

3 NEED FOR FINANCIAL DIVERSIFICATION: DEVELOPMENT OF A DEBT MARKET IN PAKISTAN

With an over-dependence on the banking sector for meeting the financing needs of the economy, the need for financial diversification in the form of developing an active debt market in the financial sector, is stronger than ever. This article examines the reasons for the slow growth in the corporate debt market and points to the need for a regular supply of long-term sovereign bonds as a pre-requisite for this development. As the central bank plays its role in strengthening the monetary policy transmission mechanism and improving secondary market activity, market psyche also has a major role to play in shifting the focus from the short-end horizon by taking initiatives to promote the long-end of the yield curve. Effective development of the term structure of interest rates will ensure the requisite commitment from both the issuer and the investor, and is another significant pre-requisite for the development of the debt market. In addition, improved liquidity, efficiency of the price discovery mechanism and a broader investor base would make it easier for new companies to raise longer term risk-capital from the capital market and reduce their reliance on conventional lenders like banks. By following improved governance practices, for instance a high level of disclosure, listed companies should be able to get better terms from lenders than similar unlisted companies.

3.1 Introduction

In the last decade or so, global capital markets have evolved into a large, dynamic and diverse force, more so than ever before. This process of evolution has a direct bearing on policy-makers and regulators, investors, financial institutions and corporations in emerging markets. A recent survey¹ of global financial assets² identifies some trends as detailed in **Box 3.1**.

Box 3.1: Global Financial Assets

- Financial Markets across the globe are becoming deeper and more liquid – the global financial stock has grown faster than world GDP, and is on pace to exceed \$200 trillion by 2010. This gives an indication of the growth in the sheer size and depth of the markets. A major portion of this growth has come from a rapid expansion of debt.
- The traditional roles of countries and regions are in a state of flux – USA continues to have a dominating share of the global financial stock, the European Union is in the process of catching up, the share of Japan is deteriorating, whereas that of China is increasing rapidly. India, Singapore, Latin America and Eastern Europe have the potential to deepen much further as their financial systems develop, though at the moment they are tiny in global context.
- Cross-border capital flows are growing rapidly, resulting in a far more integrated global financial market than ever before, with the US Dollar and the US market at its core.
- Alongwith the growth in size, a striking feature of the global financial stock is the *shift from bank deposits to private debt securities*, which are the largest (and growing) component of global financial assets. Additionally, *international* issues of private debt, while still small, have grown three times as fast as *domestic* issues, reflecting the increasing globalization of capital flows. Growth in private debt markets is a positive development for large corporations looking for financing options.
- The role of government and private debt securities in increasing the overall share of debt varies across geographical jurisdictions. Growth of debt in Japan, Italy and France is almost entirely due to government securities whereas in UK, private debt securities have been the major drivers of growth. Countries like the US and Germany have seen an even level of activity in three classes of debt : government, private and asset-backed securitization (ABS), which is basically driven by mortgage portfolios. However, the liquidity crunch associated with the US sub-prime mortgage market has had a serious impact on the future growth of asset-backed securitization products.

Source : Mapping the Global Financial Markets, Second Annual Report, McKinsey Global Institute, January 2006

¹ Undertaken by McKinsey Global Institute, covering 100 countries from 1980 onwards, January 2007

² Financial Capital available for intermediation. In specific terms equity securities, private and government debt securities and bank deposits.

A general trend observed in Asian economies, as in Pakistan, has been an over-reliance on the banking system to fulfill the financing needs of the economy, with capital markets relatively slower to develop in comparison. Whereas in most countries the banking system has absorbed the evolving financing requirements of various sectors, the efficiency of scale that emerges with the availability of long-term and alternative financing options from bond markets, has been, until recently, conspicuous by its absence. **Table 3.1** gives a comparison of the various financial structures in place in Asian economies, and to put things in perspective, **Figure 3.1** gives a further break-up of the bonds outstanding by type of issuer, showing that generally, government debt represents a significant portion of the outstanding bonds category.

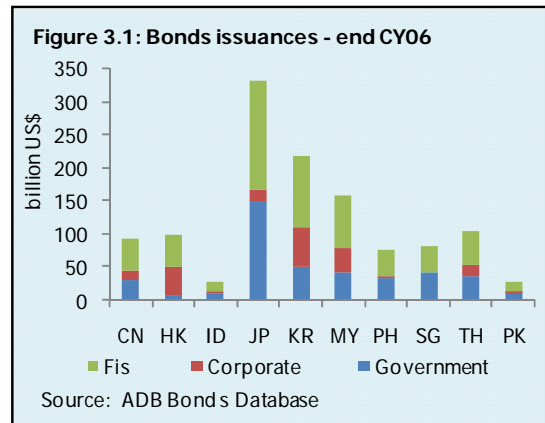


Table 3.1 : Structure of the financial system in Asian countries
percent of GDP

	Bank Assets			Equity market capitalization			Bonds outstanding		
	1997	2004	2005	1997	2004	2005	1997	2004	2005
China	124.4	207.4	191.6	11.2	27.1	20.9	12.9	29.3	28.6
Indonesia	34.3	14.4	68.4	36.4	36.8	39.8	2.1	22.4	27.0
Korea	67.7	118.0	91.9	14.5	51.8	89.6	45.0	75.6	74.9
Malaysia	100.6	170.0	162.5	93.0	154.2	140.6	56.9	90.5	89.7
Pakistan*	49.1	50.1	52.5	16.8	25.2	46.1	5.4	7.1	15.4
Philippines	76.5	68.4	61.3	51.4	34.0	39.3	30.5	29.7	35.6
Thailand	79.7	127.4	102.1	15.1	70.6	69.7	7.1	40.7	40.2
Hong Kong	208.2	343.3	443.3	238.0	528.5	591.9	26.4	47.1	46.5
Singapore	122.7	178.0	185.3	111.5	203.7	220.3	24.8	73.6	68.2

Source: IFS, BIS, ADB Asian Bonds Online and SBP staff calculations

*Pakistan's numbers are upto 2007, outstanding bonds do not include T-bills

One of the prime examples of the grave implications of a skewed financial sector is the East Asian crisis, where banks were looked upon as the predominant provider of external finance. A post-crisis reflection on events brought forth the awareness of the significance of debt markets and in particular, of bond markets, as a complementary source of finance. Moreover, the continued integration and deepening of financial markets is a significant issue for policy makers, and particularly for central banks entrusted with the formulation and implementation of monetary policy, since well-integrated and efficient financial markets are crucial in ensuring a smooth transmission of monetary impulses to the economy.

In comparison with the developed markets, there is little evidence of cross-country market integration in Asia – the Asian capital market is a collection of distinct national entities, where the relatively more developed economies are starting to integrate well with the more advanced economies, but are still hesitant to seek the same level of integration with one another. As discussed above, bank deposits and government debt securities are the major growth drivers in the Asian financial stock.

Literature on bond market³ development suggests several reasons for the particular process of evolution in emerging economies. A few general trends observed show that individuals in such countries have a greater preference for liquid short-term bank deposits; institutional investors are underdeveloped or non-existent; few companies are sufficiently large and

³ Shirai (2001) and Yoshitomi and Shirai (2001)

reputable to issue bonds; and the requisite informational, legal and judicial infrastructure is not in place.

3.2 State of the Debt Market in Pakistan

Similar to the trend observed in most Asian countries, the major drivers of financial assets in Pakistan are deposits and government bonds, whereas corporate bond issuances remain a miniscule portion,⁴ with the total outstanding (listed) issues at Rs. 45.1 billion (0.7 percent of GDP) at end FY07, in comparison with Korea at 28.3 percent and Malaysia at 32.5 percent. Pakistan Investment Bonds (PIBs), introduced in the year 2000,⁵ remain the longest tenor sovereign bonds, providing the benchmark yield curve for private issuances.⁶ National Savings Schemes (NSS), on the other hand, with tenors upto 10 years, provide risk-free investment options to retail and institutional investors.

Two main reasons which signify the importance of the development of a vibrant debt market in Pakistan are discussed below. The first relates to the efficiency and stability of the financial system and the other to the effectiveness of monetary policy.

3.2.1 Efficiency and Stability of the Financial System

Essentially, a viable debt market provides an alternative source of external finance to firms, usually dominated by the banking sector in emerging economies like Pakistan. Indeed, the monopoly of the banking sector is an impediment to the fundamental principle of perfect competition; it leads to inefficiency and therefore to sub-optimal outcomes in the loan market, and jeopardizes the stability of the financial system. Consider the following:

- When the banking sector has to face competition from a well developed local currency bond market, it is forced to improve the efficiency of its operations. The scenario in Pakistan is dominated by the banking sector that faces very little competition from the corporate debt market. Indeed, extraordinary banking spreads, as witnessed in Pakistan recently, provide some evidence of the lack of competition and efficiency in Pakistan's financial markets.
- The short tenor of bank loans, itself a consequence of the nature of banks' deposits particularly in Pakistan,⁷ leads to maturity mismatch issues in the banks' asset and liability portfolios. This essentially means that long-term funding needs are financed by a consistent roll-over of short-term loans, and in times of tight liquidity, borrowers finding themselves unable to roll over their maturing obligations might experience a credit crunch. Access to bond markets then serves the purpose of a *complimentary*, rather than the *alternative* source of finance, as propagated by the much cited example of the essential "spare tyre".⁸ This is particularly true when a growing economy like Pakistan needs to raise sufficient funds for financing long-term infrastructure projects.
- When firms can raise their own funds through the issuance of bonds, they are less dependent on banks and therefore are immune to the difficulties that banks might face. This also puts pressure on banks to improve their efficiency as they no longer possess captive clients. Consequently, banks can focus more on those enterprises of the economy that typically face credit constraints due to their small size, relatively new stage of development, or simply asymmetrical information.

⁴ As part of overall financial sector reforms, companies were allowed to issue "Term Finance Certificates" (TFCs) from 1995 onwards.

⁵ PIBs replaced the Federal Investment Bonds (FIBs) introduced in 1992, regular auctions of which were held until 1998.

⁶ PIBs were initially issued in the tenors of 3, 5, and 10 years. In 2004, the benchmark yield curve was further extended with the launch of PIBs of 15 years and 20 years in an endeavor to create a sovereign benchmark yield curve for developing the mortgage industry. In 2006, the yield curve was further extended to 30 years when PIBs of this tenor were issued in December.

⁷ This is discussed in detail in the thematic article on "Efficiency of Financial Intermediation: An Analysis of Banking Spreads" in Part I of this report.

⁸ Remarks by Alan Greenspan with reference to the East Asia financial crisis, 1999.

- One inherent characteristic of bond and securities finance is the provision of better risk-sharing than banks. When securities are spread across a large number of individuals, the risk is more efficiently diversified. Better risk sharing then is an incentive for creditors to commit themselves for longer periods of time, thus facilitating the borrowers in meeting their long-term funding needs. Indeed, all this adds up to the stability of the financial system.

3.2.2 Transmission Mechanism of Monetary Policy

Effectiveness of monetary policy has a crucial dependence upon the behavior of long-term interest rates, which are greatly influenced by the short-term interest rates. A well developed debt market is crucial in determining the 'effectiveness' of the short-term rates and therefore for the transmission mechanism of monetary policy. Consider the following:

- Central banks around the world usually have direct control over short-term interest rates and these are therefore their main policy instruments. When a central bank raises or reduces these rates, the market-determined long-term interest rates tend to behave accordingly.
- It is so that when a central bank wishes to reduce inflation, it would raise short-term interest rates. As it is at this point in time that the market would forgo its current consumption to invest in long-term bonds (to consume in future). The foregoing of consumption at this time dampens aggregate demand and thus reduces inflation.
- However, for this mechanism to work effectively a well-developed debt market, including both long-term government and corporate bonds, that ensures intermediation for long-term lending, is crucial. In the absence or near non-existence of such a market, it is rather challenging for a central bank to achieve its desired goal(s).

3.3 Impediments to the Development of a Corporate Debt Market

Even though the corporate debt market has made some progress since the implementation of capital market reforms, it still lacks depth. Some of the impediments in its development are :

3.3.1 Yields on NSS Instruments

Historically, the key obstacle to the development of the corporate debt market has been the competition for long term investment alternatives from the NSS instruments, which offered zero risk yields much higher than returns on corporate bonds. In order to align NSS rates with market-based yields on instruments of similar tenors, the yields on NSS instruments were first reduced,⁹ and then pegged to the yields on the government's market-based long term bonds. From March 2000, institutional investors were barred from incremental investment in NSS. However, the policy-reversal¹⁰ by the government to re-allow institutional investment in NSS has dampened the demand for TFCs, making it essential to keep NSS rates in line with the overall interest rate structure in the economy.

3.3.2 Market Psyche regarding Disclosure Requirements

A large number of business entities in Pakistan tend to be family owned and managed, and display an inherent reluctance to share or disclose information. Among other factors, this is one of the reasons why the number of listed companies decreased from 762 in 2000 to 658 in the year 2006. Over a period of time, a number of listed companies have opted for de-listing, whereas the newly listed companies are mainly privatized public sector entities.

While a large majority of these entities avail financing facilities, they are reluctant to list themselves on the exchanges for fear of loss of control, sharing of information, disclosure

⁹ These were reduced with effect from May 14, 1999 and this move was followed by two more cuts in NSS rates effective from January 1, 2000 and July 1, 2000 that brought down the average rate on 10-year DSCs from 15 percent to 14 percent during this period.

¹⁰ Effective October 2006.

requirements, requirements relating to corporate governance, etc. This is also evident from the number of corporate borrowers (including partnerships) in the e-CIB database, i.e. 29,502 as of end-June FY07, in comparison with around 52,000 private limited companies registered with the SECP, showing their preference to meet their funding needs from internal resources.

This mindset does not only adversely impact the development of the corporate debt market but also has a bearing on the financing structure of the corporate sector, since borrowing from the banking sector is the most commonly used option to mobilize funds. Ideally a corporate entity, before embarking upon borrowings from the banking sector, should assess and weigh various options to mobilize funds through new issuance of equity instruments, quasi-equity instruments like preference shares, long term debt instruments like TFCs or short term debt instruments like commercial paper. Lack of willingness to diversify the sources of capital and borrowings also impedes the growth potential of the corporate sector.

3.3.3 High Transaction Costs

High transaction costs have been a major hindrance, especially in the initial period, when TFC issuance was discouraged by the relatively high issuance, listing and taxation costs. The listing costs are in the process of being rationalized, through combined efforts of the SECP and KSE, in addition to a rationalization of the withholding tax rates and stamp duties on these instruments. Factors related to turnaround time on documentation requirements and approvals needed from SECP are also in the process of being addressed.¹¹

3.3.4 Illiquid Secondary Market

While the primary market of TFCs has made some progress, the secondary market is quite illiquid. This is due to a number of factors including small issue volumes, a certain reluctance among holders of instruments (due to inexperience in trading debt instruments), lack of competition), and a lack of ongoing fresh supply of sovereign instruments.

Several measures have been taken by SECP in recent years to promote the development of a vibrant debt market. For instance, SECP formed a committee of experts in 2006, to identify the issues hindering the growth of debt markets and to make suitable recommendations to provide a facilitative environment. SECP envisages that the recommendations of this committee, once implemented, will lead towards the growth and development of a vibrant debt capital market in the country. This will also strengthen the linkages between the Commission, the State Bank of Pakistan, and other stakeholders within the Government and the corporate sector.

3.4 The Way Forward for Pakistan

In view of the above, this section discusses a few factors which could potentially facilitate the development of a debt market in Pakistan.

3.4.1 Role of Banks

The banking sector, which has a virtual monopoly on providing financing to all sectors of the economy, can play a contributing role in the development of the debt market. Banks are often among the most important issuers, holders, dealers, advisers, underwriters and guarantors in the market.¹² Given the skewed nature of their balance sheets with maturity mismatch issues, banks can issue long-term bonds for Asset Liability Management (ALM). This is particularly relevant from the perspective of financing long term projects. To further manage their risk profiles in changing interest rate environments, there are now sophisticated risk-management tools such as Interest Rate Swaps (IRS) at their disposal. Subordinated bond issuance also has the advantage for banks of being recognized as tier 2 capital, which helps them in meeting their capital adequacy requirements.

¹¹ Proposed Reforms to Pakistan's Debt Capital Market, presented to SECP by the Debt Capital Market Committee, April 2007.

¹² As discussed in "Bond markets and banks in emerging economies", BIS Paper No. 11.

3.4.2 Role of SBP in promoting secondary market trading

The central bank has a crucial role in promoting secondary market trading of debt securities – by improving the effectiveness of monetary policy implementation. Efforts to reduce the volatility of short-term interest rates, while credibly signaling the policy stance, go a long way in increasing investor confidence while promoting the maturity transformation of financial intermediaries' portfolios. Moreover, stable money market rates foster repo activity and anchor the yield curve as trading develops in longer maturities. In FY07, as in FY06, SBP focused essentially on improving the transmission of the policy rate, by draining excess liquidity from the inter-bank market and maintaining the O/N repo rates close to the discount rate. This approach has proved to be very effective and SBP will continue to work towards further improving the mechanisms of monetary policy implementation.

3.4.3 Developing the term structure of interest rates

Development of the term structure of interest rates depends on regular issues in the primary market, increased trading activity in the secondary market, and providing ease of entry and exit to both the issuers and the investors. Regular auctions of Pakistan Investment Bonds (PIBs) since May 2006 is a step in this direction.

Developing bond markets and enhancing the capacity of public- and private-sector borrowers to issue long-dated, domestic currency denominated debt securities is high on the country's policy agenda, as is the case in both East Asia and Latin America.¹³ Despite the setback to the development of the bond market due to the policy reversal on institutional investment in NSS, the recently initiated PIB auctions give an indication of the Government's inclination to develop the long-term yield curve, and thus the bond market. This is all the more so because for the first time in the history of local bond offering, a 30 year PIB issue was floated in December 2006. Regular PIB auctions of sizable amounts will increase GoP's average debt maturity profile, which has been significantly shortened due to its reliance on short-term borrowing, contribute towards developing and extending the yield curve, and generate the requisite liquidity in the secondary market.

3.4.4 Developing the investor base

Among other factors, the presence of the requisite investor base is crucial for the development of both the primary and the secondary markets in debt securities. The regulatory environment should provide the right incentive framework to encourage both individual and institutional investors to invest, and trade in, debt instruments. SBP's Primary Dealer system, which includes commercial banks, DFIs and brokerage houses, helps in widening the investor base of government securities to corporates, pension funds and retail investors. A wide range of investors, with varying risk preferences, time horizons and trading motives would ensure active trading and liquidity. Moreover, the role of a reputable credit rating agency is quite significant in this respect, to instill confidence among the investors in understanding the credit risk parameters.

In conclusion, a basic set of key recommendations for emerging markets is to strengthen macroeconomic policies to provide a stable setting for both borrowing and lending, to strengthen corporate governance to ensure that firms would borrow prudently, to strengthen financial disclosure requirements to enhance the ability of potential bondholders to make prudent investment decisions, to encourage the growth of institutional investors to enhance diversification opportunities and reduce transaction costs, and to strengthen bond market infrastructure generally by creating efficient clearing and settlement, credit enhancement and custodial facilities.¹⁴

¹³ As discussed in Eichengreen et al, 2006.

¹⁴ As discussed in "A Tale of Two Markets : Bond Market Development in East Asia and Latin America", Barry Eichengreen et al, March 2006