STATE BANK OF PAKISTAN

Bond Market Development in Pakistan

Muhammad Arif

September 2007

Abstract: Bond market development has now gained priority in fostering financial sector growth in all economies whether developed or developing. Asian and Mexican crises have given a clear message that this market, falling between equity and bank finance, needs proper attention failing which investment climate within these countries would remain under threat. With this perspective, the paper has been drafted highlighting Pakistan's economic conditions, its financial market architecture, securities market structure with its status, issues, and reforms in hand and then finally proposing future agenda.

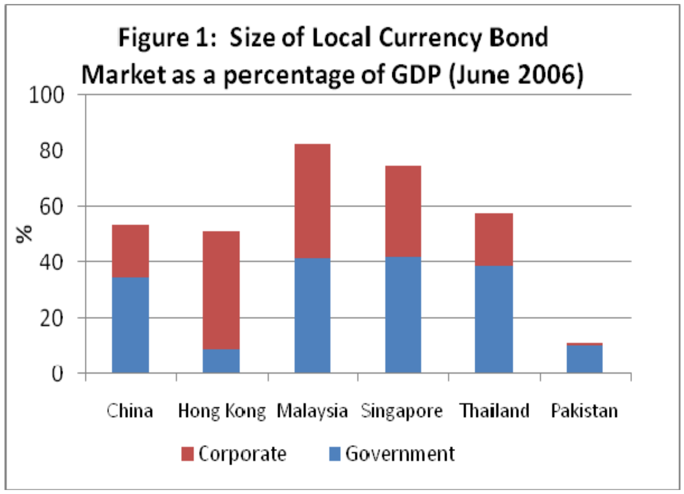
Author is a Senior Manager in State Bank of Pakistan working on Monetary Policy execution Framework and Debt Market Development. Views expressed in this paper are not of SBP and are of the author's. Paper has been drafted for the project "Capacity building of bond markets in UNESCAP member states". The paper has been read in UNESCAP workshop in Bangkok on February 14-15, 2007. The author also acknowledges the support of Mr. Athar Ghafoor, Mr. Muhammad Aamir Mahmood and Mr. Muhammad Kashif Rahim of FSCD, SBP Karachi in accomplishing data for this paper and its formatting. The source of data is SBP Annual Report 2005-06, SBP website, Pakistan Economic Survey 2005-06.The paper has been finalized in the last week of December, 2006 - first week of January, 2007 and now has been updated with the Support of Mr. Hastam Shah of FSCD in Aug-Sep, 2007.

TABLE OF CONTENTS

INTRODUCTION

The fixed Income market falls in between equity market and bank finance. Hence obviously, it suits to the class of investors/borrowers that are neither high risk lovers nor completely risk averse or relatively act under safe parameters within bank finances.

Various financial market crises surfaced during the last decade of 20th century notably Mexican and Asian Crisis in 1997 which gave clear message that without developing domestic bond markets, an economy would remain under risk of capital outflows. To attract capital flows and support growth efforts, existence of domestic bond market is highly essential that provides opportunity to the investors to diversify the risk profile of their portfolio.



Geographically, Pakistan falls in very important location with immense appetite to attract investment and it is therefore imperative to give fresh thoughts to develop its Capital market especially focusing on developing local Bond Market as its current size is very small and is not in conjunction with its requirements.

The paper tries to discuss the status of debt market in Pakistan with issues and dilemmas confronting its development with suggesting ways for their resolutions.

HISTORY

Prior to 1990, Federal and Provincial Governments used to borrow on tap instruments with predetermined rates. The main thrust of Federal Government borrowing was through captive funding. Large statutory preemptions and borrowing from SBP at highly concessionary rates enabled the Government to finance its large fiscal deficits. In such an environment the only tool available to counteract was to makes successive increases in Statutory Liquidity Requirement (SLR) and Cash Reserve Requirement (CRR). There was very little scope for development of Government Securities Market in Pakistan that could provide benchmarks for private sector to play their role in development of Capital Market in the country. To cover non-banking segment, Prize Bonds were introduced in 1960 followed by various NSS schemes. However 1990 onward, market based Government Securities came in to existence. With the introduction of long term paper in 1992 (FIB), long term yield curve emerged that gave opportunity to the Corporate to come up with their instruments that became reality in 1995.

Long-term instruments gained momentum after the introduction of Pakistan Investment Bonds (PIBs) in 2000, to stream line the auction of Government Securities and to develop secondary market for the Government paper. SBP introduced selective Primary Dealer System (PD) in 2000. In 2001 KIBOR/KIBID rates were introduced to provide inter-bank call money curve. With the development of Fixed Income Securities Market in Pakistan, SBP allowed Commercial banks to make available Derivative products to their clients. In this regard SBP issued guidelines on Forward Rate Agreements (FRA), Interest Rate Swaps (IRS) and Currency Options in 2005.

Foundation of the corporate bond market was laid in 1995 with the first issue of Term Finance Certificates (TFC). Since then, issuance of listed TFCs has totaled approximately PKR 67 billion. The Corporate Bond market in Pakistan has been much more vibrant over the 2001-05 periods, adding approximately PKR 65 billion in issuance or 98% of total issuance to-date.

Pace of development of Islamic Money and Sukuk market is a new phenomenon that gained importance with the induction of 6 full-fledged Islamic Banks and 16 conventional banks to conduct Islamic banking business in Pakistan; however the size of Sukuk Market is very small at the moment. To facilitate Corporates to raise short term funding i.e. up to 9 months, Commercial Papers have recently been allowed but the market has yet to take its roots.

PART I

OVERVIEW OF THE ECONOMY AND FINANCIAL SECTOR

1. Overview of the Economy:

Pakistan's economy has grown at an average rate of 7.0 percent per annum during the last five years (2002/03 – 2006/07). The growth momentum sustained by Pakistan for the last five years is underpinned by dynamism in industry, agriculture and services, and the emergence of a new investment cycle with investment rate reaching new height at 20.0 percent of GDP.

The growth targets for FY07 have been achieved despite headwinds faced by the economy from rising oil prices, hovering around $ 70-75 per barrel that put severe strains on the country's trade balance on the one hand and budget on the other, and massive earthquake of October 8, 2005 causing extensive damage to property, infrastructure, School, Hospital etc.

The current status of some of the macroeconomic indicators of Pakistan is as follows:

Table 1: Macroeconomic Indicators

Indicators	FY 02	FY 03	FY 04	FY 05	FY 06	FY07
Real GDP Growth	3.1	4.8	7.5	8.6	6.6	7.0
Current Account Deficit % of GDP	4.0	4.9	1.8	-1.4	-3.9	-4.3
Currency Adjustments PKR/US$ % p.a.	6.42	3.79	-0.55	-2.56	-0.87	-0.51
M2 Growth	15.4	18.0	19.6	19.3	15.2	19.4
Interest Rate (6 months T-Bills)	6.43	1.66	2.23	7.98	8.48	8.90
Inflation CPI	3.15	3.1	4.6	9.3	7.9	7.8
Fiscal Deficit % of GDP	4.3	3.7	2.4	3.3	4.2	4.2

Real GDP:

Real GDP grew by 7.0% in 2006-07 as against 6.6% last year. Pakistan economy has grown at an average rate of almost 7.0% per annum during the last five years and over 7.5% over the last four years, thus enabling it to join the exclusive club of the fastest growing economies of the Asian Region.

Agriculture Sector:

Agriculture sector accounts for 20.9 percent of the GDP and employs 43.4 percent of the total work force. Growth in the agriculture sector registered a sharp recovery in 2006-07 and grew by 5.0 percent as against the preceding year's growth of 1.6 percent. Recovery of major crops from (-) 4.1 to (+) 7.6 on the back of higher production of wheat and sugarcane helped this sector to contribute positively in the overall GDP growth.

Manufacturing Sector:

Overall manufacturing sector accounts for 18.2 percent of GDP. This sector registered an impressive and broad based growth of 8.45 percent in FY07 compared with 9.9 percent in FY06.

Large-Scale Manufacturing:

Growth in large-scale manufacturing (which accounted for around 70 percent of overall manufacturing) at 8.75 percent somewhat decelerated against last year's achievement of 10.68 percent. The decline in growth in the manufacturing sector is attributed to multiple reasons like reduced production of cotton crop, sugar shortage, steel and iron problems, high oil prices etc.

Services Sector:

The services sector continued to perform strongly for third year in a row and grew by 8.0 percent in 2006-07 as against 9.6 percent of last year. Growth in the services sector in 2006-07 was primarily attributable to strong growth in the finance and insurance sector, better performance of wholesale and retail trade, as well as transport and the communications sector.

Pakistan's per capita real GDP:

Per capita real GDP has risen at a faster pace during the last five years i.e. 13.0% per annum on average in US Dollar term leading to a rise in average income of the people. Per capita income, defined as GNP at market price in dollar terms divided by the country's population, grew by 11 percent during 2006-07 to US$925 up from US$833 last year. Such increases in real per capita income have led to sharp increase in consumer spending during the last couple of years which drives the growth in almost all the sectors.

Investment:

During the fiscal year 2006-07, the real gross fixed capital formation or domestic fixed investment grew by 20.6 percent against 17.6 percent last year. As percentage of GDP, total investment reached 23 percent in 2006-07 from 21.7 percent last year.

Public sector investment on the other hand registered massive growth of 46.7 percent as against a hefty 32.9 percent increase last year. The growth in domestic investment was largely a public sector phenomenon last year but this year, it was mainly public-private sector partnership driven.

Savings:

National savings as percentage of GDP increased to 18.0 percent in 2006-07 from its previous level of 17.2 percent last year. National savings contributed to around 84% of financing of domestic fixed investment during 2006-07.

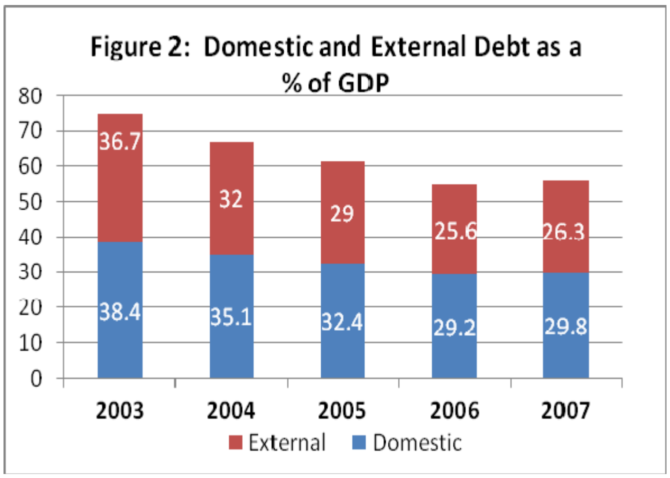
Policy Environment:

Fiscal Policy:

Pakistan has gained further strength on fiscal side. Revenues are buoyant, expenditure is rationalized, fiscal deficit is at sustainable level and revenue deficit has almost been eliminated. Resultantly, Public debt is fast moving towards a sustainable level. Tax collection by the Federal Board Revenue (FBR) has picked up. As a result of prudent fiscal management over the last 5 years, the burden of interest payment in domestic budget has declined sharply, thereby, releasing resources for development and social sector program. Pakistan has succeeded in reducing fiscal deficit from an average of 7 percent of GDP in the decades of 1980s and 1990s to an average of 3.5 percent during the last seven years.

Debt Management:

Pakistan's public debt grew at an average rate of 18 percent and 15 percent per annum during the 1980s and 1990s, respectively – much faster than the growth in nominal GDP i.e. 11.9% and 13.9% respectively. Resultantly, public debt rose from 56 percent of GDP at the end of the 1970s to 92 percent by the end of the 1980s. In other words, it increased by 36 percentage points of GDP during the 1980s. Public debt was 85 percent of the GDP by the end of the 1990s. The root cause of rising debt burden has been the persistence of large fiscal and current account deficits. Pakistan, on average, sustained fiscal and current account deficits of almost 7 percent and 5 percent of GDP, respectively during 1990-99.



It is in this background the Government decided to devise new debt management strategy to arrest the rising trends of debt. Reduction in the fiscal and current account deficits, lowering the cost of borrowing, raising revenue and foreign exchange earnings, and debt re-profiling from the Paris Club have been the key features of the debt reduction strategy. To provide legal cover to debt reduction strategy a Fiscal Responsibility and Debt Limitation Act 2005 has been promulgated in June 2005. As a result of the credible strategy being followed by the Government, the public debt- to-GDP ratio, which stood at almost 85 percent in end June 2000, declined substantially to 53.4 percent by the end of March 2007, a decline of 28 percentage points in country's debt burden in 7 years.

Monetary Policy:

Easy and accommodative monetary policy stance that have been pursued during the last few years by the SBP which underwent considerable changes during the FY05, switching from a broadly accommodative to aggressive tightening. In order to arrest the rising trend in inflation, SBP continued with its tight monetary policy stance till FY08 by raising discount rate from 9.5 percent to 10.0 percent from 1st August, 2007. Tight monetary policy stance is likely to continue until inflationary pressures are significantly eased off in the time to come.

Monetary Aggregates:

Annual trends of monetary aggregates i.e. M1, M2 and M3 since June 2000 are below:

Table 2: Stocks of monetary Aggregates						
End Period Stocks	**Monetary Supply and Monetary Assets**			**(% age Change)**		
	(M1)	**(M2)**	**(M3)**	**(M1)**	**(M2)**	**(M3)**
June 2000	739.0	1400.6	2137.2	14.9	9.4	11.7
June 2001	761.4	1526.0	2313.9	3.0	9.0	8.3
June 2002	876.8	1761.4	2640.9	15.2	15.4	14.1
June 2003	1106.3	2078.7	3102.0	26.2	18.0	17.5
June 2004	1371.6	2486.6	3517.0	24.0	19.6	13.4
June 2005	1624.2	2966.4	3975.5	18.4	19.3	13.0
June 2006	1840.6	3416.52	4423.4	13.3	15.2	11.3
March 2007	3256.7	3793.0	4837.5	7.7	11.0	9.4

Whereas M1 consists of the outstanding stock of currency in circulation, the demand deposits of scheduled banks and other deposits with the State Bank of Pakistan and M2 is M1 plus the outstanding stock of time deposits of scheduled banks and the outstanding stock of the Residents Foreign Currency Deposits (FRCDs). Similarly M3 includes: the outstanding stock of the M2, outstanding deposits of the national saving schemes (NSS), and outstanding deposits of the provincial cooperative banks of the Punjab, Sind, NWFP, Baluchistan, AJK and the Northern Areas.

Interest Rate:

Pakistan experienced an unprecedented inflow of foreign exchange after the events of 9/11. SBP had to actively intervene in the FX market to purchase the excess supply of foreign exchange with the objective to contain volatility in the exchange rate, manage liquidity in the system and at the same time to build-up foreign exchange reserves. These market interventions led to surplus liquidity in the banking system. Therefore, SBP had to sterilize the expansionary effects of foreign capital inflows on monetary aggregates and inflation. MTB yields - that are considered tool for interest rate signaling - went down considerably without any change in discount rate during FY 02 and FY03 in wake of heavy inflows that started coming in onward Sept,2001 (*See* **Table 3** and **Figure 3**).

Table 3: Interest Rate										
MTB	2002-03		2003-04		2004-05		2005-06		2006-07	
	End June	Change bps	End June	Change bps	End June	Change bps	End June	Change bps	End June	Change bps
03-M	1.66	(415)	1.74	9	7.51	577	8.32	81	8.69	37
06-M	1.67	(477)	2.23	56	7.98	576	8.48	50	8.90	42
12-M	2.37	(462)	2.24	(13)	8.45	620	8.79	34	9.12	67

Situation started reversing since mid 2003 and gained pace 2004 onward under rising inflation figures that forced SBP to increase its discount rate by 200 bps in April 2005. Thereafter SBP intervened in the inter-bank market quite frequently. For example during FY07 SBP conducted 71 OMOs and withdrew liquidity to the extent of Rs 936.65 billion against the marginal injections of Rs 61.0 billion resulting in average overnight rates to hover around 9.0 percent for most of time during FY07.

Figure 3: MTB Auction Cut-Offs

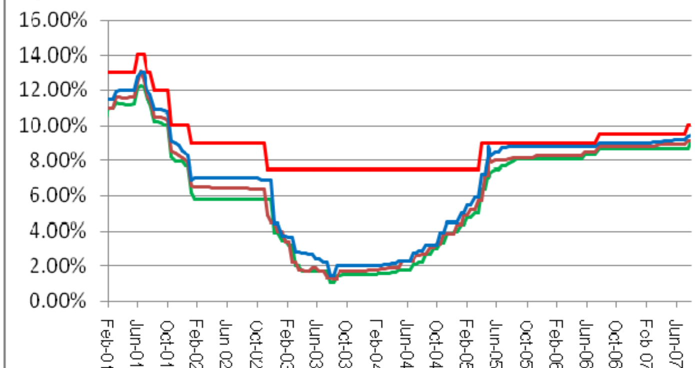
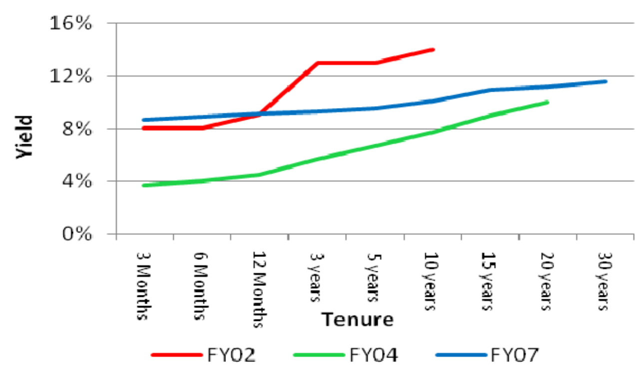


Figure 4: End-Period Yield Curve



The present tight monetary policy stance has been reflective in rising interest rates in the secondary market, particularly the short-term interest rates as 6-month and 12-month KIBOR rose by 92 bps to 9.61 percent and 76 bps to 10.06 percent, respectively. The long-term interest rates did not experience any significant changes from their trend levels due to lack of activity in long-term papers in the absence of PIB auctions for two consecutive fiscal years. Therefore, the higher pace of hike in short-term interest rates relative to long-term rates flattened the yield curve.

Foreign Exchange Rate Policy:

One of the major responsibilities of the State Bank is the maintenance of external value of the currency. In this regard, the Bank is required, among other measures taken by it, to manage foreign exchange reserves of the country in line with the stipulations of the Foreign Exchange Act 1947. As an agent to the Government, the Bank has been authorized to purchase and sale gold, silver or approved foreign exchange and transactions of Special Drawing Rights with the International Monetary Fund under sub-sections 13(a) and 13(f) of Section 17 of the State Bank of Pakistan Act, 1956.

In order to promote exchange rate stability, Pakistan has experimented with different exchange rates systems i.e. fixed, managed; free float with a cap on its downward movement till the rupee was finally set on free float from July 21, 2000.

One of the most important episodes in Pakistan's FX history was the freezing of Residents Foreign Currency Accounts after nuclear detonation by Pakistan in 1998. A two-tier exchange rate system was introduced w.e.f. 22nd July 1998, with a view to reduce the pressure on official reserves and prevent the economy to some extent from adverse implications of sanctions imposed on Pakistan. However, effective 19th May 1999, the exchange rate has been unified, with the introduction of market-based floating exchange rate system, under which the exchange rate is determined by the demand and supply positions in the foreign exchange market.

As the custodian of country's external reserves, the State Bank is also responsible for the management of the foreign exchange reserves. The task is being performed by an Investment Committee which, after taking into consideration the overall level of reserves, maturities and payment obligations, takes decision to make investment of surplus funds in such a manner that ensures liquidity of funds as well as maximizes the earnings. These reserves are also being used for intervention in the foreign exchange market.

Figure 5: End of Period Exchange Rate (PKR/USD)

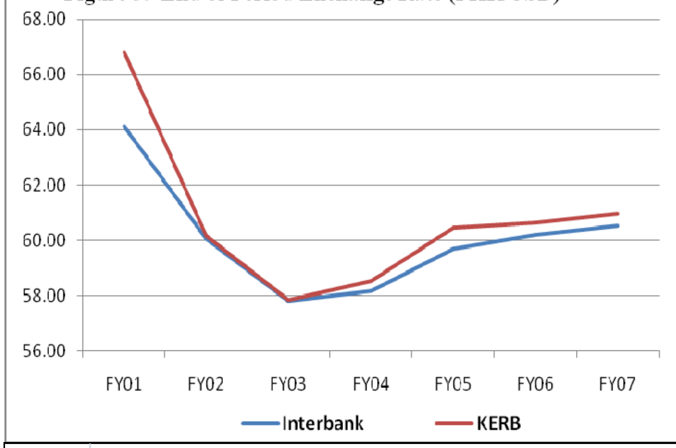


Table 4: End-Period Average Exchange Rate (PKR/USD)

	FY01	FY02	FY03	FY04	FY05	FY06	FY07
Interbank	64.11	60.05	57.80	58.17	59.69	60.21	60.52
KERB	66.80	60.18	57.85	58.53	60.46	60.63	60.95

SBP has successfully achieved exchange rate stability during FY07 as rupee registered a marginal depreciation of 0.51 percent compared to 0.87 percent last year (*see* **Table 4**). The stability of Pak rupee was mainly contributed by prudent intervention of SBP in the inter-bank forex market and increased inflow of workers' remittances. Higher demand for dollar due to rise in oil prices coupled with surge in demand for imported machinery generated some pressure on Pak rupee during FY05 – FY07. However, this pressure was effectively managed by SBP through provision of support for oil and commodities thus maintaining the exchange rate stability.

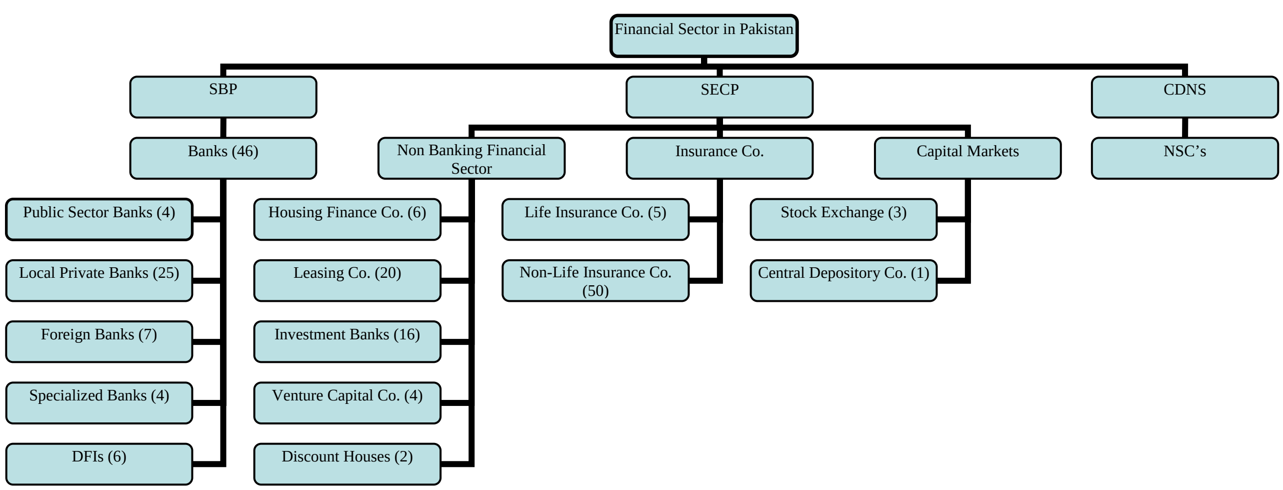
2. <u>Financial System</u>

- **Architecture of Financial System in Pakistan:**

The Financial system in Pakistan is now market oriented as against its past. State Bank of Pakistan, Central Directorate of National Savings and Securities and Exchange Commission are the main institutions regulating the financial system. The features of financial system in Pakistan can be summarized as under:

- Autonomous Central Bank.
- Commercial banks, Investment banks, Leasing companies, Modarba, Mutual Funds are permitted in the private sector.
- Deposits and lending rates determined by the banks themselves.
- Market oriented interest rate policy.
- Use of indirect monetary management tools.
- Floating exchange rate regime.
- Benchmark yields curve available for 3 months to 30 years on the basis of 9 benchmark issues.
- Equity and Corporate Bonds market being regulated by a separate entity viz. SECP.
- Securities are exchanged on the basis of delivery versus payment system with T+3 for corporate securities and T+0 for Government Securities.
- National Saving schemes being regulated by a separate entity viz. CDNS working under MOF. CDNS has been given autonomy in 2007.
- Commercial Banks are in phase of merger and acquisitions for having healthy equity base for meeting Basle II requirements whereas new banking licenses are now being issued to the Islamic banking institutions only.

Structure of Financial Industry in Pakistan:



Central Bank: Objectives, Functions & Organization:

State Bank of Pakistan is the Central Bank of the country. Under the State Bank of Pakistan Order 1948, the Bank was charged with the duty to "regulate the issue of Bank notes and keeping of reserves with a view to securing monetary stability in Pakistan and generally to operate the currency and credit system of the country to its advantage". The scope of the Bank's operations was considerably widened in the State Bank of Pakistan Act 1956, which required the Bank to "regulate the monetary and credit system of Pakistan and to foster its growth in the best national interest with a view to securing monetary stability and fuller utilization of the country's productive resources". Under Financial Sector Reforms, the State Bank of Pakistan was granted autonomy in February 1994. On 21st January 1997, this autonomy was further strengthened by issuing three

Amendment Ordinances (which were approved by the Parliament in May, 1997) namely, State Bank of Pakistan Act, 1956, Banking Companies Ordinance, 1962 and Banks Nationalization Act, 1974. The changes in the State Bank Act gave full and exclusive authority to the State Bank to regulate the banking sector, to conduct an independent monetary policy and to set limit on government borrowings from the State Bank of Pakistan.

Like any Central Bank of developing countries, State Bank of Pakistan performs both the traditional and developmental functions to achieve macro-economic goals. The traditional functions, which are generally performed by central banks almost all over the world, may be classified into two groups: (a) the primary functions including issue of notes, regulation and supervision of the financial system, bankers' bank, lender of the last resort, banker to Government, and conduct of monetary policy, and (b) the secondary functions including the agency functions like management of public debt, management of foreign exchange, etc., and other functions like advising the government on policy matters and maintaining close relationships with international financial institutions. The non-traditional or promotional functions, performed by the State Bank include development of financial framework, institutionalization of savings and investment, provision of training facilities to bankers, and provision of credit to priority sectors. The State Bank also has been playing an active role in the process of Islamization of the banking system. The main functions and responsibilities of the State Bank can be broadly categorized as under.

1. Formulation and Conduct of Monetary Policy - *Interest Rate Management.*
2. Regulations and Supervision – *Sound Financial System*
3. Exchange Rate Management --*Maintaining Value of Currency*
4. Payment and Settlement System – *Smooth conduct of banking transactions*

- **Banking System (Bank Institutions):**

Financial landscape of the country was significantly altered in early 1970s with nationalization of domestic banks and expansion of public sector development finance institutions. By the end of 1980s, it became quite clear that objectives of nationalization were not achieved. At the end of FY90, the share of public sector banks was 92.2 percent in total assets, while the rest belonged to foreign banks as domestic private banks did not exist at that time

During 1990's realizing the inherent weaknesses of the financial structure, Government initiated a broad based program of reforms in the financial sector. Reforms covered seven important areas:

1. Financial liberalization,
2. Institutional strengthening,
3. Domestic debt,
4. Monetary management,
5. Banking law,
6. Foreign exchange
7. Capital market.

Under financial liberalization banking licenses were allowed to Private Sector in 1992 and Privatization process was initiated under which major Public Sector Banks were privatized to improve efficiency and competitiveness in the banking sector. Now there are only four public sector banks with less than 15% of deposits base.

Roles, Degree of Consolidation and Competition between Private and Public Sector Institutions:

SBP continued with its reforms agenda for banking system and strengthening of supervisory capacity during FY 2007 to ensure soundness of financial system. It undertook initiatives in a number of areas like enhancement of minimum capital requirements (MCR) for banks to Rs.6 billion by end of December, 2009, introduction of variable capital adequacy ratio based on Institutional Risk Assessment Framework (IRAF) rating of banks/DFIs along with outlining a road map for smooth transition from Basel-I to Basel-II. As the implementation of Basel-II poses tremendous challenges for the banking system, SBP has encouraged the financial institutions for capacity building in terms of upgrading the IT systems and enhancement of expertise in specialized areas like risk management and Anti-Money Laundering (AML) through seminars and workshops.

Since 2000 mergers and acquisitions have taken place in the banking industry. The policy of merger and consolidation has resulted in efficiency for banks/DFIs through high penetration of technology and greater manoeuvrability in enhancing their business volumes, sale and size to achieve cost efficiencies.

In order to reduce size on non performing loans schemes was devised that has enabled banks/DFIs to make huge recoveries and write-off which reduced the ratio of non-performing loans from 9.9 percent in 2002 to 1.98 percent by end-March 2007.

Table 5: Year-wise % of Net NPLs to Net Loans:

2002	2003	2004	2005	2006	2007*
9.9	6.9	3.8	2.1	2.1	1.98

*: Up to 31st March 2007

Non-Banking Financial System (Non-Bank Financial Institutions):

Non-bank Financial Institutions (NBFIs) play a pivotal role in mobilizing savings in the economy. NBFIs can be categorized into ten groups: -

1. Development finance institutions (DFIs)
2. Investment banks (IBs),
3. Leasing companies
4. Mutual funds
5. Housing finance companies (HFCs)
6. Modaraba companies
7. Discount houses (DHs)

8. Venture capital companies (VCCs).
9. Investment Advisory Services.
10. Asset Management Services.

These institutions play a key part in channelizing funds in Pakistani financial system by accepting term deposits of differing maturities and providing financing to a variety of sectors of the economy, with SMEs and consumer financing being the areas of especial focus. Parallel to the broader banking sector, in the early 1990's, the financing activities of these institutions registered healthy growth under the market reforms instituted. During this period NBFIs in Pakistan underwent a significant shakeout due to a program of comprehensive financial sector reform which included: -

- Liberalization of the foreign exchange market and interest rates.
- Increased autonomy to the central bank and its focus on monetary policy and banking supervision.
- Establishment of an independent Regulatory Department at Securities & Exchange Commission of Pakistan (SECP) for capital markets and NBFIs.
- Upgrading of legal and regulatory frameworks.
- Reduction of NPLs in the banking sector.
- Restructuring of government-owned financial institutions.

Further, structure of non-bank financial institutions was more skewed with a hefty share of development finance institutions (all in public sector) at 78.6 percent. Apart from DFIs, non-bank financial institutions remained practically unsupervised due to lack of autonomy and multiplicity of supervisory agencies over them that included Corporate Law Authority, Monopoly Control Authority and Controller of Capital Issues, all attached directly with the Ministry of Finance. During 1990's an NBFI Regulation and Supervision Department was established in State Bank that subsequently issued 'Rules of Business' to supervise them. In 2003 the regulations of NBFIs except DFIs were transferred to SECP.

4. Financial Markets:

Financial Markets in Pakistan comprise of Money Market (MM), Equity Market, Bond Market, Foreign Exchange Market (FX) and Derivatives Market. The main players are Banks, Non Bank financial Companies (NBFCs), Corporates, Stock Exchanges, Government and general public and the Regulators i.e. SBP and SECP.

Money Market (MM):

Money Market is mainly comprised of MTB issuances of 3, 6 and 12-month tenors, OMOs, Repo, outright; Call Market, Discount window and FX market activities. It operates through Primary and Secondary Market framework. MM is also used for carrying out monetary policy operations through impacting interbank by changing the Reserve Money Stock.

Primary Market: MTB Auctions:

In Pakistan, MTB auctions provide interest rate signals to the market. Auctions are held on fortnightly basis and are used for raising short-term funds for the Government. SBP holds MTB auctions through selective PDs (Currently there are 10 PDs i.e. 8 banks, 1 DFI and 1 Brokerage house). MTBs are available at discount at quoted prices i.e. auctions are held at multi priced basis. MTBs with its risk profile serve the purpose of meeting banks SLR requirements and as collateral in the Repo market.

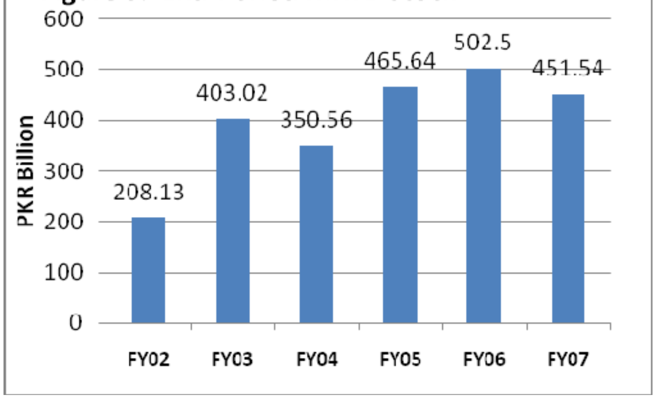
Table 6: MRTB Stock (Rs in billion)

FY02	FY03	FY04	FY05	FY06	FY07
208.13	403.0	350.5	465.6	502.5	451.5

Government Borrowing from SBP:

Government borrowing from the SBP impacts MM as it results in increase in monetary base that subsequently constraints SBP to check it through its monetary policy operations. In Pakistan Government can borrow from SBP without any limit (SBP Act provides that SBP can enforce limit if it is being understood that Governments will meet its additional credit requirements direct from commercial banks through market based auctioning system to be conducted by the SBP). The Government borrows from SBP at 6 month MTB cut off rate arrived at in the last auction. Prior to 1990 Government used to borrow from SBP at 0.5% that was discontinued with the introduction of Financial Sector Reforms initiated in 1990. Government borrowing direct from the SBP is one of the major factor of market volatility and major cause of creating inflationary pressure. To curb this ill some form of ceiling on GOP borrowing from the SBP is required to be imposed to control volatility in the MM.

Figure 6: End-Period MRTB Stock



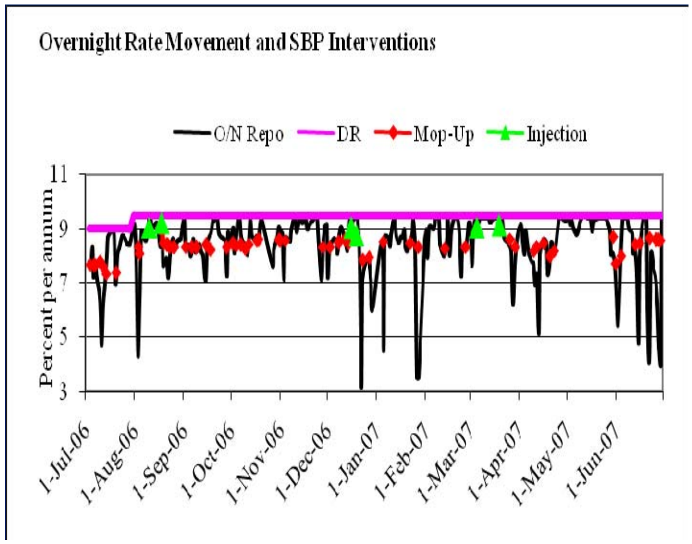
Secondary Market:

OMOs are conducted through Repo or outright basis and are intended to absorb or inject liquidity in the MM using T-Bills. Only Commercial Banks are allowed to participate in the OMO. The role of Open Market Operations as a monetary policy tool went under various evolutionary phases. From 1995 – 2004, SBP's Monetary Operations were focused on T-Bill Auctions with pre-determined schedule of fortnightly OMOs of fixed tenors with no forecasting capability of market liquidity. The mechanism resulted in high degree of volatility in Overnight (O/N) & short-term Money Market Rates. In 2002, pre-determined approach was abolished and the conduct of OMOs was made flexible on as and when required basis to counter unpredictability of cash flows (but tenors were in the multiple of one week). These arrangements helped in better management of liquidity and kept short-term interest rates as per monetary policy targets.

The complete profile of OMO's since 1999 is as follows: -

Table 7: OMO's Conducted							
	FY01	**FY02**	**FY03**	**FY04**	**FY05**	**FY06**	**FY07**
Mop-ups	26	8	6	26	46	64	34
Amt in Bln	103.0	56.4	66.9	410.7	611.2	644.6	469.3
Injections	18	31	4	9	5	30	2
Amt in Bln	45.4	251.5	54.8	76.6	44.2	429.3	21.2
Total OMOs	**29**	**36**	**10**	**33**	**51**	**94**	**36**

To counter interim flows and reserve averaging liquidity, it was decided in April-2005 that broken-date OMOs could be conducted (from 01-day onwards). This measure helped SBP in managing market flows effectively and bringing short-term rates in line with Monetary Policy objectives.



During 2005, SBP Treasury introduced Money Market Computerized Reporting System (MM-CRS) for Banks which not only helped in assessing the Market Liquidity, but also helped SBP to have a better grip on Market Gaps and interbank activity, thus strengthening the market management capability of SBP's through better forecasting. These arrangements have so far being helpful in curtailing market volatility to a greater extent.

O/N Rates –Movements:

This is also evident from the SD and CV numbers for FY 2004-05, 2005-06 and 2006-07.

Table 8:			
O/N Rates	**FY05**	**FY06**	**FY07**
Average %	3.95	8.07	8.01
S D	2.33	0.75	0.97
C V	0.59	0.09	0.12

Repo/Call/Outright: - One of the strength of MM in Pakistan is its Repo Market that is the largest in the region due to its volume. This facilitates MM players to match their funding/securities requirements on short-term basis. Along with this non-collateralized lending/borrowing market (Call) is also very active. However, the Outright Market mostly remains in the vicinity of 10% of Repo volume. The spread between Repo and call market usually remains within a margin of 5-10 bps. In the last two years better liquidity management of the SBP has brought stability in the rates in Repo/Call/Outright markets.

Table 9: Secondary Market Transactions						
Type	**Volume** (PKR in billion)			**% of Total**		
	FY07	**FY06**	**FY05**	**FY07**	**FY06**	**FY05**
Outright	753	488	575	6%	5%	8%
Call	1,999	1,173	1,371	16%	13%	19%
Repo	8,590	6,842	5,100	68%	74%	70%
Clean	1,286	702	248	10%	8%	3%
Total	**12,628**	**9,205**	**7,294**	**-**	**-**	**-**

Discount window activities:

Through this window SBP provides funds to the banks as lender as last resort. This is done through 3 day Repo arrangement but effectively market prefers to avail this kind of borrowing on O/N basis. Further this also provides interest rate signals in addition to signals given through MTB auction. Historically, the role of discount rate as a ceiling to cap overnight interest rates has remained very effective.

Discount Rate as Ceiling for O/N Repo Rate:

Figure 8: Weighted Average O/N Rate Movements

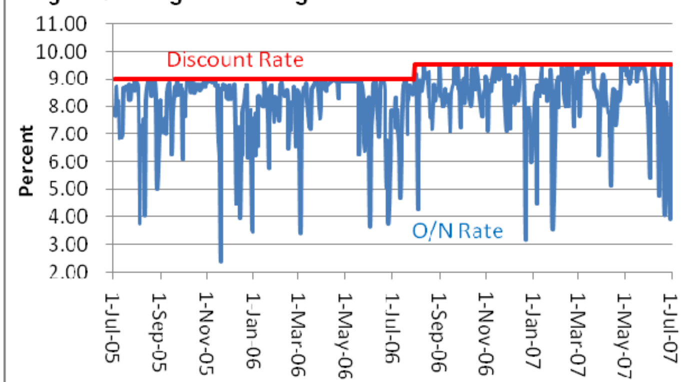
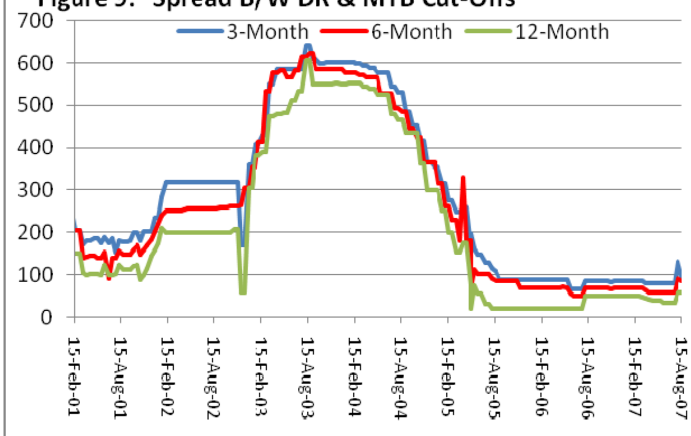


Figure 9: Spread B/W DR & MTB Cut-Offs



The role of DR as an interest rate signal/direction has seen various stages of effectiveness. During the period of high interest rates (before 2002), it was effective in giving monetary policy and interest rate signals and MTB cut-offs and sovereign yield curve used to mimic changes in the discount rate.

After 9/11 and in the wake of huge foreign inflows, the discount rate reduced gradually to indicate monetary policy stance. Since a decrease in discount rate was always followed by big drops in MTB yields hence this gradual process was followed in very cautious manner. During this period November 2002- August, 2003, consistent decline in MTB yields took place, though SBP picked up large amounts in auctions. Normally the spread between discount rate and MTB yields remain within a range of 200 bps, but during this period it went up to 600 bps.

The situation as such made the discount rate insignificant and market started to look for some other explicit interest rate signal and consequently, 6-month cutoff yield emerged as the major monetary policy signal during this period. The role of discount rate at that time was dormant. However, onwards August 2003, with MTB yields picking up, discount rate once again gained its importance.

Table 10: Discount Window Facility (PKR Billion)					
	FY03	FY04	FY05	FY06	FY07
No of Occurrences	65	11	60	125	74
Volume in billion	688.9	46.5	521.4	762.3	687

Since SBP has now started using OMO as more effective tool 2005 onward, so obviously one can question that consequent to this occurrences of resorting to this activity should have been dropped down. However this did not happen and cannot happen till monetary policy execution framework in Pakistan is changed by adopting some other framework to manage interest rate (currently it is being done by targeting monetary aggregates that are not proving effective particularly when the Central Bank has no clue about Government outflows/inflows i.e. Main component of MM flows).

FX Market activities:

FX market interventions by SBP either in form of ready or swap have great impact in the money market as either inter-bank market goes liquid or short in PKR being counterpart of USD. SBP undertakes these operations to achieve objectives to impact MM liquidity, Exchange rate or Forward premiums in FX market.

Table 11: Impact of FX Interventions in Money Market (PKR in billion			
	FY05	**FY06**	**FY07**
Impact in PKR in millions (Mop up)	(74,860)	(119,342)	11,551

Equity Market:

Equity Markets has remained buoyant during last three years and its shares in GDP have jumped from 10% in 2002 to 36% in 2006. Equity markets have played an important role in mobilizing domestic and foreign resources and channeling them to the most productive medium and long term uses. Since these funds are not intermediated therefore it is desired that the resource allocation should be more efficient. In Pakistan capital market includes:

An Intermediated financial system dominated by NBFC's. The performance of three stock exchanges in Pakistan i.e. KSE, LSE and ISE can be viewed from Table 12.

Table 12: Performance of Stock Exchanges in Pakistan										
	FY98	FY99	FY00	FY01	FY02	FY03	FY04	FY05	FY06	FY07
Karachi Stock Exchange										
Total Listed Companies	773	765	762	747	712	702	668	659	658	655
New Companies	2	-	1	4	4	2	16	15	14	11
Fund Mobilized (Rs. Billion)	2.2	1.6	0.4	3.6	15.2	23.8	4.2	54	41.4	22.3
Total Turnover of Shares (in billion)	15	25.5	48.1	29.2	29.1	53.1	97	88.3	104.7	33.5
Lahore Stock Exchange										
Total Listed Companies	-	-	-	614	581	561	647	524	518	519
New Companies	2	1	2	3	3	2	18	5	15	7
Fund Mobilized (Rs. Billion)	0.3	-	0.4	2.5	14.2	4.1	3.1	42.1	24.5	7
Total Turnover of Shares (in billion)	5.6	9.8	1.6	7.8	18.3	28.2	19.9	17.5	15.1	5.6
Islamabad Stock Exchange										
Total Listed Companies	-	-	-	281	267	260	251	232	240	240
New Companies	2	1	0	5	3	1	8	5	6	6
Fund Mobilized (Rs. Billion)	11.3	5 .0	0	0.8	3.7	11.5	2.6	27.6	-	12
Total Turnover of Shares (in billion)	0.5	3.3	3.1	1.4	2.7	2.1	1.4	0.7	0.4	0.04

Table 13: KSE-100 Historical Highs and Lows					
KSE-100	**FY03**	**FY04**	**FY05**	**FY06**	**FY07**
Index High	4606.0	5620.7	10303.1	12273.8	13772.5
Index Low	2356.5	4473.3	6220.3	8766.9	10066.3
Change-%	95	26	66	40	36

Performance wise equity market in Pakistan looks highly lucrative in the group of emerging economies, however its volatility as depicted through lows and highs in its indices is causing problems and has invited attention of its immediate regulators (Stock Exchanges) and apex regulator (SECP) to take appropriate steps. Some of these are as follows.

Table 14: Performance of Global Stock Markets during FY07

Index (in local currency terms)			
Country	**30-Jun-06**	**30-Jun-07**	**% Change in USD**
Pakistan	9,989	13,772	37.6
India	10,609	14,651	56.4
Taiwan	6,704	8,883	30.8
Hong Kong	16,268	21,773	33.0
Malaysia	915	1,354	57.0
Japan	15,505	18,138	8.7
China	1,672	3,821	139.9

1. COT/Badla financing have been replaced with continuous funding system (CFS) since august 22, 2005. This is an interim arrangement to enhance market liquidity and would end on alternate mode of leverage financing i.e. margin financing.
2. To protect investors and curbing market abuse, the proprietary trading regulations have been amended.
3. Listing regulations have been brought in line with code of corporate governance.
4. For protection of investors trading via account of other brokers have been barred.
5. Futures contracts have been standardized with multiple durations i.e. for 30, 60 and 90 days.
6. Risk management governance and transparency measures have been brought in i.e. providing margin verification system, exit mechanism, regulations for good governance and disclosure in future market.
7. Unique identification numbers have been developed by the central depository company for each investor.
8. KSE has introduced free float index as KSE-30 sensitive index to represent the market on free float rather then the number of outstanding shares.

Pakistan's equity market performance was not good when compared to other emerging markets of Asia. As shown in the accompanied table, Pakistan ranked amongst the worst performing market by posting a dollar gain of only 3% in 2006 versus MSCI EM return of 29%. In fact, Pakistan's performance was slightly over stated as it also includes dividend yield of approx. 6.0% in 2006. Pakistan has a "total return" Index compared to most of regional indices which do not include dividends.

Bond Market (Government & Corporate Bond Market):

Bond Market is composed of Pakistan Investment Bonds of 3, 5, 10, 15, 20 and 30 year maturities Corporate bonds (Term Finance Certificates), Sukuks and Commercial Paper. Overall this market is 5% of GDP at the moment which is very small as compared to other economies.

Table 15: Asian Emerging Markets

Country	Index	US$ Return 2006
China	SSE A	138.3%
Indonesia	JSX	69.9%
Philippine	PSE	54.1%
India	SENSEX	49.3%
Sir Lanka	CSE All	34.6%
Malaysia	KLCI	30.4%
Taiwan	TWII	20.3%
Korea	Kospi	13.0%
Thailand	SETI	10.1%
Pakistan	KSE-100	3.2%

Government Bond Market:

Volume of Govt. bonds market in Pakistan can be seen from Table 16.

Table 16: Outstanding Amount of Securities (Rs. In Billion)

	June 04	June 05	June 06	June 07
PIB	331.65	307.60	303.87	352.52
FIB	33.54	14.59	6.64	2.15
Total	365.18	322.19	310.51	354.67

Main features of government bond market in Pakistan are as under:

- Bonds are issued in 3, 5, 10, 15, 20, and 30 years tenors.
- Bonds are issued through auction system in which only Primary Dealers (PDs) can participate.
- Issued at Par.
- Coupon payments are made semi annually.
- Bonds are issued in the form of un-certificated bonds and are maintained in SGLA maintained by the SBP.
- Bonds are SLR eligible securities and individuals, institutions and corporate bodies including banks can purchase, irrespective of their residential status.
- Bonds are tradable in secondary market.

Corporate bond Market:

Main features of the corporate bond market in Pakistan are as under:

1. The corporate bond in Pakistan is in form of Term Finance Certificate (TFC).
2. TFCs are based on legislation enacted in 1984, which authorise issuance of redeemable capital securities. As a debt instrument TFC is slightly different from the corporate bond because it was specifically designed to comply with Shari'ah law. The key difference is that the TFC substitutes the words "expected profit rates" for "interest rate".
3. TFC issuers include both NBFIs as well as public and private firms.
4. The coupon rates on the TFCs display a wide variety with different fixed coupons as well as floating coupons linked to various interest rates including the discount rates, PIB rates and the KIBOR.

Table 17: Term Finance Certificates					
FY	**No of**	**Coupon Range**	**Volume (Million**	**Matured**	**Outstanding**
1995-00	11	16.25% - 19.00%	9,890	460	9,430
2001-03	50	8.00% - 11.25%	48,694	2,450	46,244
2004	4	7.00% - 16.00%	2,700	1,601	59,683
2005	14	4.47% - 14.30%	16,100	7,080	70,305
2006	9	10.66% - 13.42%	18,135	3,840	80,088
2007	10	12.07%-13.06%	11,650	22,402	84,767
Total	**98**	**-----**	**107,169**	**15,431**	**-**

Sukuk (Shariah Compliant instrument) Market: -

Sovereign Sukuk market does not exist in Pakistan, though GOP has floated a Sukuk in the international market in 2005 that fetched US$ 600 million at 6 months Libor+ 220bps. The concept used in this issue was Ijarah (Leasing). SBP in this regard has proposed a product for the domestic market based on Ijarah concept. Moreover, to fulfil the needs of short-term instrument having T-Bill features, a hybrid product (Combination of Ijarah and Murhabah concepts) has been proposed to the GOP.

Table 18: Corporate Sector (Sukuk)			
Issuer	Tenor	Rupees in million	Return
Sitara Chemicals	5 years	350	Variable (Musharkah)
Al Zamin Lease	5 years	275	Variable (Mudarbah)
WAPDA (Quasi)	7 years	8,000	6 month KIBOR+ 35bps

On Corporate side three Sukuks have been issued as under:-

Commercial Papers:

Commercial Paper (CPs) is an unsecured tradable instrument used by highly rated corporate entities to raise short tern working capital. It is usually sold to cash rich financial institutions which have an appetite for short term MM instrument. CPs are discount instrument like T-Bill and are issued in the form of promissory note. They can even be traded in the secondary market; however secondary CP market is not yet developed in Pakistan.

Derivative Market:

Derivatives business started in Pakistan in 2003 when Citibank Pakistan entered into a Forward Rate Agreement with its client with prior permission of SBP. Since then banks have executed thousands of derivative transactions mostly in the Foreign Currency (G-7 currencies only) Options, Forward Rate Agreements and Interest Rate Swaps. Dealing into any other structure requires prior SBP approval on case-to-case basis.

The basic purpose of permitting banks to undertake derivatives is to enable the market participants and/or corporate to hedge their exposures in the financial markets. However since the market is at a very nascent stage therefore it was decided that initially Financial Derivatives Business Rules (FDBR) issued by the SBP would cover only the vanilla structures and Banks who wish to enter into non-vanilla structure would take SBP approval.

5. Debt and Foreign Exchange Reserve

Gradual but persistent increase in reserves has taken place due to proactive monitoring and liaison with inter-bank market, effective exchange rate management, minimizing the exchange volatility, wining back the confidence of investors, implementation of new computerized systems to keep complete track of FX cash flows and removal of abnormalities in the Kerb market. FX reserves improved to such an extent that the State Bank of Pakistan decided to opt for outsourcing a portion of reserves in 2002.

Table 19: Reserves V/S External Debt

	FY02	FY03	FY04	FY05	FY06	FY07
Liquid Reserves US$ million	6,432	10,719	12,328	12,618	13,137	15,611
Reserve to GDP %	8.77	14.62	14.77	11.44	10.24	10.76
Reserve to External Debt %	19	32	37	37	37	39

Reserve Management function would continue to remain an area of high priority in the years to come in order to achieve goals to bring SBP in line with the best practices of other Central Banks in the area of Reserves Management

6. Foreign Direct Investment Inflows:

Flow of foreign direct investment (FDI) is an important indicator of economic performance as well as the economic prospects of an economy; on the one hand, FDI reflects the investors' confidence in an economy, and on the other hand it provides the required funds to capital deficient economies.

Table 20: FDI Flows in Pakistan

	FY98	**FY99**	**FY00**	**FY01**	**FY02**	**FY03**	**FY04**	**FY05**	**FY06**	**FY07**
Billion USD	0.6	0.5	0.55	0.45	0.55	0.8	0.9	1.7	3.3	5.1

During FY06, FDI flows into Pakistan sustained its trend. This reflects the improved macroeconomic fundamentals and relative policy stability, while privatization proceeds have registered an unprecedented rise to US$ 1.5 billion mainly on account of privatization of PTCL, KESC and HBL.

PART II

DEVELOPMENT OF THE BOND MARKET

1. General Overview;

Government Bond Market:

The Debt management reforms in early 90's in conjunction with monetary management measures resulted in establishment & development of well functioning primary & secondary market for short as well as long term government papers.

In 2000 the State Bank of Pakistan introduced new long term GOP paper "Pakistan Investment Bond" (PIB) with maturities of 3, 5, 10 years by replacing Federal Investment Bonds (FIBs) having same maturities. The FIBs were discontinued in 1998.

To streamline the auction of government securities and to develop secondary market for the government papers, SBP introduced selective Primary Dealer (PD) system in 2000. Scheduled banks/DFIs/listed Brokerage Houses of good repute were selected under this distribution mechanism as PDs. Currently there are 10 PDs including one DFI and one brokerage house. Inception of auctioning mechanism coupled with PD system have resulted in the development of secondary market for both short- and long-term government securities and efficient price-dissemination mechanism improving overall efficiency of Bond and Money Market.

In 2001 KIBOR/KIBID rates were introduced up to 6 months to provide interbank call money curve. This was in addition to PKRV curve already introduced in the market by Financial Market Association (SRO representing market) and used for revaluation of Government Securities up to available tenors. In 2004, all corporate lending by banks were made to be benchmarked to KIBOR. This created significant transparency in Fixed Income Market. In 2003, non-competitive bid option was introduced in PIB auctions to facilitate retail investors to access PIB at weighted average yield arrived at in the auction. In 2003, to make Government Debt, Market based, NSS rates were rationalized by using PIB rates as benchmark. To create liquidity in the Government Bonds market, two Jumbo issues were floated in 2003 and 2004.

In 2004 KIBOR/KIBID was extended, further to 3 years to create benchmark rates available up to this extent to the Fixed Income Market. In 2004, Yield curve was further extended up to 20 years through introduction of 15 and 20 years PIBs. This provided benchmark rates to mortgage /long term financing market in Pakistan.

In 2005, SBP introduced a system of performance measurement for PDs to ensure their full role in creating liquid bond market in Pakistan. In 2005, SBP also facilitated market participants in developing Government Bond Indices in Pakistan. Currently three indices representing Total Return and Clean Price indices are being quoted by two brokerage houses and Financial Market Association (FMA), body representing Treasuries of the banks. With the development of Fixed Income Securities market in Pakistan, SBP allowed Commercial banks to make available Derivatives products to their clients. In this regard SBP issued guidelines on Forward Rate Agreements (FRA), Interest Rate Swaps (IRS) and Currency options in 2005.

Corporate Bond Market:

Foundations of the corporate bond market were laid in 1995 with the first issue of Term Finance Certificates. Since then issuance of listed TFCs has totaled approximately PKR 80 billion A combination of factors resulted in the issuance boom in the past five years. Amongst those were de-regulation of the banking sector, lower interest rates, availability of benchmarks for both fixed and floating rate debt, active inter-bank trading markets in government securities, coming of age for mutual funds, etc.

Corporate bond market in Pakistan is smaller in comparison to many equivalent rated economies (less than 1% of GDP) although the situation is improving. The reduction in interest rate volatility during 2005 brought life back into issuers. Issuers appear less perturbed by higher rates than by volatility. Hence, 2005 and 2006 remained good years in terms of the number of issues and volume of issuance.

Sukuk Market:
Immense growth in Islamic banking industry during the last four years has necessitated for emergence of Sukuk (Shariah complaint instrument) market in Pakistan. However till this day only three issuances have come into the market and that too from the corporate side (***See Part I for details***). GOP Sukuk has yet to be issued that is being awaited as it would in-fact provide yield curve for future Sukuk issuances.

Commercial Paper:

SBP and SECP issued guidelines for their issuance three years back. The tenor of commercial papers is 3, 6 and 9 months. The Corporates can issue CPs on attaining criteria i.e. equity of the corporate is not less than Rs 100 million, minimum credit rating for short term CP should be A- and for long tenor A, it should have clean credit information Bureau (CIB) report and as per the latest ended balance sheet report the company maintains a minimum current ratio of 1:1 and a debit equity ratio of 60:40. CP market is at very nascent stage in Pakistan. Packages Ltd was the first company to raise working capital through CP.

2. Size, Structure & Market Liquidity

Issuance in Domestic Market (in local currency)

Table 21: Government Bonds							
	2001	**2002**	**2003**	**2004**	**2005**	**2006**	**2007**
Outstanding (Rs in billions)	46.12	153.8	228.6	331.6	307.5	303.8	352.52
No of issues	11	12	3	5	1	3	5
Coupon%							
3 years	10.5-12.5	7.0-10.5	6.0-7.0	6.0	6.0	9.1	9.1
5 years	11.0-13.0	8.0-11.0	7.0-8.0	7.0	7.0	9.3	9.3
10 years	12.0-14.0	9.0-12.0	8.0-9.0	8.0	8.0	9.6	9.6
15 years	-	-	-	9.0	9.0	10.0	10.0
20 years	-	-	-	10.0	10.0	10.5	10.5
30 years	-	-	-	-	-	11.0	11.0

Banks invested heavily in 10-years PIBs (***see* Figure 10**).followed by 5-years. Investment in longer terms PIBs is still mainly because they have been introduced in recent past. We except more invest in longer term PIBs in future as the market matures.

The number of listed TFCs remained low compared with FY01 and FY02 mostly because corporate preferred to borrow from the banks/non-banks due to its cost considerations. Similarly, Issuance of commercial papers also remained thin due to high cost in its issuance.

Issuance in External Market (in foreign currency)

On external sector GOP floated three of its Sovereign Bonds including one Sukuk to make its presence on the radar of international debt market. The significant achievement on this front is successful auction of 30 years bonds at competitive price. This has paved the way for Corporate in Pakistan to access international debt market.

Pakistan floated its bond for the first time in 1994 and then in 1997 to the amount of USD 610 million (US$ 150 million on 22-12-94 at 11.5%, US$ 160 million on 26-2-97 at 6% & US$ 300 million on 30-5-97 at 6 Month Libor+395 bps) however in 1998 on detonation of atomic bomb Pakistan was left with no position to repay them on their maturity. So they were restructured at high premium i.e. 10% interest rate with final repayment in December 2005.

Pakistan reverted back to the international capital market in 2004 with better credit rating emanating from its improved

Figure 10: PIB Distribution Profile as on 31-Aug-07

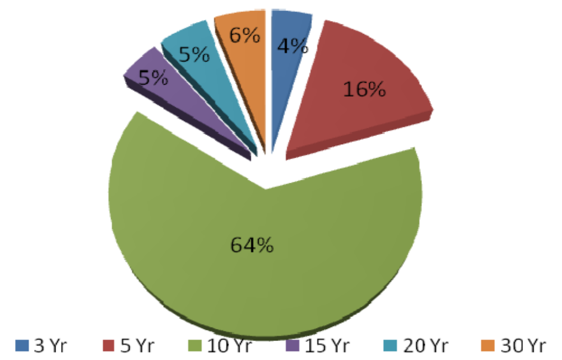


Figure 11: Number of Listed TFCs Issued

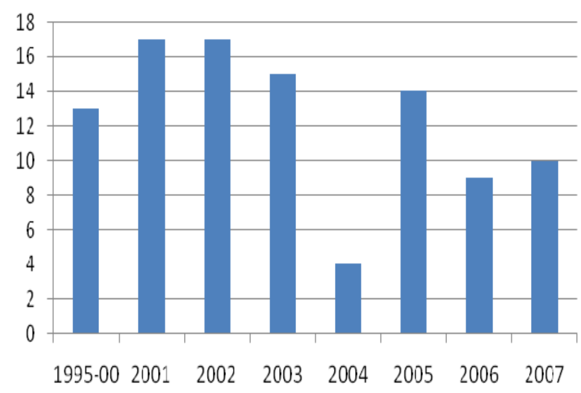


Table 22: Turnover ratio (Rs in billion)

Year	PIB outstanding	Turnover	Annual Turnover (Time)
FY05	307.60	2,124	6.91
FY06	303.87	1,351	4.45
FY07	352.52	1,131	3.21

Table 23: Sovereign Bonds Issuance in Global Market (In million US$)

	FY05		**FY06**		**FY07**	
	Amount	Coupon	Amount	Coupon	Amount	Coupon
EURO Dollar 5 Years	500	6.75%	-	-	-	-
SUKUK 5 Years	-	-	600	6M LIBOR+220 bps	-	-
EURO Dollar 10 Years	-	-	-	-	500	7.125 %
EURO Dollar 30 Years	-	-	-	-	300	7.875 %

macro economic indicators. Currently its Sovereign rating by Standards and Poors is B+ (Foreign currency) and B for short term and BB for long term
(Local Currency).

This process seems likely to continue to keep Pakistan's presence in the international Capital Market for developing its domestic bond market as well.

Table 24: External Liabilities against Bond Issues

	FY02	FY03	FY04	FY05	FY06	FY07
Volume in million USD	620	465	810	1225	1900	1905

3. <u>Bond Market Infrastructure:</u>

SBP manages Government Securities market on behalf of the GOP, whereas SECP is responsible for Corporate Bond Market. Both are autonomous bodies.
Trading and Settlement System: - Government Securities are exchanged through depository of State Bank of Pakistan or through its Public Debt Offices in case the security is in physical form. Equities and corporate bonds are exchanged through computerized books maintained by Central Depository Company constituted under Central Depositories Act, 1997. Funds are transferred through clearing system catered by SBP. Securities are held and transferred in accounts maintained at Central Depository Company of Pakistan on delivery versus payment at T+3 arrangements for Corporate Securities. State Bank depository is providing settlement at T+0 arrangements for Government Securities. National Clearing Company Ltd (NCCL) providing settlement for equity trading would undertake Corporate Securities cash settlement in future.

The efforts are in hand for implementing RTGS system in Pakistan by the SBP.
Law: - For government securities issuance, profit payment and redemption, State Bank Act 1956, Banking Companies Ordinance 1962, Public Debt Act, 1944 and Public Debt Rules, 1946 are the relevant laws. For equity and corporate bonds issuance, Company Law, Trust Act 1882, SECP Act 1997 and Securities and Exchange Ordinance 1969 are relevant. The work is in hand with the Banking Commission for bringing reforms in banking laws and SECP for modifying Capital Market Laws.

Investor Base (Individual/Foreign/Institutional Investor):
The efforts are in hand to bring about level playing field for all types of investors in Pakistan. However, their present status is as under:

- The retail market meant for individual investors is weak in Pakistan. For easy investment, either the individual investors have to resort to national saving schemes or deposit schemes in the banks. However, immense volatility in interest rates during couple of years has restricted their options which have to be addressed by the regulating authorities.
- After discontinuation of investment by the institutional investors in the saving schemes, Government has now provided them the long term bond viz. Pakistan Investment Bonds. The other avenue for them can be the corporate bond market which has started to take off within a period of last ten years.
- Foreign investors are allowed in Pakistan but their less presence denotes that the investment policies are not perfect to the liking of foreign investors. In Pakistan, capital account convertibility is not allowed nor did the reserve position of the

country allowed to go for such luxury in the past. However, the matter can be addressed by allowing certain other incentives, like floating of exchange/inflation linked bonds as have been experienced in other countries or by offering tax incentives.

- Issuance Strategy: - In Government Securities market the T-Bills are issued on fortnightly basis whereas PIBs are issued on quarterly basis; however no prior announced calendar exists. PDs serve the distribution channel for Government securities whereas Corporate Bonds are issued after taking approval from the SECP and on getting rated from the Rating agencies and finally on listing from the Stock Exchanges. Banks/ Asset Management Companies/Brokerage Houses serve as manager for their issuances.

Table 25: Tax Structure

	With holding Tax		Capital Gain	Stamp Duty
	Corporate	Individual		
Government Securities	10%	10%	-	-
Corporate securities	10%	*10%	-	0.15% (initially) 0.10% (Transfer)

*For amount above 0.150 million

Table 26: Accounting & Auditing Standards

	Accounting standards to be applied to bond issuers	Organizations that set the accounting standards
Government Securities	IAS as per SBP Act 1956 and BCO 1962	Institute of Accounting Standards of Pakistan (ICAP)
Corporate securities	IAS as per Companies Ordinance 1984	ICAP

Benchmarks: - Sovereign curve exists for 30 years. KIBOR Curve, reflecting clean market, from 7 days to 3 year exists. PKRV curve up to 30 years and IRS Curve up to 10 years also exist.

Local Credit Rating Agencies:

There are two local rating agencies in Pakistan namely PACRA and JCR-VIS.
PACRA was established in 1994 as a joint venture between IBCA Limited (the international credit rating agency), International Finance Corporation (IFC) and the Lahore Stock Exchange. To date, PACRA has completed well over a hundred ratings, including major industrial Corporate, financial institutions and debt instruments. In addition to local ratings, PACRA has also successfully completed two international rating assignments in collaboration with Fitch.

JCR-VIS is operating as a “Full Service” rating agency providing independent rating services in Pakistan since January 2001. JCR-VIS is a joint venture between Japan Credit

Rating Agency, Ltd. (JCR) - Japan's premier rating agency, Vital Information Services (Pvt.) Limited (VIS) – Pakistan's only data bank and financial research organization, Karachi Stock Exchange and Islamabad Stock Exchange.

Government Efforts to Develop Capital Market:

Regulatory Framework:

SBP is responsible for monetary policy and managing government securities market whereas SECP caters for corporate securities market. Autonomy extended to SBP and SECP and with their automation a well-placed regulatory framework is already there for securities market in Pakistan.

Clearing and Settlement System:

The importance of the payment and settlement systems mainly stems from their role in the financial sector. Following the financial sector reforms that had targeted reducing financial risks and increasing reliability and speed, the payment and settlement systems have changed to a large extent.

To provide an efficient clearing facility Inter-Bank Clearing of Paper Based Instruments State Bank of Pakistan has outsourced this activity to National Institutional Facilitation Technologies (Pvt.) Limited (NIFT). NIFT has established centers in 14 cities and also provide services as Local US Dollar Instruments Collection and Settlement System and Society for Worldwide Inter-bank Financial Telecommunication (SWIFT).

The RTGS System named PRISM (Pakistan Real-time Inter-bank Settlement Mechanism) is ready to start function in August 2007 which will automate the current manual inter-bank settlement process of large value payments at SBP. The PRISM will provide platform to commercial banks for settlement of inter-bank transactions in real time mode. Moreover, SBP has also prepared a draft law called Payment Systems and Electronic Funds Transfer Act and sent it to the Federal Government for enactment.

SBP/CDC depositories for government and corporate securities respectively work on DVP with settlement at T+0 and T+3 respectively.

4. The Rationales for Developing Domestic Bond Market

Benefits of Having a Well-Functioning Bond (Government and Corporate Bond) Market are:

- Linking issuers having long term financing need is established with investors willing to place funds in long-term interest bearing instruments.
- Government Bonds provide benchmark yield curve and help establish the overall yield curve.
- At macro economic level it provides an avenue for domestic funding and budget deficits other than by central Bank.

- It helps implementation of monetary policy, including achievement of monetary targets or inflation objectives through use of market based indirect monetary policy instruments.
- Funding of Government Budget deficits on market-oriented funds reduces the debt servicing cost over the medium to long term through development of a deep and liquid market of Government Securities.
- At micro economic level development of securities market helps change the financial system from bank-oriented system to multi layered system where capital markets can complement bank financing.
- The development of bond market forces the financial intermediaries to develop other products like Repo, Structured finance and Derivatives.

Motivations for Developing Domestic Bond Market:

Challenges and Strategies to Develop Well-Functioning Bond Market:

Basic pre requisites for developments are: -

(a) Credible and Stable Government.
(b) Sound fiscal and monetary policies.
(c) Smooth Exchange Rate and Capital Account Policies.
(d) Effective legal, Tax and settlement system.
(e) Smooth and Secure settlement System
(f) Liberalized financial system with competing intermediaries.

The strategies and techniques in bringing developments and reforms need to be properly sequenced and phased; otherwise they can hamper the overall objectives of reforms. In Pakistan the pre 1990 era was bit slow, however post 1990 era was amply fast which brought distortions in some areas of Financial and Capital Market developments. It has been experienced time and again that liberalization of financial markets can not bring good results till it is followed with tailored made regulatory framework. The Mexico, Brazil and Asian financial market crisis have made it abundantly clear that moving ahead in financial market developments are to be based upon necessary regulatory framework.

Challenges and Strategies to Develop Well-Functioning Bond Market:

Factors Hindering Bond Market Development:

- Fiscal and Trade Deficits.
- Law and order problem.
- Cross border tension
- Bad Governance, lack of accountability on the part of bureaucracy, Public and Private Sector institutions.
- Ineffective Implementation of law and delay in adjudication.
- Lack of market expertise.
- Lack of awareness of new financial products.
- Lack of infrastructure and automation.
- Lack of stringent regulatory policies and their effective enforcement.
- Lack of self-policing system in the market.
- Lack of awareness of market ethical values.

- Political interference in the regulatory functions.
- Clear laws curtailing clear interpretations.
- Inconsistent supply and small size issues of Government Bonds.
- Corporate Bond Market being not cost effective due to stamp duties levied by the Provincial Governments on their transactions and certain fees to be paid on their issuances and time taking procedures for their approval.
- Non issuance of Sovereign Sukuk
- Transaction cost as Stamps duties on Commercial Paper making them non cost effective.

Past Efforts / Recent Initiatives:

Since its inception in 1990, Bond Market in Pakistan has witnessed lot of initiatives. Some are as follows: -

- Sale of government securities auction based through introduction of 6-month market treasury bills in 1990. 3 and 12 months MTBs were introduced in 1997.
- Government borrowing from SBP made market based.
- Liberalized current account restrictions
- Introduced OMO in place of direct controls to manage liquidity and interest rate in the money market
- Introduced 3-day repo as lender as last resort facility
- Federal Investment Bonds were introduced in 1992 to provide yield curve up to 10 years maturity
- Extended depository arrangements by the SBP for government securities in form of Subsidiary General Ledger Account (SGLA)
- Established Securities and Exchange Commission of Pakistan (SECP) as an autonomous body
- Introduced Selective Primary Dealer System in 2000
- Introduced Pakistan Investment Bonds in 2000 in place of FIBs that were discontinued in 1998
- Introduced Jumbo Issue of PIBs and Non-competitive Bidding Option for active PIB trading in secondary market.
- Established Central Depository Company to introduce scrip-less trading in shares/Corporate Bonds.
- Introduced PIBs of 15 and 20-year tenors in Jan 2004 that has now been extended up to 30 years.

Recent initiatives that are yet to materialize include allowing bond strips against PIBs, listing of Government Securities on Stock Exchanges, calendar for Government Securities issuances

Roadmap (Plan/Strategy) for the Development of Bond Market (Financial Sector):

There cannot be any doubt that financial system of Pakistan has a lot of potential, however, it is to be searched and put in place. Another angle, which needs to be brought into the system, is to integrate it with global financial system. The vision, which anybody can have in the market for the future financial system of Pakistan, can be briefed as under:

- It has to be market based

- The market should have its own policing system in addition to Regulatory framework.
- Development of new hedging products like derivates.
- Updating of accounting/auditing and reporting system in line with the international standards.
- Fully automated financial system.
- New Government Securities Act to replace out dated Public Debt Act 1944.
- Listing of Government Securities on Stock Exchange to widen investor base.
- Implementation of Real Time Gross Settlement System to mitigate systemic risk in fund settlement.
- Bond Stripping to create liquidity in the bond market and to induct zero coupon yield curve.
- To foster growth of corporate Bond market in Pakistan by making it cost effective.
- To develop Trading/Risk Management/price dissemination mechanism for Corporate Bond Market.
- Financial Institutions to have controls i.e. Clear Strategies of duties at all levels, Dual Controls, Rotation of assignment of duties, Internal auditing of all operations, Audit programs for external auditing, Operational reviews.
- Development of newly inducted Islamic Finance (*See* **Box 1**)
- Development of Investor base specifically Mutual Funds (*See* **Box 2**)
- Development of Sub National Bond Market in Pakistan (*See* **Box 3**)
- Development of Infrastructure/Mortgage Finance (*See* **Box 4**)

Role of the Central Bank / Government in Developing Bond Market:

Government is very keen to develop Capital Market in Pakistan. SBP and SECP, the two main regulators of the whole financial system are bringing about reforms for the development of capital market of the country in conjunction with GOP support. Recently the main efforts made in this direction can be summarized as under:
Capital adequacy requirements have been raised for the participant institutions.
T+3 system has been introduced to make the system efficient. T+0 is already in vogue for Government Securities.

Badla Financing has been replaced with Continuous Financing System (CFS) with restriction on In-House CFS to curb speculative business in equity. Trading systems for Corporate Bonds and Risk mitigating mechanism are in phase of development.
Derivative instruments have been introduced and their further development is on agenda.
The automation of SBP, Banking industry, Non-banking Financial Companies and stock exchanges are at full swing.

RTGS system is in wake of Implementation. Legislation on Payment system and Future Trading is in process of finalization at the level of GOP.

New Government Securities Act to replace Public Debt Act 1944 for Government securities is under finalization. Further new Act for Corporate Securities to replace Securities and Exchange Ordinance 1969 is also under finalization.
Supervision systems of SBP and SECP have been revamped.
Establishment of Commodity Exchange is in phase of Implementation.
Demutualization of Stock Exchanges is in process.

Professional hands are being appointed at the management level of all institutions of the financial system to take care of their affairs efficiently and diligently.
Training arrangements have been given new importance and new shape to refresh and enhance the working capabilities of staff working in the financial institutions
State Bank has been made completely free to decide its monetary management policies.
SBP/SECP and GOP are providing full support in growth of Islamic/Mortgage/Infrastructure finance.

PART III

POLICY IMPLICATIONS FOR BOND MARKET (FINANCIAL SECTOR) DEVELOPMENT:

1. Creating depth in money and securities market to improve the transmission channel of monetary policy. This would facilitate investors/issuers to have better view of interest rate movements. This includes introduction of SBP own instruments, review of monetary policy execution framework to switch over to explicit interest rate targeting, establishment of Market Stabilization Fund (an arrangement in which Government share the cost of monetary policy operations with Central Bank), Capacity building of DPCO, Projections of Government Cash flows.

1. Building up institutional and market microstructure for developing Government securities market in Pakistan i.e. developing distribution channel through market makers and dealers having expertise in securities business.

2. Keeping consistent supply of large size long-term Government instruments for creating liquidity and proper yield curve. To achieve this goal, reopening, stripping and fungibility need to be allowed.

3. Timely market information to the issuers as well to investors through data dissemination.

4. Diversifying the investor base. The steps include development of Asset Management Firms/Mutual Funds/Discount Houses to diversify investor base through legislative support.

5. Containing crowding-out effect through reducing deficit financing for developing Corporate Bond Market.

6. Creating appetite for bond market by supporting Islamic Fund Industry, Mortgage and Infrastructure Finance initiatives.

7. Building Benchmark curves i.e. Revaluation, Clean, IRS, zero coupon curves.

8. Aligning Sub National/local Governments/Public Sector requirements with Government Bond Market by providing them same infrastructure.

9. Reducing fees/Stamp duties on Corporate Bonds/Commercial papers to make them cost effective.

10. Allowing Supranational Bonds in Pakistan to create liquidity in Corporate Bonds Market and to have best international practices through their presence.

11. Attracting non-resident investors by providing them better opportunities to have positive yields by extending some concessions like tax exemptions.

12. New legislation aligned with current environment for Government as well Corporate Securities Market.

13. Creating tax base on equity providing level playing field to all investors.

14. Allowing international depositories linked with domestic depositories for facilitating international investors to invest in Pakistan.

15. Establishing cross border settlement mechanism. This would reduce cost of doing business in own and with others markets.

16. Developing Derivatives market for facilitating investors/issuers to hedge the risks on their portfolios.

17. Developing Bond Market in sequenced manner i.e. from simple to complex instruments/infrastructure.

18. For developing above Government as well Regulators (Central Bank and Securities Commission) to work together in devising policies and than coordinating in their Implementation process.

Box 1: Development of Islamic Instrument Market (IIM)
State Bank of Pakistan is in process of developing IIM in Pakistan. In this regard GOP has already been suggested by the SBP to issue its domestic Sukuk (Islamic instrument) for fostering growth of Sukuk market in the country. Further SBP is also working to develop the Islamic inter-bank market in collaboration with Islamic Financial Services Board (A body representing Central banks of various countries for developing Islamic banking). For the time being main challenge is to have such Instruments that can be used to generate short term liquidity and for their use as monetary policy instrument. SBP is working for their issuance /documentation/Term structure and pricing dynamics. The purpose is to build up Primary and Secondary Market of Islamic instruments in Pakistan enabling level playing field for Islamic banks to ensure their future growth.

Box 2: Development of Mutual Fund Industry
Pakistan was the pioneer in the field of Mutual Fund Industry in the South Asia Region when it launched National Investment Trust (NIT), an open ended Fund in 1962 followed by the establishment of Investment Corporation of Pakistan (ICP) in 1966 which launched a series of close ended Funds. However in the subsequent years it lost pace. Now there are 27 Asset Management Companies in Pakistan. They are managing 20 funds in close ended sector and 26 in open ended sector with total net assets valuing Rs 167.921 billion. The plus point about these funds are their aggressive marketing and innovative approach. Further they represent private sector as compared to NIT and ICP which were Public entities. However recent decision of GOP to allow institutional investors (including Mutual Funds) to invest in NSS (Tap instrument) would no doubt affect their strategies. It is likely that they may adopt passive approach for their investment by investing in NSS that provides ensured return above PIBs (Market based security) with put option. So for growth of Mutual Funds in Pakistan, Government has to refrain from taking such steps in future.

Box 3: Development of Sub National Bond Market
Prior to 1990, Provincial Governments used to borrow directly from the market though predetermined rates (In 1991 this borrowing was Rs 3.9 billion), however during post Financial Market Reforms era of 1990, this practice was discontinued and since than these Governments are meeting their funding requirements exclusively from the Federal Government.
With emergence of devolution process and constitution of Local Governments to the gross roots level, the realization is getting back that Provincial/Local Governments may be allowed to arrange their funding requirements direct from the Market using the same infrastructure as being used by the Federal Government for such purpose. The main issue confronting this kind of arrangement is agency and moral hazard problems as revenue generation systems complemented with accounting and other standards of these Governments are not strong and in case of any default the burden would fall on the Federal Government. One way to solve this issue is the use of Securitization/Islamic Financing techniques where underlying asset is necessary for generating funds. This would mitigate risks on such lending. However to make such arrangement workable, there is a need to evolve a mechanism/system in this regard.

Box 4: Development of Infrastructure/Mortgage Finance in Pakistan

Since 1995 some of the developing economies in Asia have been able to finance a lot of their infrastructure projects, however they are still unable to a substantial level of liquidity for these infrastructure related sub sovereign securities.

In this regard, efforts were made in recent years in Philippines, Vietnam, Indonesia, Malaysia, China, and Japan which have brought some successes. India is also showing remarkable progress in this regard. Due to its geographical location Pakistan has lot of potential to develop these sectors. ADB in one of its recent surveys has indicated that Pakistan would be able to list its infrastructure funds in equity market in 2008, Bond market could fund the city or the fund if the bonds were secured by infrastructure assets, however they viewed that structured funds would need another few years to emerge. As good sign, housing finance has grown from Rs 19 billion in 2003 to Rs 63 billion in 2006 paving way for providing critical mass to lay down foundation for mortgage financing in Pakistan. However to proceed in this area following points are pertinent: -

1. Activation of domestic Capital Market to mitigate credit/market risks and for creating market liquidity.
2. Legislative support to have regulations and monitoring standards/arrangements to perform real time surveillance of ongoing progress regarding Infrastructure/housing projects.
3. Leading Institution/s exclusively equipped to deal in this kind of finance. To develop this expertise, agencies (ADB, IFC etc) interested to invest in these sectors can provide helping hand and technical support.