks in region add to larger efficiency and have low cost. Furthermore those private banks perform better than public sector banks especially private banks having greater part of foreign ownership.

Gul, Irshad and Zaman (2011) observe factors affecting profitability of Pakistani banks covering the time period of 2005-2009. By implementing pooled ordinary least square method analyzed the effect of inflation, market capitalization, assets, equity and loans on the capability to earn profit. They conclude that external and internal both factors affect profitability of banks.

Harper (2002) inspects privatization effects on the financial performance and operating performance of enterprises of Czech Republic during 1992-1994, by comparing the performance of privatized companies with the government owned firms. Results show that first wave of privatization generated dissatisfied results. A vivid decline in proficiency, employment and real sales in first wave of privatization, on the other hand, later on profitability increased considerably and is still significant. Dorra & Sonia (2011) investigate the impact of privatization on risk level of banks for the period of 1990-2010 and find that liquidity risk increases due to withdrawal of government's capital from privatized banks and concluded that privatization manage credit risk in a better way rather than solvency and liquidity risks. Das (2002) makes an attempt to analyze the change in risk and productivity of public sector banks. The findings of the study, using data for the period of 1995-96 to 2000-2001, show that less state ownership tend to get better output and performance of banks.

According to Henry (2000) lower cost of capital is associated to high liquidity which comes from financial liberalization. Liberalization decreases the cost of capital of a country and shares risk between domestic and foreigner agents. Vining & Boardman (1992) examine the contribution of ownership in performance in terms of efficiency of publically owned firms using 500 non-financial firms of Canada comprising 93 mix-owned, 12 government owned firms and the remaining as private firms. Controlling some factors, i.e. size and market share, findings direct that privately owned companies are batter in terms of profitability and operating efficiency than publically owned and mix owned companies. Obeid & Bhatti (2011) conduct a study on privatization impact on stock performance of firms using a comparative approach of performance. Their results show that those firms which are privatized have better performance as compare to the control group.

3. Methodology

This study aims at comparing the financial performance, including efficiency, profitability, solvency and liquidity of privatized and public sector banks over a period from 2005-2012. Data have been collected from the annual audited financial reports of the selected banks. This study compares the mean differences of privatized banks with public sector banks. Differences in financial performance of the two sets of banks are analyzed through two sample t-tests. The methodology is adopted from Kader, Asarpota and Al-Maghaireh (2007). Using this methodology the following hypotheses are tested.

H₁: The efficiency of privatized banks is significantly different than public sector banks.

H₂: The profitability of privatized banks is significantly different than public sector banks.

H₃: The solvency of privatized banks is significantly different than public sector banks.

H₄: The liquidity of privatized banks is significantly different than public sector banks.

4. Results Analysis and discussion

Table 4.1 Paired sample t-test results

* Significant at $p < 0.1$

	Mean	Std. Deviation	Std. Error Mean	t	Sig. (2-tailed)
1. ROA of privatized banks - ROA of public sector banks	1.17	1.39	.49	2.39**	.048
2. ROE of privatized banks – ROE of public sector banks	23.59	26.38	9.33	2.53**	.039
3. Profit to revenue of privatized banks - Profit to revenue of public sector banks	7.62	12.03	4.26	1.79	.116
4. Debt to total assets of privatized banks - Debt to total assets of public sector banks	3.42	1.80	.64	5.37***	.001
5. Equity to total debt of privatized banks - Equity to total debt of public sector banks	-3.98	2.28	.81	-4.93***	.002
6. Cash & cash equivalents to deposits of privatized banks - Cash & cash equivalents to deposits of public sector banks	-2.38	1.80	.64	-3.74***	.007
7. Advances to deposits of privatized banks - Advances to deposits of public sector banks	8.84	6.79	2.40	3.68***	.008
8. Operating margin of privatized banks - Operating margin of public sector banks	1.18	1.38	.49	2.42**	.046
9. Equity multiplier of privatized banks - Equity multiplier of public sector banks	.99	5.83	2.06	.48	.647
10. Assets utilization of privatized banks - Assets utilization of public sectors banks	.14	.52	.18	.77	.466
11. Operating efficiency of privatized banks - Operating efficiency of public sectors banks	3.07	3.91	1.38	2.22*	.062

**Significant at $p < 0.05$

***Significant at $p < 0.01$

Table 1 shows that ROA and ROE of privatized banks are higher than public sector banks and both values are significant at a p-value of 0.05. While the profit to revenue ratio of privatized banks, although, is greater than public sector banks but its value is not statistically significant at any of the acceptable significance level. Overall the profitability ratios indicate that privatized banks are more profitable than public sector banks during the study period of 2005-2012. Value of total debt to total assets ratio for privatized banks is greater than public sector banks and this difference is statistically significant at a p-value of 0.01. The equity to debt ratio, which measures a safety for solvency, shows a significant

difference in privatized and public sector banks. Privatized banks have significantly less equity to debt ratio as compare to public sector banks.

Operating efficiency of privatized banks is significantly better than public sector banks. All the three measures used in this study are significantly higher for privatized banks which show that after privatization such bank are operating more efficiently as compare to those banks which are still in the public sector. Similarly, privatized banks are having significantly higher advances to deposits ratio which shows that privatized banks are following more aggressive lending policies. Lastly, privatized banks have a lower ratio of cash & portfolio investments to deposits and its value is statistically significant at a p-value of 0.01. Due to the aggressive lending policies followed by privatized banks, as evident from advances to deposit ratio, these banks have lower value of cash and cash equivalents. We have also calculated the robustness check by calculating weighted average paired sample t-test, to avoid any biasness in the results due to size differences, but it provided same results.

Our results confirm the findings of previous studies which conclude that private/privatized banks are more efficient (Vining & Boardman, 1992, Sathye 2005) and significantly more profitable Frydman, *et al.*, 1999, Megginson, & Netter, 2001, Harper, 2002, Burki & Niazi, 2003). Similarly, our results show that the liquidity and solvency ratios of private/privatized banks are significantly lower than public sector banks which confirm the findings & Sonia (2011). But as mentioned by Dorra & Sonia (2011) private banks are better able to manage these risks effectively. of Das (2002) and Dorra

5. Conclusion

Based on the findings of this we concluded that privatization has a positive impact on the efficiency and profitability of those banks which were previously in public sector. The efficiency and profitability of such privatized banks are significantly better than those banks bank which are still in public sector. On the other hand, the solvency and liquidity of privatized banks are lower than public sector banks. This can be associated with more liberal lending policies adopted by privatized banks are compare to public sector banks. To increase their revenues and to leverage their profitability privatized banks are lending significantly more, as measured by advances to deposits ratio, than public sector banks while keeping a lower equity to debt ratio, allowed by banking regulations. But as suggested by previous studies we conclude that privatized banks are able to manage these risks more effectively as compare to public sector banks. Hence we can conclude that privation has a significantly positive effect on the overall performance of Pakistani banking industry.

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