Issues and Challenges of Consumer Financing In Pakistan

Author Details: Noor Hassan
Abdul Wali Khan University Mardan Pakistan.

Abstract
This research is based on qualitative study and up to some extent on quantitative base too. The major objective of this study is to gain insights of consumer financing in Pakistan from a consumer perspective. At the same time, the study investigates and analyzes the defined rules and regulations for banks and for consumers during the time of obtaining the loans from banks and as well as from other financial institutions. Hence the report seeks out those issues and challenges that are hindering to meet customer demand for sound consumer finance.
Keywords: *Consumer financing, Customer complaints, Interest rates, financial institutions, Regulatory framework.*

INTRODUCTION

This study is initiated to identify major issues challenging the consumer financing in Pakistan and seeking probable “solutions” to recommend.
Personal Loans have become a part of life for millions of Pakistanis. It plays a very important role in the day-to-day life of the households. Typically they pursue loans for personal requirements such as renovation and/or purchase of house, education of their children, marriage of their daughters and meeting urgent medical expenses etc. However, over the recent decades, a large number of foreign bank branches operating in this country have been offering a variety of financial products: with the expansion and growth of Banking Industry in Pakistan, which triggered an “openness” to personal loan, have inducted the ‘consumer financing’ market (Ahmad et al., 2009).

Over the last ten years, Pakistan’s banking sector has substantially promoted the consumer financing by unleashing a wide range of products such as credit cards, auto loans, personal loans etc. This unprecedented growth of consumer financing is largely attributed to the economic policy liberalization attuned to the principles of free market economy, and an availability of huge liquidity to the banks in the aftermath of 9/11 (Rahim, 2010). While a few prominent foreign banks took the lead in introducing credit cards during mid 90s, their accomplishment was limited to the top tier of salaried customers and businessmen.

Alternatively, a combination of other factors are responsible for the widespread popularity of *consumer loan* in recent years: the financial liberalization process over the last decade or so, has led to the creation of a banking system which is largely owned and operated by the private sector, and is free to allocate resources to respond to the market demand. Secondly, the influx of liquidity in the banking sector since FY02 motivated banks to outreach its venture into previously untapped areas, and third, the easy monetary policy from FY02 to FY05 provided customers flexible financing options with competitively lower rates than before (JPMorgan, 2007). Foreign banks apparently paid best intention to exploit such opportunities and, sooner or later, domestic private banks that have exhibited remarkable adeptness in adopting new procedures for credit risk assessment, setting up the requisite policy and collections units, and upgrading the scope of their IT based systems. (Ahmed et al., 2009).
Consumer financing always appear worthwhile to take on; however, without a sound policy and an ability to repay, it might backfire the consumer. Therefore, this paper studies upon such issues challenging the consumer financing in Pakistan while it also endeavors to offer solutions for the issues and challenges to be resolved.

From a consumer perspective, consumer financing tends to be quite significant to improve the quality of life to those people who have the capacity of servicing the loans. However, there is strong evidence that this capacity is declining in Pakistan due to an array of issues. For instance, high spread and variable interest rates on loans seem to set an obstacle for such financing. Depositors are not getting due returns due to high difference between lending and deposit interest rates. Meanwhile, the volume of consumer complaints is rising day by day due to processing delays, service inefficiencies, hidden charges, and poor disclosure practices. In addition, lack of consumer education on banking terms and conditions, policies, rules, and regulations is also a critical factor in securing financial rights. It is to be noted: since the consumer-financing portfolio is increasing and quality of related banking services is becoming a serious issue. Processing delays, service inefficiencies, unauthorized debits and non-compliance with requirement of providing monthly bank statements are few examples of poor quality of banking services. Hence, dealing with these issues is a key challenge to achieve a sound financing system.

The purpose of this research comes into three fold:

- First, to get an overview of the consumer financing in Pakistan. This includes historical review, a precise description of different types of loans available and, narrates the consumer financing growth and relevant factors.

- Secondly, to investigate or map the public concerns and regulatory weaknesses related to consumer financing and insurance services in Pakistan. This includes identifying social, economic and regulatory issues and challenges primarily perceived by the consumers.

- Finally to help to bridge the missing links between consumers and regulatory system. This comprises the socioeconomic descriptions (i.e. lacking education and awareness) and makes effort to map out some solutions or recommendation.

Interviews of Borrowers and Bank personnel

"Interviews with all the various stakeholders in the domain, is a vital way of gathering user stories" (David and Phil, 2005). A list of banks was collected from the Quarterly Performance Review of the Banking System (June 2007) published by the State Bank of Pakistan. Out of total banks, a representative sample consisting of 11 banks (representing 30% of all banks) was randomly selected. One branch of each bank was identified for interviews of borrowers. Branches of most of the banks were located in urban areas only; while rural branches existed, majority of these did not deal with any consumer-financing product. Total of 11 branches were contacted, which would not have been successfully performed without their honest cooperation. However, the data about the nature of public grievances and concerns was collected from the borrowers who were selected by *exit* interviews (e.g. customers coming out from the bank) of 11 scheduled banks. At first they were simply asked if they were interested to take part in the research interviews and later on the interested participants were requested to leave the contact details to be contacted later.

Interview was conducted over telephone (i.e. telephonic interviews) and a ***non-probability sampling*** method was used, which included the bank selection, employee selection and of course, borrowers and consumers selection. According to Jordan (1998) it is impossible to analyze the collected data from respondent without respondents' permission; hence, I contacted them again during my analysis part for better interpretation.

LITERATURE REVIEW

This part present key area of this research work:

Campbell (2006, p. 15) argues that house- hold finance "*asks how households use financial instruments to attain their objectives*." Recognizing the roles of households, businesses, and regulators, a more explanatory definition of the field might be as follows: Consumer finance is the study of how institutions provide goods and services to satisfy the financial functions of households, how consumers make financial decisions, and how government action affects the provision of financial services. However, following the functional approach of Crane et al. (1995) and Merton & Bodie (1995), which holds that financial systems are best understood in terms of the functions they deliver, these functions may be delivered by a wide variety of institutions and through a wide range of products. Further clarification could be identified through four primary and necessary functions of the consumer finance sector:

Moving funds, managing risk, advancing funds from the future to today and Advancing funds from today until a later date. (Peter, 2009), (Campbell, 2006) and (Crane et al., 1995.

Model of Consumer Finance

Lending in a Competitive Market

An individual, Debtor, seeks to borrow money in order to smooth consumption over time. A firm, Creditor, offers to lend money at a certain rate of interest. In a competitive market the interest rate will reflect the time value of money, inflation, and the risk of default. Debtor accepts the offer if the benefit, that is, the transformation of future wealth into current consumption, exceeds the interest rate (Pierce, 1991; Strahan, 1999). If Debtor defaults on the loan, he is legally required to pay Creditor. If in fact Debtor does pay damages as a result of a lawsuit, or forfeits collateral of sufficient value, there is no "default" in an economic sense, as Creditor is fully compensated (CRCP, 2008). The problem for Creditor is that Debtor may be judgment proof as a result of both legal and illegal factors. The legal factors, to be discussed more extensively below, include restrictions on the ability of Creditor to seize assets or future income in order to satisfy a judgment. Illegal factors include the difficulty of tracing Debtor if he flees the jurisdiction or goes into hiding and collecting from Debtor if he simply does not ever earn enough money to pay off the debt. Default usually occurs in a bad state of the world in which Debtor loses his job, his health, or a valuable asset (Strahan, 1999). Risk-averse debtors want insurance against such bad states, and in addition to the usual forms of insurance, such as automobile and health, Debtor may purchase credit insurance, which would repay his debt to Creditor if he underwent certain hardships such as unemployment, illness, disability, or destruction of the collateral granted to Creditor. Debtor may also obtain insurance from Creditor himself in the form of a commitment from

Creditor to forgive missed payments if certain events occur. Nonrecourse loans also reflect this interest in insurance (CRCP, 2008).

Consumer loans take many different forms. Simplest is an unsecured loan of cash. Open-end loans like credit card transactions roll over from period to period; closed-end loans terminate after a specified number of payments of principal and interest. Creditors also issue loans secured by goods, contract rights, and other collateral. Both ordinary creditors and retailers often lend money necessary to purchase a particular good, and retain a purchase money security interest in that good. Banks and other creditors issue home equity loans; these are loans secured by real estate.

There is argument about why secured credit exists. Creditors should be indifferent between issuing a risky unsecured loan with a high interest rate, and a relatively safe secured loan with a lower interest rate. Debtors should be indifferent between an additional claim on their assets and a higher interest rate. Therefore, because issuing secured rather than unsecured credit involves additional administrative costs greater than zero, secured credit should not exist. Two simple inefficiency explanations for the existence of secured credit are (1) that security interests are used for transferring risk to tort and other non-adjusting unsecured creditors, and (2) that in the consumer finance context, security interests may be used to circumvent property exemption laws (White, 1984). Efficiency explanations for secured credit are beyond the scope of this paper, although we note below where they are relevant to the law of consumer finance.

Monopoly Power

Abundant evidence suggests that the credit market is generally competitive (DeMuth, 1986; Pierce, 1991; Elliehausen & Wolken, 1990), but there may be local monopolies in certain areas of the country, perhaps poor neighborhoods, perhaps the result of regulations that raise the cost of entering the credit market. In addition, many laws to be discussed below are defended on the ground that they correct inefficiencies created by creditors' market power, so it is useful to examine the possibility that creditors do have market power.

In an environment with full or symmetric information, a creditor with monopoly power will charge an interest rate that is greater than that available in a competitive market but will generally supply the same non-price terms as a creditor in a competitive market (Schwartz, 1977). Non-price terms provide means of various contract features that allow a bank to mitigate liquidity and credit risk to outset a better lending relationship, and to enhance their ability to monitor borrowers over the course of the relationship (Strahan, 1999). Such non-price terms may include bonds, treasuries for customers as well as debt collection procedure or quality service for banks. Even if these non-price terms are otherwise beneficial to the creditor, they will reduce the willingness of well-informed debtors to pay for credit. As long as these terms are efficient, the creditor would prefer to use its market power to force the debtor to pay a higher interest rate.

The conclusion that the monopolist will use the same terms as a competitive lender requires some technical assumptions. Otherwise, because the monopolist lends less in equilibrium, the optimal terms of the contract may change. Still, there is no reason to believe that the contract terms in the monopolized market would be harsher than the contract terms in the competitive market. And there is no reason to believe that forcing monopolists to supply some of the terms that would prevail in a competitive market would produce a gain. Because the monopoly power remains, further distortions would occur in the unregulated terms (Schwartz, 1977). Alternatively, monopoly power can have other effects as well, but these require asymmetric information and thus will be discussed below.

Consumer Ignorance

Even if there are numerous lenders in a market, each lender may have some degree of market power because of the inability of consumers to costless compare prices and terms. Depending on the source of the information failure, this may result in either an abnormally high price or abnormally harsh terms. Some creditors will lend only to those consumers who are unable to compare the (price or non-price) terms of the loan offered with the terms available elsewhere in the market.

The problem requires that a large enough number of consumers find it difficult to shop around. The competitive outcome would occur if a significant subset of the consumers become informed and if creditors are unable to discriminate between these creditors and the uninformed by, for example, offering loans with different terms and interest rates with only the informed consumers able to determine the most desirable loans. (Schwartz and Wilde, 1979, 1983). That is, if enough consumers compare loans before borrowing, no lender could make a profit by lending only to those who did not compare.

Creditors would seem to have every incentive to distinguish themselves from their competitors if they offered credit on more attractive terms. However, they cannot overcome consumer ignorance (possibly resulting from misleading claims made by rivals) when that ignorance is severe enough. There is a limit to how much explaining a creditor can do before losing the attention of its customers. Further, in a competitive market each creditor has insufficient incentive to educate consumers because of that creditor's inability to internalize all of the gain from that information. This problem is lessened somewhat if lenders have market power because they capture more of the returns from the information and thus have an incentive to provide information about the entire product, not just the brand (CRCP, 2008). However, a creditor with market power may have an incentive to provide too little information in order to aid in price discrimination (Beales, Craswell, and Salop, 1981a). Furthermore, creditors will have insufficient incentive to explain the economics of the credit market, and the meaning of contract terms, because they cannot prevent people who have benefited from their expectations from seeking loans elsewhere. (Beales, Craswell, and Salop, 1981b).

Creditor Ignorance

The simplest form of information asymmetry occurs when Debtor knows his willingness to pay for credit while Creditor does not. If Creditor has a monopoly, he has an incentive to discover Debtor's valuation so that he can price discriminate. It is possible that Creditor can separate higher and lower valuation debtors by offering contracts with inefficient terms. For example, Creditor might offer a loan with a high interest rate and a loan with a collateral requirement but a lower interest rate if this would help him distinguish between those who are particularly sensitive to the interest rate and those who are not. The efficiency implications of this practice are obscure. As long as the monopoly remains intact, a law that prohibits the inefficient term will both eliminate the cost associated with the term and reduce value by interfering with price discrimination. Creditor will offer an average interest rate that drives low valuation debtors out of the market (Craswell, 1995).

Another form of asymmetric information occurs when Debtor knows the probability of default and Creditor does not. Assume that because of personal characteristics unobservable by creditors, some debtors have a high probability of default ("bad" debtors) and others have a low probability of default ("good" debtors). Harsh remedial terms are more costly for bad debtors than for good debtors because the bad debtors are more likely to default and thus to become subject to the terms. If creditors believe that any debtor who fails to grant a security interest (or agree to some other harsh remedial term such as a cognovits clause) is a bad debtor, creditors may offer two contracts: a secured loan with a low interest rate and an unsecured loan with a high interest rate. The good debtors effectively "signal" their type by choosing the secured loan with the low interest rate while the bad debtors choose the unsecured loan. The creditors' beliefs are validated in this separating equilibrium. This would be true regardless of whether the market is competitive or monopolistic (Rea, 1984; Aghion and Hermalin, 1990).

A rule banning security interests and other harsh remedial terms would be efficient if the total costs of the signaling exceed the total gains. If there is no credit rationing and no effect on the debtor's efforts to avoid default (we discuss both these assumptions below), the reduced interest rate charged to the good debtors should be roughly offset by the increased interest rate charged to the bad debtors. In fact, it is even possible that banning such signaling would benefit the good debtors. The reason is that the good debtors might prefer a contract with no collateral and with an interest rate that reflected the average probability of default in the population, compared to a contract with collateral and a lower interest rate. In the absence of a legal ban on security interests The fact that security interests and other consensual creditor remedies can be used to signal information about debtors does not necessarily mean that they should be banned because this signaling may play a role in reducing a related problem caused by asymmetric information, credit rationing (Betser, 1985; 1987). Creditor sets the interest rate to reflect the average probability of default in his portfolio. Assume that good debtors are less willing to pay a higher interest rate because they are more likely to repay the loan. If Creditor cannot distinguish among debtors, the expected profit from any particular loan will decline as the interest rate rises beyond some point, because as the interest rate increases the good debtors drop out of the market. Therefore, creditors (monopolistic or competitive) will not raise interest rates above this point and credit will be rationed: the demand by bad debtors for (even high-interest) loans will be unmet (Stiglitz and Weiss, 1981). If there are too many bad debtors in the market, their probability of default is sufficiently high, and the divergence in the probability of default is too large, the market unravels leaving only the bad debtors willing to borrow, but creditors unwilling to lend to them. This is the phenomenon of adverse selection (Akerlof, 1970).

Security interests and related terms may reduce adverse selection by enabling the creditor to distinguish among good and bad debtors. Security interests and similar terms can serve as signals because they are cheaper for debtors who are less likely to default. Credit rationing can also result if there is asymmetric information about whether or not the debtor "can" repay a loan (Jaffee and Russell, 1976). That is, debtors may have an incentive to claim destitution in order to avoid repayment and it may be difficult for creditors or courts to verify that this is correct. In an extreme case, the only mechanism that the creditor may use to force repayment is to deny future credit (Allen, 1983). Collateral with personal value to the debtor and other forms of creditor remedies ensure that a defaulting debtor cannot in fact repay if the debtor would rather repay the loan than endure the “punishment” of repossession (Rea, 1984; Scott, 1989).

Another kind of problem arises when Debtor has private information about the care with which he avoids default. “Care” can mean a lot of things: (i) working hard, so that he is not fired and deprived of an income to repay the loan; (ii) protecting assets or collateral so that they may be liquidated in case of default; (iii) avoiding physical risks that might result in injury; or (iv) avoiding risky investments. If Creditor cannot observe Debtor’s level of care and penalize Debtor if he takes insufficient care; and if Debtor does not expect to repay the debt in full because of the legal and illegal factors mentioned above; then Debtor will take a suboptimal level of care. This is the problem of *moral hazard*.

One response to this moral hazard is to prohibit, by contract, behavior that increases risk. An example is the covenant against using residential property for commercial purposes. But this response really assumes away moral hazard by supposing that conduct is observable: when conduct is unobservable, it cannot be prohibited by contract. The second response to moral hazard is to require Debtor to bear some of the cost of default, thus converting a debtor who might otherwise be fully judgment-proof into one who is partly judgment-proof. For example, requiring that personally valuable property be collateral reduces the probability that Debtor will be able to protect it at the time of default through judicial process. Alternatively, Creditor might seek to destroy Debtor’s reputation by publicizing the default; to cause psychic harm by liquidating a guarantee from a loved one; or, in the case of loan sharks, to break bones. Even though these actions provide no direct benefits to Creditor while conferring costs on Debtor, they may be efficient because they reduce moral hazard (Rea, 1984).

Consumer Finance in Pakistan

According to the Regulations, consumer financing means “any financing allowed to individuals for meeting their personal, family or household needs”.

Consumer financing in Pakistan is broadly categorized into four types of products: Personal Loans, Auto Loans, Housing Finance and Credit Cards.

The minimum standards to be observed while carrying out consumer financing activities include risk management process, record of customers’ dealings with banks/DFIs and the latest information obtained from CIB about credit worthiness of the customer. Besides, the PRCF require the banks to obtain written declaration from the customer containing details of all consumer financing facilities of other banks availed by the customer. The objective is to help banks avoid exposure against a person having multiple facilities from different financial institutions on the strength of sole source of repayment. In many cases, the banks do not obtain this declaration, and process the applications with minimum documentation with the aim of profit maximization. In addition, the internal audit and control system, as well as, properly equipped and managed accounting and computer systems are also requisites for processing and management of consumer financing activities.

A noteworthy point is that the regulations do not put any limit on the margin requirements on consumer financing facilities provided by the banks/DFIs. They have been given discretionary powers to decide the margin requirements after assessing the risk profile of the borrower.

All the banks/DFIs are required to develop a special programmed; the regulations on credit card have limited the maximum unsecured limit to a borrower to Rs.500, 000.

ANALYSIS: KEY ISSUES IN CONSUMER FINANCING

Pakistan has witnessed phenomenal growth of consumer financing products and services over the last seven years. Most of the commercial banks are involved in consumer lending through one or more financing modes, as it has become very lucrative business due to high spread and variable interest rates. The increase in consumer financing has come with many challenges facing the national economy as well as the individual borrowers.

Growth of Consumer Financing in Pakistan

The banking system was adversely affected by the rapid expansion of branch network within the country, interest rate controls, the system of credit ceilings, subsidized loans, and directed credits and high government borrowing both from banks and national savings schemes.

During the pre-reform period, the financial sector in Pakistan mainly accommodated the financing needs of the government, of public enterprises and of priority sectors. Financial intermediaries were insulated from competition in the domestic market through oligopolistic practices and barriers to entry in the sector, and from outside competition through tight restrictions on current and capital accounts transactions. In such an environment, which was typical of many pre-reform situations, distortions were widespread, interest rates were generally negative in real terms, taxing savers and providing incentives to inefficient investment, credit was rationed based on government determined priorities and excessive regulations hindered the activity of financial intermediation.

Consequently, economic efficiency remained low and growth suffered from relatively low savings and investment rates in the private sector.

According to SBP, the consumer loans witnessed an increase of Rs.72.4 billion or 29% and reached Rs.325 billion during 2006, whereas till June 2007, it further increased to Rs.354.4 billions. The share of consumer loans in the overall loans increased to 14.3% till June 2007 from 9.4% in 2004. If we compare the total financial outlay of consumer financing products in December 2006 and June 2007, the portfolio has increased significantly in all products except for consumer durables (Table 1).

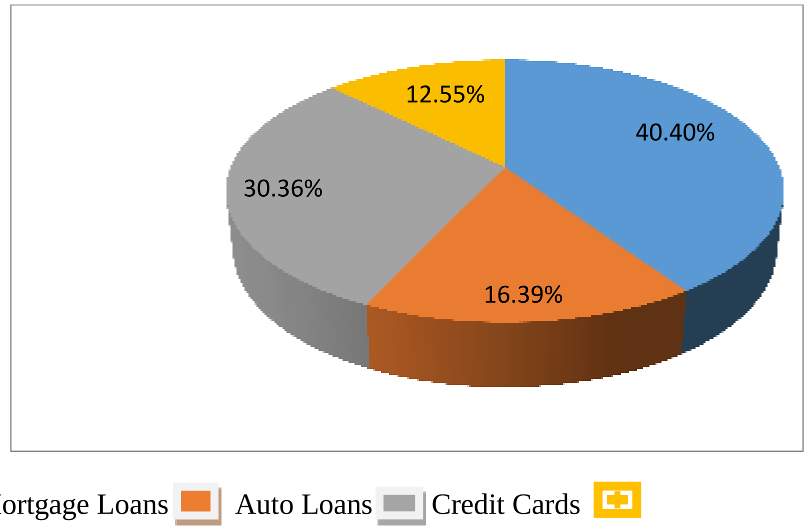
Table 1: Consumer Financing Portfolio of Banks (December 2006 and June 2007)

Year	Portfolio	Credit Cards	Auto Loans	Consumer Durables	Mortgage Loan	Other Personal Loans	Total
December 2006	Amount (Rs, in Million)	39,243,1	104,057,2	1,301,5	49,245,4	131,324,2	325,171,4
	No. of Borrowers	1,207,885	253,097	59,082	24,313	1,310,371	2,689,736
June 2007	Amount (Rs, In Million)	44,460,5	107,575,7	1,003,6	58,052,2	143,286,0	354,378,1
	No. of Borrowers	1,615,569	265,876	55,139	24,007	1,383,847	3,211,117

Source: State Bank of Pakistan (SBP)

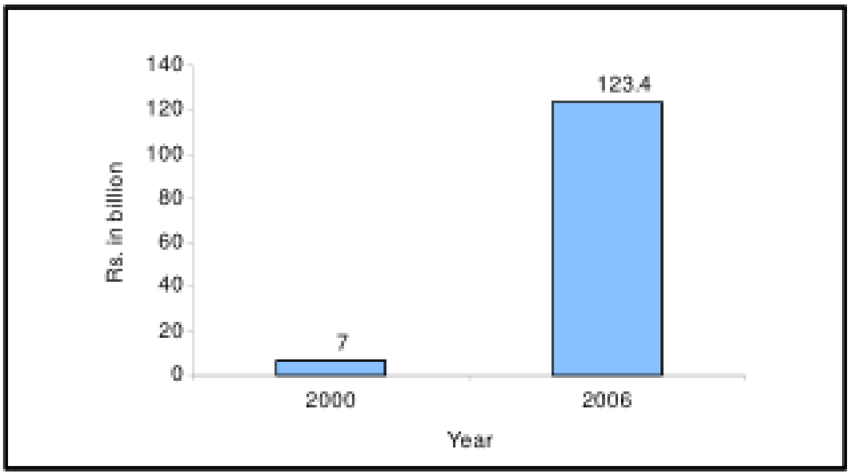
Category-wise analysis of consumer financing in rupee terms reveals that personal loans carried the highest share i.e. 40.4% followed by 30.36% of auto loans, 16.39% of mortgage loans and 12.55% of credit cards. However, in growth terms, the credit card category and mortgage loans witnessed highest growth. The number of borrowers has also increased significantly. According to the official estimates, the number of ATM and credit card users is increasing in excess of 50% every year.

Chart 1: Share of Products in Total Consumer Financing Portfolio



Source: Banking Surveillance Department, Quarterly Performance Review of the Banking System. June 2007

Chart 2: Rise in Pre-Tax Annual Profits of Banks in Pakistan



Source: Economist. January 28 - February 3, 2008.

In Pakistan, the banking sector is concentrated despite a large number of banks entering the market in the last decade. The top five local banks enjoy 80% of the market share of the banking sector. These banks are charging high lending rates, and passing only a portion of the profit on to their depositors on whose money they make the profits. The banking sector has enjoyed the highest profits in the Asia- Pacific region.

In recent months, some slow down trends are on the rise in consumer financing. For instance, the default rate in the banking sector is rising, which reflects upon the poor risk management. According to the SBP, the total NPLs of the commercial banks rose to Rs.151.9 billion in June 2007 from Rs.142.8 billion in March 2007. A considerable proportion of the NPLs is related to the consumer financing products of the commercial banks. The ratio of these loans for consumer financing sector increased to 2.2% in 2006 from 1.2% in 2005. The number of borrowers of mortgage loan and loans for durables has also decreased in 2007 (Table 1).

The statistics reveal that growth in consumer loans slowed down to 6.6% during first seven months of fiscal year 2008 from 10.4% in the preceding year. The growth has declined in all categories of consumer loans, except mortgage loans. The deceleration in the growth of auto finance is attributed to lower demand for automobiles due to increase in prices of locally produced cars, and risk aversions of banks following recovery issues, according to the SBP analysis. The use of credit worthiness reports from CIB has also affected the growth. The mortgage finance, however, depicts a robust growth of 17.6% as compared to 15.5% rise in the corresponding period last year (Table 2). The deceleration, however, does not appear to affect the growth of consumer financing significantly in the long term, given the huge banking profits associated with this business.

Table 2: Growth in Consumer Financing (July-January 2007 and 2008)

Portfolio	Fiscal Year	
	2007	2008
Mortgage Loans	15.5	17.6
Credit Cards	19.2	6.9
Auto Finance	8.0	6.0
Personal Loans	7.9	3.0
All	10.4	6.6

Source: State Bank of Pakistan. Second Quarterly Report for FY 08

Issues and Challenges from a Consumer Perspective

The consumers as well as the banks are entitled to certain financial rights, which must be protected in an institutional-cum-legal framework, which is capable to strike a balance between rights of both entities independently. The dilemma in Pakistan is that the consumers remain a weaker party vis-à-vis the banking sector, thus balancing the equation in favor of the latter. The market-oriented vision of economic managers has served the banks more favorably than the consumers.

The banking sector has demonstrated capacity to influence the policies, procedures and rules in its favor, as it is better equipped with financial resources, knowledge, technology, and lobbying with the governance machinery. This leverage is leading to emergence of a whole range of problems and grievances, especially in relation to consumer financing, thus negatively affecting the ability of consumers to articulate and protect their financial rights, and access justice if the banks violate these rights.

High Interest Rate Spread

Low interest rate spread is an important indicator of the efficiency and competition in the financial systems and helps in economic growth through increased investments. In the national context, the most important issue in consumer financing from the standpoint of national economy as well as individual consumers is that Pakistan has one of the highest interest rate spread in the world.

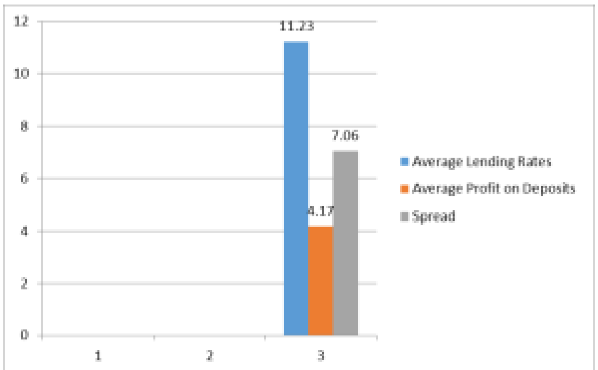
An analysis of the interest rate behavior in Pakistan reveals that the spread has vacillated between 5.95% and 9.58% during the period from 1990 to 2005. This indicates that average deposit rates have been very low, as compared to average lending rates. One could have expected a decrease in spread as a potential gain of competition among the increasing number of banks in the post-2001 period. However, little change has been observed in average spread, which points towards a cartel-like behavior of the banking sector.

If we look at the nominal and real interest rates, it becomes evident that consumers have had suffered a great deal at the hands of banks. From 1990 to 2004, the nominal weighted average lending rate has always been higher than inflation rate. The real lending rates averaged between 1.98% and 9.69%, which means that the banks earned net profits on lending in all these years. In contrast, the average deposit rate was slightly higher than inflation rate in four years only (1999-2002). The real deposit rates were negative in 11 years. It partly explains the impact of inflation on interest rate spread. The banks keep the lending rate high enough to ensure that the real lending rate is almost always positive.

Table 3: Interest Rate Behavior in Pakistan

Year	Inflation Rate	Weighted average Lending Rate		Weighted average Deposit Rate		Interest Rate Spread	
		Nominal	Real	Nominal	Real	Nominal	Real
1990-95	10.57	12.55	1.98	6.53	-4.05	6.02	5.95
1996	10.8	14.4	3.6	6.4	-4.4	8.00	8.00
1997	11.8	14.6	2.8	6.8	-5.0	7.8	7.8
1998	7.8	15.6	7.8	6.8	-1.0	8.8	8.8
1999	5.7	14.8	9.1	6.5	0.8	8.3	8.3
2000	3.6	13.52	10.9	5.47	1.9	8.05	9.00
2001	4.4	13.61	9.21	5.27	0.87	8.34	8.34
2002	3.5	13.19	9.69	3.61	0.11	9.58	9.58
2003	3.1	9.40	6.3	1.61	-1.49	7.79	7.79
2004	4.6	7.28	2.68	0.95	-3.65	6.33	6.33
2005	9.3	8.81	-0.49	1.37	-7.93	7.44	7.44

Source: SBP Annual Reports (Various Issues)



In recent years, the spread has exceeded 7%
on the average. The high difference between lending and deposit rates indicates that the depositors are not getting due returns, as compared to huge profits being earned by the banks. Indeed, the lending rates have increased and deposit rates have decreased over the last few years.

Chart 3: Weighted Average Lending and Deposit Rates in February 2008
Source: State Bank of Pakistan, 2008

High interest rate spread indicates that competitiveness in the banking sector in Pakistan is either absent or is very poor. A cartel-like behaviour in banks appears to have taken place within the policy space provided by SBP.17 In April 2006, the present Governor of *Source*: State Bank of Pakistan, 2008the SBP had said that banking spread was very high in the county and termed it an inefficiency of banks. In December 2006, she said that spreads were high because the sector was not facing competition and it was hurting the economy.18 However, she said that time was yet to come when SBP should exercise its powers.

Variable Interest Rate

A variable interest rate moves up and down based on factors including changes in the rate paid on bank certificates of deposit or treasury bills. From a consumer's standpoint, it makes a huge difference whether the bank is charging variable or fixed rate on credit. If a consumer enters into an agreement with the bank on the basis of fixed interest rate, the bank cannot change the overall payable interest during the entire tenure even if interest rates go up in the market. In contrast, when the interest rate is variable, the bank ties the rate with an index. The interest payable by the consumer varies as the index changes.

In Pakistan, almost all consumer loans are on the basis of variable mark up rates. This policy is attributed to two reasons. First, variable rates are in the larger interest of banks due to high probabilities of increase in rates in the future. Second, a long-term debt market has yet to be developed to provide term funding to the banks. However, banks also offer loans in which borrowers are given the choice of fixed or variable mark up. If the borrower chooses fixed mark up, the rate offered is generally higher than the variable mark up rate at the time of the contract. Therefore, borrowers most often choose variable mark up, without realizing their future financial liability, in the hope that the rates will fall in the future. This has seriously affected the loan servicing capacity of the borrowers with deleterious effects on their savings.

Some countries have determined fixed or variable interest rate for each sector depending on specific needs. In the United States, for example, the interest rates on education loans were changed from variable rates to fixed rates in 2002. In addition, there are examples of discount periods for variable interest rates. Such practices need to be introduced and scaled up in Pakistan in order to serve the interests of small borrowers.

Deteriorating Quality of Services

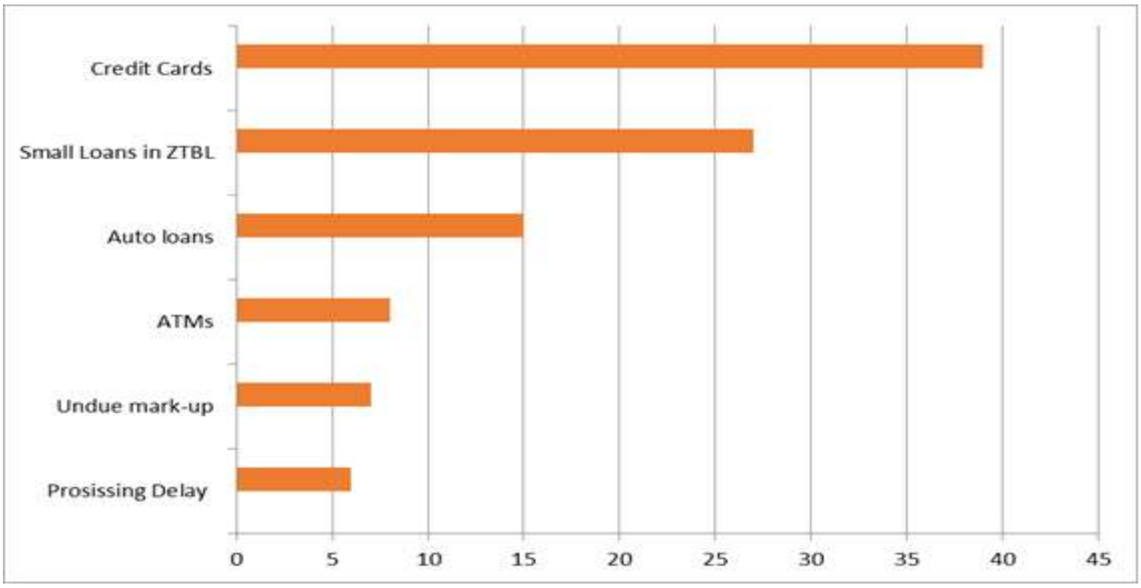
As the consumer-financing portfolio is increasing, quality of related banking services is becoming a serious issue. Processing delays, service inefficiencies, unauthorized debits and non-compliance with requirement of providing monthly bank statements are few examples of poor quality of banking services. Other issues such as non-transparent advertisements, violation of agreed terms and conditions, levy of unjustifiable charges, and arduous complaint redress mechanism, etc. also reflect upon the poor quality of consumer services.

The press frequently reports such complaints, which speak of the issues in quality of banking services. For example, some banks are involved in charging late payments penalties despite payment on time. Similarly, many credit card users complain about service charges appearing on their credit statements, which make no sense to anybody. The number of complaints is increasing every year. For example, in the first eight months of the operation of Banking Ombudsman in 2005, about 40 per cent complaints filed with the Ombudsman were related to consumer products, and among these complaints, 30 per cent were related to credit cards alone (Banking Ombudsman, 2005).

In 2006, Banking Ombudsman received 215 complaints out of which 18 were rejected, 71 were declined and 90 complaints were granted. There were 36 complaints related to internal banking fraud scam, still being investigated by the Banking Ombudsman. The complaints received at Banking Ombudsman were related to service rules, service inefficiency, loan remission of mark-up waiver, frauds and consumer products including ZTBL loans. However, it is observed that percentage of complaints received regarding consumer products including ZTBL loans was 46%, much higher than other type of complaints received.

The complaints related to consumer products included credit cards, small loans Inc ZTBL, auto loans, undertake mark up, processing delays and ATM's complaints. Magnitude of credit card complaints was much more than all other complaints, nearly 40% of total complaints.

Chart 5: Types of Consumer Complaints in 2006



Source: Annual Report of Banking Ombudsman, 2006

Unsolicited Financing

Aggressive marketing campaigns launched by the banks are targeting the consumers and repeatedly encouraging them to purchase a loan or credit card. In some cases, the banks have gone to an extent where a consumer who has not even applied for a loan, is informed through telephonic call that the bank has approved a loan for him. Misleading phone calls are made to the consumers who are misled by false promises; they succumb to attractive offers and later discover that the commitments and assurances held at sign up stage were not being honored. The supply- driven approach is creating artificial consumerism on one hand, and is limiting the choices for consumers, on the other. For example, auto leasing makes a fit case of banking sector's dominance over customers. A car lessee, for instance, is bound to insure the car from an insurance company of the bank's choice.

Lack of Consumer Education

The issue of consumer education is equally important. Most of the bank users do not have enough understanding of the very basic rules and terms and conditions. Another problem is that the documents prepared by banks are usually technical and the information, which may affect financial rights of the consumers, is never stated clearly and plainly in these documents. Indeed, the SBP and other scheduled banks have excluded consumers as a legitimate stakeholder in formulation of, or any change in policies and procedures. There is a need to focus on public awareness about the financial rights of the citizens, and the forums available to them for accessing justice, if these rights are violated.

Poor Information Disclosure Practices

Although PRCF require the banks to ensure transparency through disclosure, access to information related to consumer financing remains a critical issue. A strong culture of secrecy prevails in the banks, as they avoid providing even ordinary and insensitive data. Apart from reporting requirements laid down in the SBP regulations and contracts, there is no law in Pakistan, which entitles the consumers to access information from private banks as a legal right. The existing freedom of information laws are applicable to only public sector banks, and do not extend to private banks and DFIs.

Loosing Competitiveness in International Trade

Banking sector has assumed greater importance due to liberalization of trade under the General Agreement on Trade in Services (GATS). Pakistan has opened up the financial sector and made a number of commitments under GATS without performing any Economic Needs Test (ENT). The impact of such decisions needs to be ascertained keeping in view the contribution of financial services in services trade. The imports of financial services have remained substantially higher than exports. Estimates suggest that the imports in financial services were US$ 77 million in

2003-04 and 2004-05, and US$133 million in 2005- 06. In comparison, exports in financial services stood at US $21 million, US$ 39 million, and US$ 70 million during the same years.

The challenge for Pakistan is to increase exports in financial services in a manner that has least impact on low-income customers. Given the huge spread in interest rates, the local banks have no incentive to improve internal efficiencies to become competitive in the international market. Therefore, urgent steps including reduction in spread need to be taken to create competitive financial environment in Pakistan.

Intimidating Recovery Practices

Recovery of dues from borrowers is the responsibility of the 'collection department'. However, when a borrower does not clear all his dues, the case is transferred to the loan recovery department. Legally, under Section 15 (sub-section 2) of the Financial Institutions (Recovery of Finances) Ordinance, 2001, the banks are required to send three legal notices to the borrowers for payment of dues within the specified time periods. If the borrower fails to pay the dues even after third legal notice, only then the bank has the authority (under sub-section 4 of section 15) to sell the property of the mortgagor, without the intervention of any court, which was kept on mortgage as a security for the bank. Keeping aside the law, the banks have constituted recovery teams comprising thugs who use strong-arm tactics to harass the borrower and make threatening calls. Despite the fact that bank's recovery teams have no legal authority to visit the borrower's residence; sometimes, recovery teams reach the borrower's house to intimidate and pressurize them for payment of dues. In some instances, they illegally coerce and misbehave the borrowers, and, in desire of earning more commission, cross the limits by abusing, brutally beating, showing guns, locking in the house and threatening to dreadful consequences.

Second annual report (2006) of the Banking Ombudsman stated a rise in the unrestrained action by the debt collectors; cases have also come to light where innocent people have been accost and maltreated as well as cases where borrowers with up-to-date payment record have been needlessly harassed. The report mentioned that in most countries, the law regulates debt collection. According to Banking Ombudsman Report (2006), some banks in Pakistan have developed guidelines applicable to debt collection but these are not strictly followed by external recovery agencies engaged for the purpose. To protect consumers from abuse by debt collectors, it was recommended that Pakistan Banks Association be asked by SBP to draft suitable set of instruction for compliance by external debt collection agencies.

Weaknesses in Regulatory Framework

The frequent violation of financial rights of the consumers is attributed, mainly, to weaknesses in the regulatory framework governing the banking sector, and low level of consumer education about the relevant policies and rules. The existing regulations do not capture the full range of problems being faced by the users of consumer financing services. For example, the regulations do not restrict the banks to levy unjustified service charges such as high fee on depositing cash in one's own account. Another case in point is the Credit Worthiness Reports maintained by the Credit Information Bureau (CIB). According to the rules, these reports are confidential documents for the borrowers, and amount to denial of the right to one's own personal information.

On the top of it, whatever regulations exist, they are yet to be fully implemented. As a matter of fact, the banks enjoy a great degree of freedom for formulating their own policies and procedures regarding credit cards, automated services, loans, interest rates, etc., which suit their interests best. These missing links, if not abridged adequately, would continue to harm the interest of the consumers on one hand, and affect the potential of banks to serve as a strong base of economy in the longer term, on the other hand.

CONCLUSION

Consumer financing has expanded in Pakistan at an unprecedented growth rate over the last seven years. The banks have intensively capitalized upon the demand for consumer financing and earned record profits within the generous space for credit policy provided by the State Bank of Pakistan (SBP). This space has further motivated the banks to get into unsolicited financing by aggressively marketing products even where no genuine demand exists. Despite that a regulatory framework is in place, the banks appear to have failed in terms of full compliance with SBP regulations, and in satisfying majority of their customers against various service parameters.

At the macroeconomic level, consumer financing has significantly contributed to economic turnaround by stimulating consumption and investments. There has been a phenomenal increase in private consumptions due to easy availability of credit from banks. However, in tandem with this development, the manner in which consumer financing is being delivered has seriously jeopardized the competitiveness in economy. A cartel-like pattern appears to have emerged in the banks, given that interest rate spread is among the highest in the world. Moreover, consumer financing has significant impact on inflation, which is rising sharply. In face of the economic challenges facing Pakistan, the SBP can no longer afford to overlook the state of poor competition in the financial sector.

From a consumer perspective, consumer financing has been helpful in improving the quality of life of the people who have the capacity of servicing the loans. However, there is mounting evidence that this capacity is deteriorating due to high spread and variable interest rates on loans. Depositors are not getting due returns due to high difference between lending and deposit interest rates. Further, the volume of consumer complaints is rising day by day due to processing delays, service inefficiencies, hidden charges, and poor disclosure practices. Lack of consumer education on banking terms and conditions, policies, rules, and regulations is also a critical factor in securing financial rights.

Recommendations

- High interest rate spread is damaging the competitiveness in economy in general, and in the financial sector in particular. Further, huge profit margins of banks at the cost of depositors' savings cannot be justified on any ground whatsoever. The SBP should exercise its powers to determine reasonable rate of returns for the banks as well as the depositors. As a matter of priority, interest rate spread should be reduced, at least, to the level of average spread in the South Asian region. The average spread in India, Sri Lanka and Bangladesh is less than 6% (CRCP, 2008).

- The rising volume of public complaints indicates that banks are not fully complying with existing SBP regulations. The mechanism for enforcement of regulations needs to be strengthened. The compliance assessments conducted by SBP should be publicized, and a ranking of banks according to the degree of compliance be publicized through print and electronic media to deter the banks from non-compliance. Also, the banks should be penalized for non-compliance with mandatory requirements.

- Aggressive marketing and unsolicited financing is promoting unnecessary private consumptions at the cost of consumer savings. The SBP regulations should discourage this approach. The unsolicited financing through personal loans, auto loans, credit cards, etc. should be forbidden. Nevertheless, the banks should have the right to offer products through transparent advertising.
- The available data about consumer financing is collected and analyzed mainly from the viewpoint of monetary policy and macroeconomic indicators. The issues, which affect the borrowers at individual level, are not fully captured in research. Standalone stories appear in the media, which are not sufficient to articulate the real issues in a broader context. Therefore, the SBP should conduct national Survey of Consumer Financing (SCF) at least every two years. The findings of this survey should be used to adjust and modify the regulations, and introduce reforms in the banking sector to address the grievances of consumers.

- Comparative information is not available to the consumers to make informed choices. If a consumer is interested to find out the bank with lowest mark up on the personal loan for instance, consolidated bank-wise data is not available in Pakistan. As a result, the consumer has to rely on misleading advertisements and false promises of banks. The SBP should prepare and advertise bank-wise consolidated data in form of charts and tables for the public in Urdu and local languages so that they are able to choose a bank on the basis of reliable information. This practice would help promote competition among the banks, and create an incentive for improving efficiency and the quality of services.

- The complaint procedure is lengthy. The normal time allowed to banks, the Banking Ombudsman and in case of appeal, to the SBP for redress of a consumer complaint aggregates to about 4 months. If a consumer has to go the judicial process against the SBP's decision, then it might take even longer. The number of days for redress of complaints should be reduced.

- The SBP regulations should bind the banks to explain ALL applicable charges on consumer loans before signing the contract. Banks fix different types of charges on credit cards and loans as a percentage as well as a minimum amount, and charge to the customer whichever is higher. For instance, some banks charge Rs.500 or 3% of cash advance amount on credit cards, whichever is higher. If the cash advance amount to be paid by the customer at the rate of 3% is less, then the bank would charge Rs.500, instead of 3%. This practice is unfair and should be abolished immediately. The bank should either charge fee or only percentage.

- The problems in interest rate spread and service delivery notwithstanding, consumers have benefited a lot from the consumer-financing sector. A large number of people have been able to meet their real needs by accessing credit from the banks. Therefore, steps need to be taken for sustainability of this sector. This requires the banks to develop databased lending strategies to manage the risks associated with this sector.

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