7 Capital Market

Karachi stock exchange remained the pre-eminent capital market in Pakistan during FY02, accounting for over 65 percent of the total shares traded, the majority of new equity (Initial Public Offerings) and the new listings of fixed income instruments in Pakistan.

7.1 Operations at Karachi Stock Exchange

FY02 was a relatively good year for the Karachi stock market, with the benchmark KSE-100 index recording a 29.5 percent rise, in sharp contrast to the 10.1 percent drop witnessed during the preceding fiscal year.

This performance, which appears to be underpinned by a steady improvement in economic fundamentals during the course of the year, is more impressive when viewed in the context of the various economic and non-economic shocks suffered by the country, as well as a number of disruptive market developments (see **Figure 7.1**).

Table7.1: Key Indicators of Capital Market

	FY00	FY01	FY02
Karachi Stock Exchange			
KSE-100 index	1,520.7	1,366.4	1,770.1
SBP General index of share prices[1]	128.8	89.7	106.7
Trading volume (billion numbers)	48.1	29.2	29.1
Paid up capital (billion Rupees)	229.3	239.9	260.6
Lahore Stock Exchange			
LSE-101 index	372.0	273.2	296.9
Trading volume (billion numbers)	16.4	7.8	18.3
Paid up capital (billion Rupees)	207.7	226.2	246.3
Islamabad Stock Exchange			
ISE-Network index	5,327.1	4,374.3	4,684.0
Trading volume (billion numbers)	2.0	0.7	1.7
Paid up capital (billion Rupees)	162.2	183.3	180.6
NBFIs			
Deposits (billion Rupees)	59.7	56.2	18.5
Disbursements (billion Rupees)	13.4	15.0	11.5
TFC's issued (numbers)	3	10	17

[1]: Base year FY01=100

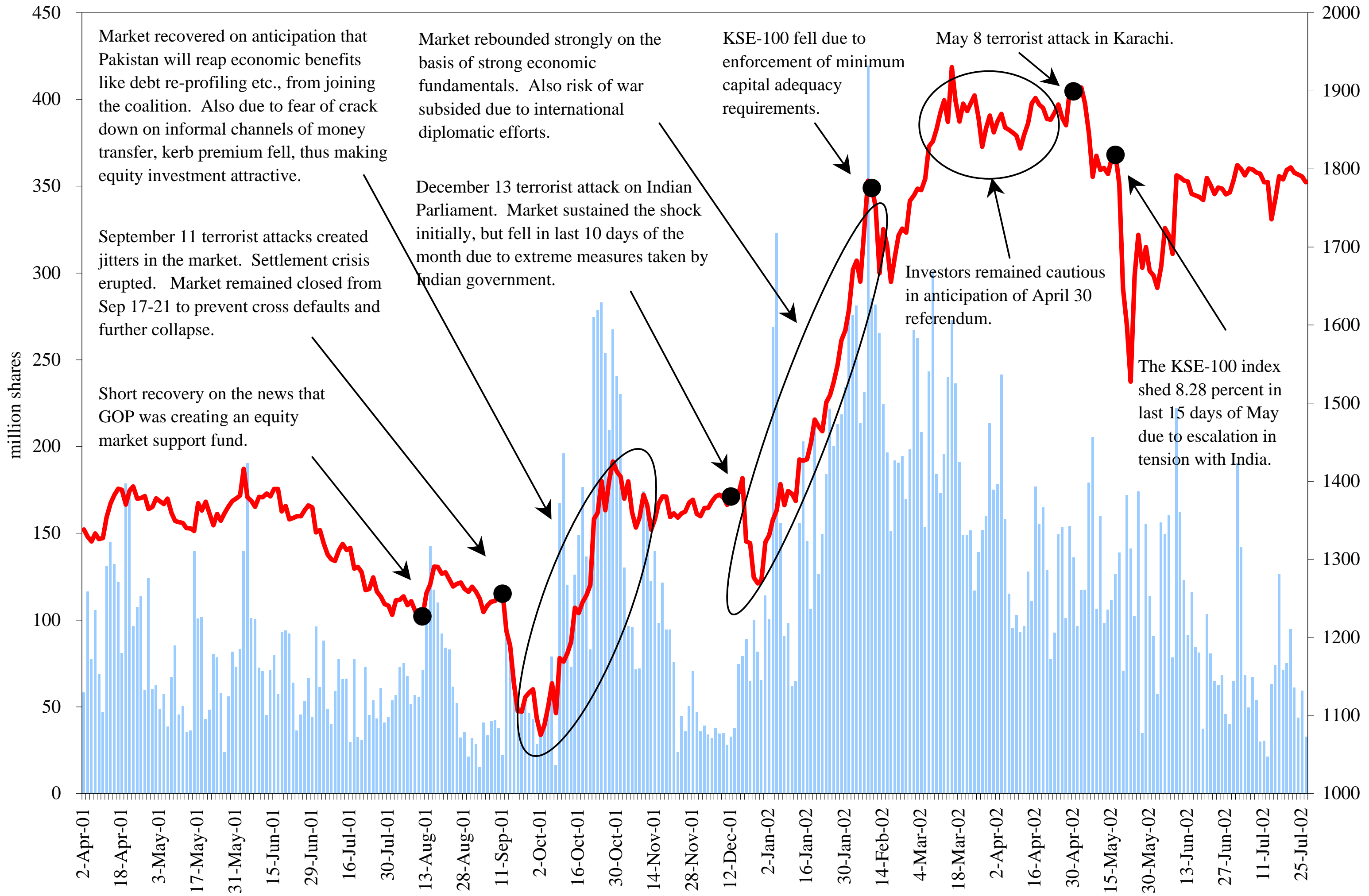
In fact the year began on a negative note, as the downtrend evident during the concluding weeks of FY01 continued in early FY02 with the KSE-100 index shedding 60 points in the first week of July 2001. Factors instrumental to this fall included the continuing uncertainty regarding T+3 settlement system[1], and the crack down by National Accountability Bureau (NAB) on certain elements of the market in end-June 2001. While the market staged a partial recovery amidst mis-conceived hopes of a government-sponsored market fund, the uncertainty persisted, and from August till September 10, 2001 the index moved in a narrow range of 51 points with low volumes.

Thus, not surprisingly the September 11 attacks in New York and Washington pushed the market over edge for a 181 point (14.4 percent) collapse to reach the lowest for the year at 1075.2 by October 2, 2001. This collapse in turn sparked yet another crisis. Due to the decline in market value of their leveraged equity purchases, many market players were trapped by the rising cost of badla finance.[2] A decision/reminder by KSE management that it would not recognize any deal involving badla charges

[1] In the T+5 settlement system, any trade conducted between Monday-Friday would have to be settled on next Wednesday. Hence, there was ample time between actual trade and settlement. This system also provided investors space for excessive speculation. However, with the implementation of T+3 system, market players were worried about some practical issues like the working of badla or COT in new system. This cautioned the investors and kept the index under pressure, but these fears did not materialize and there was a smooth and gradual transformation to new settlement system.

[2] Badla is an informal source of financing, widely used in the Pakistan's stock exchanges. This transaction is made when an investor, who lacks funds, commits himself to buy certain shares. Badla *financier* provides financing against such shares at market-determined premium (rate of interest). This short term collateralized lending is very similar to a repurchase agreement (repo) used in the interbank market. In simple term, badla is a credit line against securities: usually brokers and financial institutions provide such badla funds. After the introduction of T+3 settlement regime, daily badla transactions are carried out.

Figure 7.1: Movement in KSE-100 Index and Volume of Trade

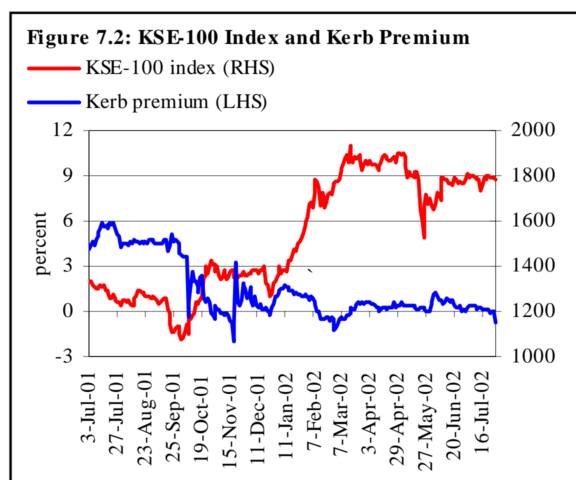


exceeding 24 percent per annum, worsened the crisis by discouraging badla financiers, who remained on the sidelines. Hence, to avoid a further decline in the market due to panic selling amidst the non-availability of badla financing, the bourses were closed down for a week (from September 17 to 21).

Among the troubled investors, Crescent Investment Bank[3] was an institution with a large but heavily leveraged portfolio. In a prompt and coordinated response, the State Bank of Pakistan, Securities and Exchange Commission of Pakistan and Ministry of Finance stepped in to pre-empt the threat of a possible cross-default stemming from a default by this large investor. Five major commercial banks were asked to buy out the otherwise healthy portfolio of Crescent Investment Bank at a discount. This helped the market by overcoming the liquidity shortage that had manifested following the September 11 events and avoided the possible systemic threat.

As a result of these measures, and with the comfort that Pakistan had assumed an important role in US led coalition; market started the second quarter on a positive note. In addition, market was anticipating that the country would reap significant economic benefits including debt rescheduling from this move. In the mean time, crack down by the international community on informal fund transfers, helped spark a sharp appreciation in the Rupee and also set expectation on future rise. The resulting de-Dollarization and accompanying fall in the interest rates (as a matter of loose monetary policy by SBP) eventually increased interest in equity investment (see **Figure 7.2**).

Figure 7.2: KSE-100 Index and Kerb Premium



Afterwards, the KSE-100 index consolidated in a narrow range of 61.86 points (between 1399.81 and 1337.95) from November 1 to December 13, 2001. However, the unfortunate terrorist attack on Indian parliament on December 13, 2001 caused edginess among investors, as Indian government accused Pakistan of complicity in the attack. Nonetheless, market absorbed this shock initially and stabilized. But it was after December 21, when Indian government raised the stakes by withdrawing its high commissioner from Pakistan and deploying its troops on the international borders. Resultantly, market went into a tailspin with the KSE-100 index shedding 130.95 points in next 10 days of the month.

Even though the Indian government continued with its rhetoric of blaming Pakistan together with its troop buildup on border, market rebounded strongly by the start of January 2002. Three factors were instrumental in this recovery; firstly, it became clear that war with India was unlikely in the wake of increasing international diplomatic efforts; secondly, domestic law and order situation remained stable in contrast to earlier fears of fundamentalist backlash and, thirdly, economic fundamentals remained strong during this period.[4]

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[3] This leveraged position of the Crescent Investment Bank was caused by the huge absorption of Hubco scrips, sold by Templeton during the July-August period. With hindsight, it is evident that excessive leveraged position could produce systemic risks and may prove to be detrimental to the player, no matter how attractive the scrip is.

[4] There was no rush on retail or wholesale markets for buying. Also, banks remained immune from large withdrawals.

The market's exceptional gains of January 2002, when the index gained 347 points (27.3 percent) were underlined by its ranking as the top performing emerging market for the month by MSCI.[5] However, this upward momentum was broken in mid-February by the KSE circular**,** prudently reminding members of the strict minimum capital adequacy rules introduced by Karachi Stock Exchange. As a result, the index fell by 119 points in three trading days before recovering on the back of strong performance reported by Hubco, MCB and Askari Bank. Thereafter, sentiments on oil marketing company stocks dominated the market, taking the market to its FY02 peak of 1930.5 on March 14, 2002 as the government announced a much-awaited increase in their margins (this was also taken by the market as a precursor to the privatization of PSO).

Afterward, index was unable to remain above 1900 level and started sideways movement showing lack of clear direction and declining investor interest. This was also evident in falling volumes during the period (see **Figure 7.1**). The primary reason for this lackluster behavior by investors was the upcoming Presidential referendum, scheduled on April 30. Historically, it is observed that sideways movement of the index and falling volumes normally precede a fall in the index.

The trigger for the fall came due to the terrorist attack on French citizens in Karachi in early-May and the KSE-100 fell to 1798.45 levels by May 10, 2002. Worst still, this downward trend was further reinforced in mid-May after an attack on Indian Army camp in Indian held Kashmir. Characteristically, Indian government was very swift to put all blame on Pakistan to reap political benefits. As a result, this caused deterioration in already strained relations between the two neighbors and risk of war soared to new heights. Consequently, the equity markets in both the countries spilled out, with KSE-100 shedding approximately 8.28 percent, while Bombay Stock Exchange lost 8.35 percent during last 15 days of May. However, the KSE-100 staged a short recovery on the basis of continuous improvement in economic fundamentals, and high liquidity and consolidated itself close to 1800 mark since then.

In short, the KSE-100 index gain resilience from the overall improvement in economic fundamentals, consequent improvement in corporate profitability prospects, and the financial market liquidity (that boosted asset prices) to overcome political concerns.

Looking at the sector-wise performance, the SBP General Index for *cables & electrical goods* showed a significant improvement of 48.0 percent by end-June 2002 over the end-June 2001, followed by *engineering* (45.3 percent) and *paper & board* (33.2 percent). *Auto & allied* sector showed a significant improvement of 16.7 percent in the same period. The latter reflects expectations of strong profits amidst rising car prices despite declining production costs (due to an appreciating Rupee and lower interest rates). The other notable improvement was witnessed in *cotton & other textiles* (15.0 percent), probably reflecting expectations of higher profitability following greater access to EU and US markets during H2-FY02. (For further details, see **Table 7.2**).

The dividend declaration record of companies listed on KSE showed deterioration during FY02 over last year (see **Table 7.3**). Another important development during the year was de-listing of 40 companies as compared to 6 during last year. Out of these 40 companies 12 were de-listed due to their mergers with another company. Four new companies with a paid up capital of Rs 5.8 billion were listed on the KSE during FY02. Summary statistics concerning the Karachi Stock Exchange are shown in **Table 7.4**.

The FY02 witnessed a decrease in outflow in foreign portfolio investment in the stock exchanges on year on year basis. During FY01, US$ 140 million flowed out of the country as compared with only

[5] The MSCI Pakistan Index was up 31.24 percent for the month. The next best performing market was Indonesia with a 22 percent rise.

Table 7.2: SBP General Index of Stock Prices & Market Capitalization
percent changes

Groups	SBP general index			Market capitalization		
	FY00	FY01	FY02	FY00	FY01	FY02
Cotton and other textiles	28.9	-4.6	15.0	57.9	-12.3	7.0
Textile spinning	37.6	13.0	6.0	32.1	6.9	-4.7
Textile weaving & composite	53.9	-26.9	12.7	79.0	-16.4	19.5
Other textile	5.8	-0.6	27.3	65.3	-22.2	8.1
Chemicals & pharmaceuticals	12.7	-4.5	19.8	15.6	-14.4	5.7
Engineering	18.7	-3.1	45.3	11.7	-2.0	37.5
Auto and allied	27.7	-3.6	16.7	21.0	-1.5	29.0
Cables & electrical goods	8.5	-5.2	48.0	24.3	0.0	12.2
Sugar and allied	-2.1	21.5	10.0	-8.2	17.5	0.5
Paper and board	34.8	-8.9	33.2	37.8	14.2	45.2
Cement	53.0	-17.9	17.4	69.6	-0.1	54.5
Fuel and energy	35.8	-12.3	14.5	63.6	-8.9	31.1
Transport and communication	-6.4	-22.7	10.9	31.7	-33.3	-1.0
Banks & other financial institutions	7.8	-8.2	13.8	20.7	6.4	43.2
Banks and investment companies	9.4	-11.8	19.1	21.3	6.5	69.8
Modarabas	9.9	-11.6	0.0	12.5	2.3	33.0
Leasing companies	3.3	-7.9	1.5	8.4	-0.8	2.6
Insurance companies	0.9	-4.5	4.1	28.8	10.7	4.4
Miscellaneous	14.0	11.6	13.8	24.2	1.6	34.9
Jute	4.7	-10.8	7.7	23.3	-18.9	25.6
Food & allied	36.3	-4.6	20.6	31.0	-11.5	23.2
Glass & ceramics	26.8	38.2	28.3	8.8	21.6	41.5
Vanaspati & allied	-6.8	-13.1	6.0	8.3	-48.7	13.4
Others	6.5	5.9	10.5	7.5	46.9	60.7
Overall	21.1	-7.8	16.7	35.5	-13.4	20.2

US$ 8 million this year. Two factors were significant in this phenomenon; firstly, previous year saw huge selling by foreign investors (mainly as Morgan Stanley Dean Witter announced the liquidation of its Pakistan Fund by end-May or June and selling by Templeton) and secondly, the outflow in previous years had reduced the residual in Pakistan.[6]

Table 7.3: Number of Companies Declaring Dividend at KSE

	Cash dividend	Bonus shares	Right shares	Total
FY02				
Up to 20%	165	18	3	186
Above 20%	141	15	28	184
Total	**306**	**33**	**31**	**370**
FY01				
Up to 20%	211	45	2	258
Above 20%	157	27	26	210
Total	**368**	**72**	**28**	**468**
FY00				
Up to 20%	281	34	4	319
Above 20%	117	14	20	151
Total	**398**	**48**	**24**	**470**

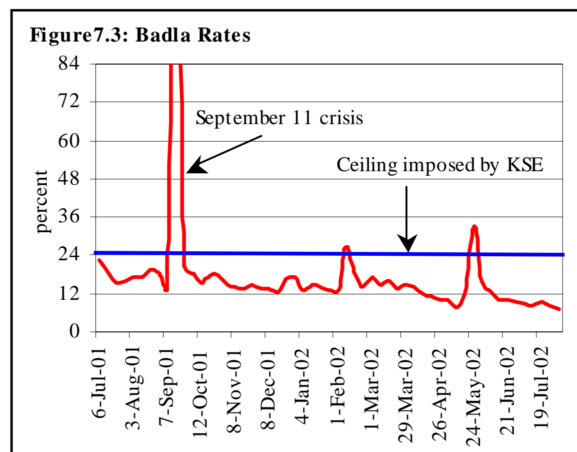
Although, on yearly basis there was a net outflow, the second half of the FY02 saw an inflow of US$ 48 million. This is in line with the Bull Run in the market, which started in January and continued till early-May 2002. With the limited liquidity available in Pakistani market, foreign portfolio investment plays a significant role in setting the direction for the KSE-100 index. An interesting observation regarding the data of foreign portfolio investment is the difference between the data released by the State Bank of Pakistan and the Karachi Stock Exchange (see **Box 9.1** in **Chapter 9**).

[6] The pressure on the market from these factors were compounded by the fact that all market participants were holding positions dependent upon short term financing and had no substantive capacity to absorb the foreign selling.

Table 7.4: Profile of Karachi Stock Exchange

	FY97	FY98	FY99	FY00	FY01	FY02
Total number of listed companies	782	779	769	762	759	725
Total listed capital (Rs billion)	206.7	211.2	215.0	229.0	239.9	260.6
KSE-100 index	1,565.7	879.6	1,054.7	1,520.7	1,366.4	1,770.1
KSE all share index	1,057.0	586.8	675.4	942.7	870.4	118.8
Initial public offering (IPO) during the year	7	2	0	3	4	4
New debt instrument listed during the year	1	3	2	3	2	10
Trade volume during the year (million shares)	8,023.1	15,004.2	25,532.8	48,108.8	29,165.3	29,140.7
Value of shares traded (Rs billion)	233.2	509.6	605.3	1,877.8	1,073.0	803.8
Average daily turnover (million shares)	33.6	63.8	103.4	193.2	119.5	120.9
Trading days	239	235	247	249	244	241
Foreign investment (during the year)						
Inflow- (Rs million)	8,392.6	31,122.4	8,869.9	7,433.8	2,306.5	5,993.0
Outflow- (Rs million)	8,618.7	27,831.9	9,997.8	8,562.4	8,148.9	10,795.4
Net flow- (Rs million)	-226.2	3,290.6	-1,127.9	-1,128.5	-5,842.4	-4,802.4

Source: Karachi Stock Exchange



Badla rates, which averaged around 18 percent at the start of FY02, ebbed as low as 9 percent during July 2002 (see **Figure 7.3**). This can be attributed to the fact that due to fall in the rate of return on almost all assets, and the advantage that badla returns are considered as capital gains (tax exempted), more money entered the badla market causing a plunge in the cost of badla finance. Although, currently badla is an important source of financing in the equity market, there is a widely held view that badla or Carry Over Trade encourages over-leveraged trade. Thus, augment systemic risk for the market. For this reason, it is expected that in future, margin financing will replace Carry Over Trade to reduce excessive volatility. Also with the development of futures market, investors now have a new instrument to hedge their risks. Another source of fall in badla rates may be the rise in the daily settlements from 1 percent to roughly 10 percent of the total trade.

Although, equity market came a long way with regard to improvement in regulations and development in infrastructure, it remained highly fragmented and relatively small. It is very skewed and concentrated in nature, as few listed companies dominate the index. The market concentration is a measure that shows as to what extent the market is skewed in favor of the top chips in the market. The less skewed the market is, the more developed it is.

Table 7.5 shows that in FY02 the KSE remained highly skewed in favor of three main chips namely Hub Power, PTCL ‘A’ and PSO. These three chips were the market leaders in terms of both market capitalization as well as market activity. In terms of market capitalization, the three accounted for 27.4 percent of the total capitalization of the market, which reveals significant skewness in terms of market capitalization. In terms of the turnover, the trend turns still more conspicuous with these three

accounting for 64.6 percent of the total market turnover for the year. Together PTCL'A' and Hub Power accounted for 58.2 percent of the trading activity.[7]

Table 7.5: Top Ten Stocks, end-June 2002

	By market capitalization			By turnover	
Stocks	billion Rupees	percent of market	**Stocks**	million shares	percent of market
PTCL'A'	64.7	15.9	Hub Power	9,198	31.6
Hub Power	26.8	6.6	PTCL'A'	7,730	26.6
PSO	20.0	4.9	PSO	1,848	6.4
KESC	11.8	2.9	Sui Northern	1,309	4.5
Fauji Fertilizer	11.6	2.9	FFC Jordan	970	3.3
Engro Chemical	8.3	2.0	ICI	897	3.1
Sui South	8.1	2.0	Engro Chemical	801	2.8
MCB	7.1	1.7	Dewan Salman	568	2.0
Sui North	6.9	1.7	MCB	476	1.6
ICI	5.6	1.4	Fauji Fertilizer	469	1.6
Total	**170.9**	**41.9**		**24,266**	**83.5**

Hence, the companies with greater capitalization proved to be the most liquid scrips as well. One plausible explanation for the fact that concentration on the basis of the turnover was far more than the concentration on the basis of the market capitalization could be that short buying and selling in these scrips, which tended to increase the turnover but did not reflect genuine trading and hence genuine market liquidity. Followed by these three were the relatively smaller but popular scrips namely Fauji Fertilizer, FFC Jordan, Sui Northern, Sui Southern and Engro Chemicals. With a market having 725 total scrips and the top ten accounting for such huge concentration, reveals that KSE is highly illiquid and lacks depth. The dominance of equity market by a handful of stocks may be traced to the weakness of the commodity-based manufacturing industries – textiles, cement, and sugar. The three sectors accounted for 30 percent of total market capitalization at the end-June 1991, but shrank to a little more than 15 percent of the market by the end-June, 2002.

Needless to mention, there is a need to enhance market access for the retail investors. Though, there are over 300 stockbrokers but none of them has retail coverage of more than one thousand active customers. After sweeping reforms and structural changes by SECP in the functioning of the bourses, retail investors should be more comfortable now. However, to address the practical issues of access to market for them, exchanges and brokers need to put more efforts. For instance, the exchanges need to develop the online trading system to facilitate trade through Internet.

7.2 Governance and Development

During FY02, the SECP and the Stock Exchanges have implemented several measures to improve the working of the capital market. These include the complete implementation of the T+3 system, rationalization of risk management measures (deposit requirements, capital adequacy & up tick/ downtick fluctuation bands), changes in the carryover market and more recently the launching of the new trading system.

[7] If market concentration is observed in relation to the entire stock market it is observed that during the FY02, in terms of market capitalization, the top ten scrips accounted for Rs 170.9 billion out of a total of Rs 407.6 billion, which was 41.9 percent of the total. The situation becomes far worse if concentration in relation to market liquidity is gauged. Out of a total turn over of 29,078 million shares, the top ten scrips accounted for 24,266 million, which makes 83.45 percent of the total turnover.

- On the regulatory front, Securities and Exchange Commission of Pakistan, for the purpose of establishing a framework of good corporate governance whereby a listed company is managed in compliance with best practices, issued the "Code of Corporate Governance" on March 28, 2002. Accordingly, all stock exchanges included the code of conduct in their respective listing requirements. This comprehensive law aims to enhance investor confidence by increasing transparency in the business practices of listed companies. It envelopes diverse areas of corporate governance including guidelines on the constitution of the Board of Directors of the company; a framework of internal control; rule on financial and accounting responsibilities of directors; directors' report; disclosure regarding pattern of shareholding; and scope of internal audit, etc.

- On July 18, 2002, in order to prohibit unfair trade practices and to ensure a level playing field for everyone, to inculcate good governance in business conduct and to promote transparency in the Securities Market, the SECP issued a directive to bar brokers or any nominee of the brokerage firm to become director in a listed company in which it has any financial interest (for example, trade in the securities or provide consultancy to that listed company).

- During FY01, SECP ordered some amendments in the Article of Association of the Stock Exchanges to address the sensitive issue like *conflict of interest* in management of bourses.[8] After these changes, SECP was able to nominate about 40 percent *outside* members on the Board of Directors, thus making it more independent from the influence of the members of the bourses.[9] Prior to that SECP could nominate only two members on the Board. As a result, influence of brokers and members of stock exchanges has been diluted and there are more checks and balances in place now. Notwithstanding these developments, SECP on August 13, 2002 and later on September 2, 2002 issued directives to bourses to make following changes in composition of their Boards from September 15, 2002 to further reinforce this process:
  - Five directors to be elected from amongst the members by the general body of the exchange;
  - Five non-member directors (including Managing Director) to be nominated and appointed by the SECP from professionals;
  - The Chairman of the exchange shall be elected by the Board from amongst the elected-member directors, where managing director shall not participate in the election process, and;
  - The position of Vice Chairman is to be abolished.

  It is expected that these steps will ensure further transparency in the market and provide comfort to investors by reducing the incidence of the conflict of interest.

- Also, with the successful implementation of T+3 system in September 2001, settlement risks are minimized. Besides, Stock Exchanges adopted a risk management system—which is perhaps the most crucial and sensitive function in any exchange—to minimize speculative and over-trading beyond the financial capacity of the brokers. These include imposition of minimum capital adequacy requirement, enhancement in exposure/loss limits for members and introduction of risk exposure margins for the badla market. Moreover, the imposition of circuit breakers has reduced the volatility in the KSE-100 index.[10] Since, the present system of static margin is impractical for effective risk management, as it does not account for the

[8] In addition to this, now SECP has final say on the appointment, removal/termination, and non-renewal of the Managing Director of KSE. Managing Director is also a member of the Board.
[9] However, purpose will only be served if these independent outside members take due responsibility.
[10] If there is 7.5 percent change (plus or minus) in price of scrip from its last closing price, trading in such scrip is suspended.

risks attached with the price volatility/liquidity of individual stocks. For this, work is presently underway on evolving a formula to determine margin on price volatility/liquidity of scrips and the concept of margins based on price volatility would be considered by SECP, once the study/report is finalized.

- Another highlight was the introduction of a market for futures contracts in July 2001. Grant of approval by SECP to KSE to commence trading in standard futures contracts in certain shares made a beginning. The emergence of a market in futures contracts would not only deepen the capital market in Pakistan but also provide investors with basic hedging instruments and investment alternatives.[11]

- An important development during FY02 has been the incorporation of the National Clearing Company of Pakistan Limited, which was incorporated on July 3, 2001. Although the system already started working but full implementation is yet to be completed.

- In an interesting development on August 10, 2002, SECP has asked the Karachi Stock Exchange to submit proposals relating to demutualization of the local bourses, a move to remove conflict of interest in the management of the exchanges (see **Box 7.1**).

7.3 Credit and Recovery Operations of NBFIs

DFIs were formed with a definitive purpose of enhancing the investment activities in the economy mostly during 1960s, these institutions played an important role in industrialization process since then. However, public sector DFIs performance started deteriorating gradually due to bad management and political influences. Increasing financial weakness due to volume of non-performing loans and the formulation of an IFI endorsed strategy for DFIs adversely impacted their financing ability. The sharp increase in the volume of non-performing loans (NPLs) forced these to consolidate their operations by reducing their gross lending. NPLs, which were 21.7 percent of the total assets of DFIs in FY90, grew to 41.6 percent in FY00. This in turn put a squeeze on the earning of these institutions. This worsening position of DFIs warranted bold decisions. The government is currently in the process of restructuring these institutions to make them financially viable.[12] While this was true for public sector, three private sector DFIs (foreign sponsored PLHC, SPIAIC and PKIC) demonstrated better performance. By looking at **Table 7.6**, it is evident that the sanction of

Table 7.6: Credit Indicators of DFIs[1]

million Rupees

Institutions	Sanctions			Disbursement			Recoveries		
	FY00	FY01	FY02	FY00	FY01	FY02	FY00	FY01	FY02
PICIC	988	2,185	3,607	193	1,030	1,602	2,926	3,264	3797
IDBP	135	27	65	91	47	26	1,161	1,304	2195
PLHC	490	335	785	401	273	437	528	428	813
PKIC	1,443	1,381	1,572	1,147	1,248	1,267	3,624	2,724	4017.7
SAPICO	965	780	1,773	798	935	1,040	1,238	1,215	1,293
ADBP	10,365	12,327	10,524	8,342	8,830	7,097	30,129	32,103	33546
FBC	36	80	155	35	60	0	5,135	5,558	3794
Total	**14,421**	**17,114**	**18,481**	**11,005**	**12,423**	**11,469**	**44,740**	**46,597**	**49,456**

[1]:excluding working capital

[11] Currently thirteen scrips are traded on this counter. These include Dewan Salman Fiber Ltd., Engro Chemical Pakistan, Fuji Fertilizer Company, FFC-Jordan Fertilizer Co., Hub Power Company, Ibrahim Fiber, ICI Pakistan Ltd., Muslim Commercial Bank Ltd., Nishat Mills Ltd., Pakistan State Oil Co., Pakistan Telecommunication Co., Sui Northern Gas Pipe Lines Ltd. and Pakistan PTA Ltd.

[12] Merger of NDFC with NBP, proposed closure of FBC, and expected privatization of ICP and NIT are the steps towards the restructuring of this sector.

Box 7.1: Demutualization of the Stock Exchanges

Demutualization is a term used to describe the transition of securities exchange from a mutual association of members operating on non-profit basis to a limited liability – for profit company accountable to shareholders. Essentially, demutualization separates ownership and voting rights from the right of access to trading.

Demutualization alters the governance structure of the exchange although its services and operation may remain the same. Access to trading becomes a matter of contract with the exchange. Shareholders, a separate group, are entitled to the profit obtained from market operations. And whereas exchange previously operated on non-profit basis, with demutualization, it becomes a profit seeking company, offering services to market intermediaries and listed companies. Although, many of the world exchanges are actively considering demutualization, few have reached the final stage of full demutualization, where shares are offered publicly and are widely held.

There are several arguments presented in favor of this process. Foremost is the stress on exchanges to remain competitive due to technological changes in a global environment. Globalization of the markets, advances in technology, a concentration of new investment capital, competitive pricing pressure and government deregulation are all contributing to the allure of demutualization. Traditional exchanges governed by its members are seen to be unable to adequately respond to competitive pressures. This may be because of the fact that the governance structure that relies on member decision-making is slow and often plagued by, conflicting interest of individual members. A shift from mutual organization to a profit seeking company with ownership separated from access to trading may allow the exchange to respond more effectively to competitive pressures and to act separately from the interest of individual members thereby creating a more streamlined and market oriented exchange.

However, in emerging markets, demutualization seems to be driven by regulators rather than the exchanges with very different basis. For example, in Thailand, Security and Exchange Commission (SEC) is pushing for demutualization of Thailand's only stock exchange. In SEC's view, the monopoly and non-profit status have resulted in inefficient use of resources and a resistance to change – with no incentive to modernize the exchange. As a result there is a poor quality of listing and Thai equity market has been marginalized with growing international competition this will only get worse.

India's National Stock Exchange (NSE) formed in 1992 is a demutualized exchange—it is owned by shareholders rather than members. The other large exchanges, notably the Bombay Stock Exchanges and Calcutta Stock Exchange have been mutual organizations. Under pressures to respond to a series of stock market scandals, the Ministry of Finance imposed a form of demutualization on these exchanges. This demutualization took the form of a Ministry of Finance decree that no broker would be allowed to sit on the board of an exchange. The brokerage representative on the board of BSE and CSE resigned leaving behind representative of Securities and Exchange Commission of India (SEBI) and a few independent board members. The authorities in India have planned to continue on this path.

In Pakistan, the changes in composition of the board of directors of the stock exchanges in December 2000, and recently in August/September 2002 again may be considered a step towards demutualization. Like in Thailand and India, demutualization in Pakistan is approached as cure for crippling self-interests of the members.

term loans by selected DFIs and specialized banks in FY02 stood at Rs 18.5 billion, which was higher than last year's Rs 17.1 billion. However, in terms of actual disbursement, a fall of about Rs 1.0 billion was recorded during the same period.

The modarabas sector is going through a critical phase. After experiencing initial boom in the 1980s, as a mode of business financing in accordance with Islamic principles, the sector suffered a setback when income tax exemption was withdrawn in 1993. Since then, the sector has struggled to stay afloat, while those engaged in equity trading have been hit again by the fall in share prices since 1994. Some of the modarabas have turned to the more profitable leasing industry in recent years. However, the sector is at a disadvantage in its funding, as modarabas are not allowed to use debt financing. As a result, financing activities of this sector are not significant, as can be seen in the **Table 7.7**.

Although the leasing companies disbursed Rs 14.3 billion during the FY02 as the term loan, it fell short of previous year amount by a significant 21.9 percent (see **Table 7.7**). This can be attributed to a general slow down in the economy, which resulted in fall in gross fixed investment approximately by 5.9 percent during FY02. Due to this lower demand in corporate sector, leasing companies have

shifted their focus on consumer leasing – vehicles, motorcycles etc. However, owing to increased competition in this field from investment banks, modarabas and banks, leasing companies are hit hard especially those with thin capital base.[13]

Table 7.7: Credit Indicators of Modarabas, Leasing Companies and Investment Banks
billion Rupees

	Sanctions				Disbursements			
	FY99	**FY00**	**FY01**	**FY02**	**FY99**	**FY00**	**FY01**	**FY02**
Overall assistance	**37.2**	**32.9**	**38.6**	**26.4**	**36.3**	**35.2**	**37.4**	**25.5**
Fixed industrial financing	13.8	19.8	23.0	19.5	13.0	20.7	22.7	18.8
Modarabas	2.6	3.7	2.8	3.2	2.5	5.1	2.8	3.2
Leasing companies	8.2	12.8	18.3	14.7	7.8	12.4	18.3	14.3
Investment banks	3.0	3.3	1.9	1.6	2.7	3.2	1.6	1.3
Working capital loans	23.4	13.1	15.6	6.9	23.3	14.5	14.7	6.7
Modarabas	1.6	2.5	3.0	2.4	1.6	4.6	3.0	2.4
Leasing companies	0.3	0.3	0.2	0.2	0.3	0.3	0.2	0.1
Investment banks	21.5	10.3	12.4	4.3	21.4	9.6	11.5	4.2
Percent changes								
Overall assistance	**25.0**	**-11.6**	**17.3**	**-31.7**	**-6.0**	**-3.0**	**6.3**	**-31.8**
Fixed industrial financing	3.1	43.5	16.2	-15.4	-43.5	59.2	9.7	-17.2
Modarabas	30.0	42.3	-24.3	14.3	-10.7	104.0	-45.1	14.3
Leasing companies	-10.9	56.1	43.0	-19.7	-57.4	59.0	47.6	-21.9
Investment banks	57.9	10.0	-42.4	-17.5	42.1	18.5	-50.0	-18.8
Working capital loans	41.8	-44.0	19.1	-55.8	49.4	-37.8	1.4	-54.4
Modarabas	-5.9	56.3	20.0	-20.0	-46.7	187.5	-34.8	-20.0
Leasing companies	0.0	0.0	-33.3	0.0	50.0	0.0	-33.3	-50.0
Investment banks	48.3	-52.1	20.4	-65.3	72.6	-55.1	19.8	-63.5

7.4 Corporate Debt Market

The country has already achieved a moderate level of capital mobilization through the bond and equity markets at 25 and 11 percent of gross domestic product (GDP) respectively, at the end of FY02. However, the figures are deceptive as government issues dominate the bond market – with corporate bond market accounting only 0.6 percent of GDP.

A Five-year bond issued in 1988 by the Water and Power Development Authority (WAPDA), a statutory corporation, was Pakistan's first corporate debt. The issue carried a coupon of 13.5 percent and raised Rs 3.1 billion, exceeding the target of Rs 2 billion. Since then, WAPDA has raised Rs 23.2 billion with seven issuances, the first six guaranteed by the Government. However, only the third and sixth issues, both of 10-year maturity, are listed on the two stock exchanges of KSE and Lahore Stock Exchange (LSE). The last three issues between 1993 and 1997 failed to raise the targeted amount because of limited investor interest and the fairly illiquid secondary market.

As early as 1985, privately placed TFCs issued by development finance institutions (DFIs) had been in existence. However, it was not until February 1995 that the first public TFCs issued by Packages Ltd. were listed on the stock exchange. The listing signaled the birth of a corporate debt market and was swiftly followed by three others, with yields of between 17.8 and 19 percent, bringing the stock of listed TFCs to a little more than Rs 2 billion. While listed TFCs are not approved securities for commercial banks' SLR, non-bank financial institutions (NBFIs) were allowed to invest in TFCs for SLR from May 1997 onward.

[13] Data from selected banks reveal that during FY02, these disbursed more than Rs 15 billion in consumer finance.

In September 1997, additional incentives in the form of tax exemption (on the 10 percent withholding tax) were granted to TFC holders, including corporate entities such as banks, giving a boost to the investor base of TFCs. However, six months later, the withdrawal of part of the tax exemption, leaving only individuals tax exemption, dealt a heavy blow to the fixed income market.[14]

While it was expected that long-term securities would be priced relative to government bonds, in reality TFCs' pricing (coupon and price) was based on the National Saving Schemes (NSS). The reason is twofold: first, secondary market for long term government papers was not in a stage where their yields were long-term benchmark rates; and second, NSS constitutes more than a quarter of all domestic government debt and is aimed mostly at the public, which the TFCs, through listing at the stock exchanges, were also targeting. This put the TFC issuers at a disadvantage in raising finance through this instrument.

However, to provide more enabling environment, the government has taken some important steps. Most prominent were changes in National Saving Schemes (rationalizing rates and banning incremental institutional investment in April 2000), and the launch of the Pakistan Investment Bonds (PIBs) with the aim of providing a benchmark for long-term securities. With the fall in interest rates, and more importantly, the cut in NSS rates since mid-1999, the effective benchmark for the pricing of corporate bonds has fallen sharply.[15] Since then, market has picked up steeply and 32 new issues were launched in the market, of which 22 were launched since the start of the FY02 to date (see **Table 7.8** & **Figure 7.4**). **Figure 7.5** shows the sector wise composition of issuers. Also in the wake of falling interest rate scenario and limited quality investment options, TFCs provide an attractive opportunity for the investors. However, secondary market for these issues largely remain dormant due to lack of liquidity and absence of market makers.

Figure 7.4: Growth in TFC Market

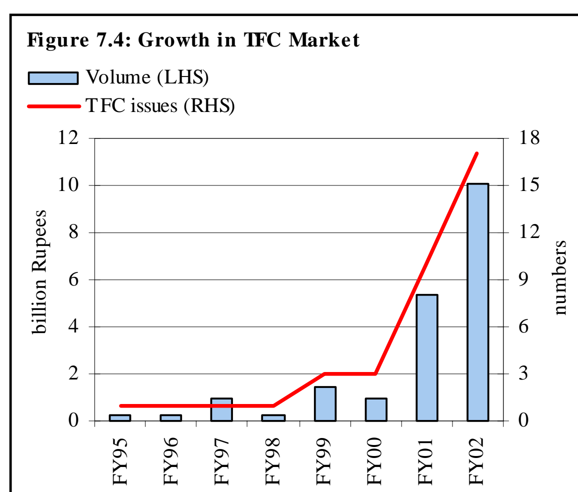
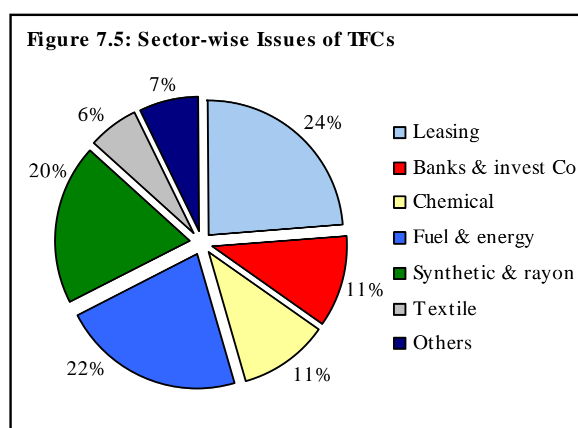


Figure 7.5: Sector-wise Issues of TFCs



In order to make issues more flexible and affordable for the investors, issuers are adding different features from shelf registration to the green shoe option to TFC structure.[16] Use of shelf registration implies that the issuer can split the TFC issue into tranches, which is

[14] The rational was to prevent banks from profiting from converting their taxable loan portfolio to tax exempt TFCs.
[15] The latest reduction in NSS rate was carried out in April 2002.
[16] Other options available with the issuers are Floating Coupon Rates, Asset Securitization and the Redemption Features like Call & Put option. A call option on TFCs gives the issuer the right to call the bond for redemption at a certain price at certain time. Likewise, a put option on a bond allows the investor the right to redeem his/her investment prematurely (commonly at fixed option dates).

Table 7.8: Corporate Debt
million Rupees

Security	Issue Date	Maturity	Issuance Size	Coupon Rate
GATRON	17-Jun-98	Jun-03	274	18.00
Inter-Bank	1-Dec-98	Dec-03	300	17.50
SPLC	28-Jan-99	Jan-03	250	18.25
DSFL	24-May-99	May-04	863	19.00
NDLC	1-Dec-99	Dec-04	550	17.00
PILCORP	21-Dec-99	Jan-05	287.5	18.00
Sigma Lease	18-Jan-00	Jan-03	100	17.00
Paramount Lease	2-Aug-00	Aug-04	250	16.25
Atlas Lease	27-Sep-00	Sep-05	200	15.00
Network Lease	4-Oct-00	Oct-05	100	16.25
Al-Noor Sugar	31-Oct-00	Oct-05	204	DR + 250bps (16.5-18.5)
PILCORP (2nd issue)	2-Mar-01	Mar-04	325	15.60
ORIX LEASING (1st Issue)	7-Apr-01	Apr-05	745	14.00
Shakarganj Mills	10-Apr-01	Apr-05	250	DR + 200 bps (15.5-18.75)
SSGC	31-May-01	May-06	1,000	Yr 1-2: Fixed at 14.15, Yr 3-5: Floating @ DR + 110bps (13.0-18.0)
Engro Asahi	15-Jun-01	Jun-06	500	5 Yr PIB + 150bps = 14.5 (13.0-17.0)
DSFL	22-Jun-01	May-05	1,816	16.00
ICI/PTA	2-Aug-01	Aug-06	1,600	PIB 5 Yr + 300bps = 16.00
Atlas Lease	16-Aug-01	Aug-06	100	15.0
PACKAGES	27-Aug-01	Jan-05	700	13.50%-17%, DR + 1.25% pa
Gulistan Textile	1-Sep-01	Sep-02	300	DR + 2%, Floor 14%, ceiling 17%
Dawood Leasing	1-Sep-02	Sep-02	250	DR + 1.75%, Floor 13.5% , Ceiling 17.5%
Interbank	15-Sep-01	Sep-06	500	13.75-16%
Nishat	19-Sep-01	Sep-05	600	14.5% 1st year, 2-4 year 1.5% over DR, floor 13% ceiling 17%
Engro Chemical	27-Nov-01	Nov-06	500	Floating rate (weighted average cut off yield of last three auction of 5 year PIB Plus 1.15) Floor 13 %, Ceiling 17%
PARCO	12-Dec-01	Dec-04	2,500	Base rate + 1.45 % (Floating rate) Floor 13% p.a, ceiling 15% p.a
Crescent Leasing	26-Dec-01	Dec-06	250	Base rate + 2 % (Floating rate) Floor 14.5% p.a, ceiling 18% p.a
Security Leasing	28-Dec-01	Dec-05	200	DR + 2.25%, 1st 2 years, Floor 14.75%, Ceiling 17.50%, 3 & 4 Year Floor 14.0%, Ceiling 17.5%
Reliance Weaving	6-Feb-02	Feb-07	150	DR + 2.5%, Floor 15.25%, Ceiling 17.50%
Union Leasing	9-Apr-02	Apr-05	250	DR + 2.25%, Floor 14.50%, Ceiling 16.75%
Shahmurad Suger	21-May-02	May-06	200	Min 15.50%, Max17.50%
SPLC 2	31-May-02	May-07	400	Weighted average last 3 cut off 5yrs PIB + 1.75%, Floor 12.00%, Ceiling 16.00%
SSGC 3	3-Jun-02	May-07	1,250	DR + 1.10%, Floor 11.50%, Ceiling 16.00%
Sitara Chemical	19-Jun-02	Jun-07	360	First 100mn 12%, increased 2% with each 100 mn
Engro Chemical 2	4-Jul-02	4-Jul-07	1,000	Weighted average last 3 cut off 5 year PIB + 1.15%, Floor 11.00%, Ceiling 15.00%
Maple Leaf Cement	18-Jul-02	18-Jul-06	225	5 Years PIB Rate + 2.50% Floor 15.25%, Ceiling 17.75%
Dawood Leasing 2	25-Jul-02	25-Jul-07	250	DR + 1.75% Floor 12.25% , Ceiling 16.25%
Orix Leasing 2	29-Jul-02	29-Jul-06	710	DR + 2, Floor 10%, Ceiling 13%
MCB	8-Aug-02	8-Feb-07	1,600	5 years PIB cut off yield + 1.50%, Floor 11.75%, Ceiling 15.75%

useful for periodic financing requirements of the issuer and also allows optimal pricing of the individual tranches.[17] Similarly, the green shoe option allows the issuer the right to retain the over subscribed portion of the initial public offer (IPO). However, the issuer has to specify the amount it would retain under this option in advance. A very interesting development is the gradual evolution in the pricing structure of the TFCs. Starting from the plain vanilla structure with fixed coupon rates, market has witnessed an increasing number of bonds with floating structures.[18]

[17] The shelf registration option is valid for a maximum period of twelve months for an issue amount of Rs 250 million and a maximum period of three years for an issue greater than this.
[18] In floater TFC, coupon rate is variable which changes with market conditions by being anchored to a benchmark rate (usually with SBP Discount Rate). This pegging protects the investors from any upward fluctuation in interest rate that would cause a fall in yield.