Address by: Yaseen Anwar, Governor,
State Bank of Pakistan
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Esteemed faculty, distinguished guests, ladies and gentlemen, good morning to you all!

The words "crowding out" have been discussed extensively in recent times within policy discussions. However, I believe that this phenomenon has been exacerbated due to the absence of a corporate debt market. In very simple terms, the process of intermediation in Pakistan is focused through banks – and the government provides the banks with very attractive returns and a constant demand for funds. These funds are then, not available to the private sector – thus leading to a reduction in investment. This is the phenomenon that economists describe as crowding out. I believe that we need to develop an alternative avenue of intermediation: corporate debt markets. These markets will allow the channelling of funds directly

from savers to the private sector – matching the demand for funds for long term investments with the supply of long term savings. Allow me to share my thoughts for why corporate bond markets are the need of the hour.

Although the relationship between corporate bond markets and economic development has been widely recognized, the Global Financial Crisis has highlighted its role in broader financial stability, as well as its potential to serve the real sector – particularly in times of economic turmoil. Corporate debt markets are important for several reasons: as a source of long term financing; providing competition to the banking sector; and enhancing financial stability. It is therefore a matter of concern, and indicative of potential, that the size of the listed corporate debt market in Pakistan stands at less than one percent of GDP.

The existence of a functioning private bond market serves both borrowers – by broadening access to funding, and by lowering borrowing costs – as well as savers. In Pakistan's case in particular,

it would provide savers with an alternative to bank deposits. It has long been recognized that the presence of such markets is a significant source of competition for the banking system.

Here's a throwback to finance 101. When firms require financing they have four basic options: retained earnings; bank borrowing; debt markets; and equity markets. In Pakistan, as in many emerging markets, the largest share of corporate financing is in the form of bank loans.

So why is there a need for a corporate debt market? In addition to providing competition to the banking system, a private debt market acts as a 'spare tyre' – in the words of Allan Greenspan. The issue of corporate debt markets has received serious attention in developing countries since the Asian Financial Crisis. The lack of developed bond markets is often cited as a reason for the severity of the crisis. As a 'spare tyre', the bond market may have been able to pick up the slack from the banking sector – acting as a financial intermediary between savers and investors while

banks cleaned their balance sheets. In addition, a corporate debt market can also enhance financial stability by mitigating rollover interest risk for borrowers. For example, in an environment of monetary tightening, firms reliant on short term bank borrowing are more likely to face higher debt servicing costs than those issuing longer term securities in capital markets.

Let's take a more recent example now. The Global Financial Crisis has highlighted for us the role that private debt markets can play in ensuring the flow of credit to the real sector. For example, European firms' reliance on bank financing makes them particularly vulnerable to the cutback in lending by risk-averse banks; and has raised concerns over the speed of the economy's recovery. One of the reasons the recovery in the US seems to be doing better than the faltering recovery in the EU is because of the better developed private bond markets in the US. Of course, let's remember that we have miles to go before our debt markets may be compared to those in the EU.

Now back to the lesson in economics. Corporate debt markets can also improve the allocation of capital, as market-determined rates provide a clearer measure of the opportunity cost of funds. For example, in Pakistan, banks have increasingly opted for investment in government securities; many argue that this has been at the expense of advancing loans to the private sector. Corporate bond markets would not only provide firms with an additional source of funding, but also rationalize the opportunity cost of banks' asset allocation decisions. In simpler words, it will incentivize a move by banks towards private sector credit.

In addition, heavy dependence on bank financing has been shown to affect investment decisions of firms. How does this happen? Well, in an uncertain macro environment, banks are reluctant to advance long-term loans to the private sector, and often resort to short-term lending. This implies that in the absence of corporate debt markets, firms will find it difficult to raise funding for long-term investment projects. Essentially, the short-term nature

of bank lending will bias capital investment in general, and may exacerbate cyclical fluctuations in economic activity. This will be particularly true in industries where costs are recovered over a much longer-term. Such industries include construction, power generation, etc.

Now, given the importance of private debt markets in a country's capital market, what constrains its development in Pakistan?

Firstly, a major obstacle has been the lack of a credible benchmark for rates on long-term bonds issued by firms. In most countries, the government – as the largest issuer of debt securities – provides the volume required for a liquid secondary market. In Pakistan, however, PIBs are unable to serve this for two reasons. Firstly, the market is not sufficiently liquid, and secondly, there is no benchmark for private bonds that are issued for a tenor of between 5 and 8 years - since PIBs are only available in maturities of 5 and 10 years. This means that the bonds issued by firms will be

linked to short-term securities, leading to significant interest-rate risk.

Secondly, competition from the government for the same pool of savings undermines progress towards greater financial deepening. The risk-free nature of investment in various NSS schemes, their ad-hoc rate adjustment, and the ability to redeem prematurely, dominates any corporate bond in the market. The private sector, therefore, has to issue bonds that carry a higher interest rate than NSS rates to compensate for the risk of default that the private sector carries. This makes the issuance of corporate sector debt expensive.

Thirdly, the administrative and regulatory cost (duties and fees for listing etc.) of issuing such debt securities is high. Stamp duty on the issuance of corporate debt is a major cost which needs to be rationalized. High level of stamp duties increasing the issuance cost for the issuer and hindering the regular issuance of corporate debt in Pakistan. Similarly, stamp duty on transfer of corporate debt

instruments discourage secondary market trading of the debt instruments, therefore, stamp duty on "Transfers" needs to be reduced and may be eliminated. Another, issue is the different rates of Stamp duties across the provinces which should be synchronized among provinces and capital territory for standardization purposes.

The process for primary issuance of corporate debt should be simpler one and fast track; so that a corporate could raise funds quickly when conditions are favorable for debt issuance. Shelf registration is an efficient way of issuing the debt instruments as it saves the cost and time. Although, in Pakistan we have shelf registration for corporate bonds but it usually takes long time for the approval process. There pertaining to transactions in corporate debt instruments needs to be developed.

- **Unified trading platform to be considered for trading of all debt instruments. Considering the persistently thin volumes on BATS developed by KSE, market participants should be**

encouraged to use Bloomberg EBND, which trades almost 65% of volumes, also trading in corporate debt instruments.

The above initiatives are of utmost importance to be above to move from a purely banking loans market towards a vibrant Debt Capital Markets. This will not only facilitate providing diversified investment avenues for various stakeholders, but will also help in improving saving ratios of the country and enable borrowers to raise efficiently price financing for crucial infrastructure projects. In this regards Investment Banks as well as Development Finance Institutions should also play a significant role in the development of a vibrant Corporate Debt Market.

Supporting an efficient regulatory framework is critical for the development of a corporate bond market.

Fourthly, the small size of the private sector bond market itself restricts liquidity. Although bonds, such as term finance certificates are listed on the stock exchange in Pakistan, trading is limited. The

absence of well-functioning secondary markets means that investors are likely to demand higher liquidity and interest rate premiums.

Finally, the appetite for raising debt on the capital markets is also an issue. Corporates are reluctant to approach the bond market because of the disclosure requirements, and their preference to remain undocumented. The corporate culture in the country must change, so that family-owned businesses are not constrained from future growth.

On to the solutions: a few steps that can be undertaken to address these issues include adherence by the government to predetermined auction targets. This means that the government must be willing to accept higher rates, if determined by the market; of course, this would also require the government to limit its direct borrowing from SBP.

The rates on the National Saving Schemes should be more sensitive to market conditions. The recent decision to bar institutional investment in NSS must not be reversed, as it was

previously. Furthermore, rates on NSS should be rationalized vis-a-vis the many other advantages that these instruments carry. This is particularly the case as NSS instruments are not always held to maturity, and this hinders the development of a secondary market.

Considering above issues and leveraging SBP's experience in debt market, collaboration with SECP has been initiated to identify hurdles in development of corporate debt market. Views of guidelines for issuance of commercial paper have also been exchanged with SECP. A joint task force has been formulated during the last quarterly meeting with the objective of putting up framework of establishing a vibrant Corporate Debt Market.

The tasks include …

- **Develop guidelines for shelf registration of corporate debt**
- **Collaboration with credit rating agencies to streamline the issuer and instrument rating process. Discussions already underway with credit rating agencies on the subject**

- Coordination with provincial authorities on rationalization of stamp duty on transfer and issuance of corporate debt Instruments

- Collaboration with FBR and GOP to rationalize tax treatment of corporate debt instruments

  To encourage the development of corporate debt market, it is essential that taxation issues are addressed in an appropriate manner and communicated to the stakeholders.

- Develop standards for valuation of corporate debt instruments.

  A document containing all conventions and standards is a need to streamline the approval process of shelf registration with an objective to facilitate the issuer.

I would like to think that I have convinced you of the need for the development of corporate debt markets in the country. As I have earlier stated, our fiscal deficit is not unmanageable, but we need to deepen our financial markets to ensure that any adverse development on the fiscal side of affairs does not negatively impact

the pool of credit available to the private sector. There is immense room for improvement when it comes to financial deepening through bond markets.

Our challenges are hardly insurmountable.

Thank you.