Fixed Income Market Development in Emerging Market Economies

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I would like to welcome all of you at the second SBP International Conference for an active discussion on fixed income market development. Capital markets today are relatively deeper and more liquid, with global financial assets growing faster than the world GDP and are likely to exceed $200 trillion by 2010.[1] Accompanying this is a *shift* from bank deposits to private debt securities which is 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,[2] reflecting the growing financial integration and increasing globalization of capital flows. Underlying these global trends are significant variations in the source and type of securities across countries, with the US and Germany standing out in terms of sizeable activity in government, private and asset backed securitization, with the latter driven by securitization of mortgage portfolio's.[3]

This global picture however masks the differences in the level of financial depth and diversification across countries. Of particular relevance and interest are emerging trends in Asia. The East Asian financial crisis brought to the forefront the inherent dangers and risks of excessive bank dependence, and a growing awareness of this encouraged several national and regional bond market development initiatives which are now yielding positive results. The East Asian Governments have promoted capital markets quite aggressively by strengthening the securities markets and its regulation and oversight, while instituting corporate governance standards. Besides a notable growth in equity market capitalization, efforts were launched to promote debt markets. As a result, bonds outstanding as a proportion of GDP have registered several fold increases in virtually all of East Asia. While a part of this is capturing the growth in government securities and bonds issued for recapitalization of banks, there is also a notable growth in private corporate debt with the evolution of market determined benchmark yields on government securities. The steepest growth in private corporate debt has been observed in Malaysia, Singapore, Hong Kong and Korea.

Benefits of Fixed Income Markets

Both theoretical and empirical literature has extensively debated the virtues of the development of the corporate bond market. Some view it is an alternate or a substitute to the banking system and a "spare tyre" as referred to by Alan Greenspan, while others have contested

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[1] Results of survey conducted by the McKinsey Global Institute, covering 100 countries from 1980 onwards - February 2005.
[2] 20 percent vs 7 percent
[3] In the US alone, around $5.3 trillion of $9.9 trillion consumer debt are mortgages packed into securitized assets.

that bond markets cannot serve as substitutes to bank debt as the performance of bonds is often impacted when there is an overall decline in economic and banking sector confidence.

Growth in debt markets is a positive development for the financial system and the economy at large. It helps to diversify the financial system, reducing excessive dependence on banks and vulnerabilities within the banking system, while providing funding to large corporations looking for long term financing options. Financial engineering of different types has facilitated the development of innovate debt products which have supplemented and complemented bank financing.

A viable fixed-income market provides an alternative source of finance to firms that exclusively rely on the banking sector in emerging economies, like Pakistan. Indeed, the monopoly of the banking sector is an impediment to the fundamental principles of a market economy based on perfect competition; it leads to inefficiency and therefore to sub-optimal outcomes in the loan market; and jeopardizes the stability of the financial system. A well-developed fixed income market helps expose banks to competition which in turn helps improve their efficiency. Indeed, extraordinary banking spreads in Pakistan in recent years is an evidence of 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, leads to maturity mismatch issues in the banks' asset and liability portfolios. Long-term funding needs hence are financed by a consistent roll-over of short-term loans, and in times of tight liquidity, borrowers often face credit crunch and difficulties in rolling over their maturing obligations. A developed fixed income market would help mitigate these difficulties and also facilitate better risk diversification as debt is spread across a large number of individuals as opposed to bank lending, and the corporate sector is able to raise longer term debt. With the development of the fixed-income market, 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.

State of Fixed-Income Market in Pakistan

In contrast to East Asia, Pakistan's private corporate debt market remains underdeveloped and is below one percent of GDP.[4] The major drivers of financial assets in Pakistan are deposits and government bonds, whereas corporate bond issuances remain a miniscule portion, with the total outstanding issues at Rs49.3 billion (0.64% of GDP) at end FY06, in comparison with Korea at 21.1% and Malaysia at 38.2%. Pakistan's corporate debt history is relatively short, as issuance of "Term Finance Certificates" (TFCs), popular corporate paper, was allowed only from 1995 onwards.

Pakistan Investment Bonds (PIBs), introduced in 2000,[5] are now the longest tenor sovereign bonds, providing the benchmark yield curve for private issuances.[6] The National Savings Schemes (NSS) on the other hand, with tenors upto 10 years, provide risk-free investment options to retail and institutional investors.

[4] As on June 30, 2006

[5] PIBs replaced the Federal Investment Bonds 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.

In general, like other central banks, SBP as a first step has been preoccupied with the development of the government securities market which is a prerequisite for the development of debt markets. SBP's efforts have facilitated the development of an effective market determined yield curve for government securities which sets the stage for the corporate debt market. A combination of factors has contributed to this but most notable has been the independence of SBP that has helped strengthen the monetary policy, its management and conduct by, among others, ensuring that budget financing, from both commercial banks and central bank, is on market rate. The 3-day repo rate, which now serves as a key policy rate for monetary policy management, helps determine the short term interest rate; given the maturity of the economy and the financial system, the monetary transmission mechanism has been working effectively and this short term rate helps in shaping the yield curve. Equally critical has been the central banks' role in the effective development of the government securities' market by ensuring proper and regular conduct of T-Bills of different maturities, and central banks' open market operations to manage its monetary policy.

While there has been for some time an effective yield curve for Government securities, there remain some impediments in the development of the corporate debt market.

First is the lack of regular issuance of long term government debt i.e. PIBs, which has caused concern regarding the effectiveness of long term debt pricing. Furthermore, the recent decision to re-allow institutional investment in NSS has also interrupted the market confidence in the yield curve. Rates of return on NSS, being a risk free instrument, were first reduced and then aligned to the market determined yields on government securities of similar tenors. Institutional investors were barred in 2000 from investing in NSS.[7]

Second, a large number of Pakistan's companies are not listed. SBP's CIB reports for 31st May 2006 shows 30,320 corporate borrowers (including partnerships) and as of 30th June 2006 there were about 2,179 non-listed public limited companies registered with SECP whereas the number of private limited companies is 45,929. Also, the number of listed companies has declined from 762 in 2000 to 653 companies by end-September 2006. Most family owned businesses are reluctant to issue corporate debt because of disclosure and other corporate governance requirements, and fear of loss of control etc. Companies either rely on internal resource generation or are exclusively bank dependent where funds can be mobilized at more competitive rates.

Third, TFC issuance has been also affected by the relatively high issuance, listing and taxation costs. The listing costs are in the process of being reduced and there is discussion to rationalize the withholding tax rates and stamp duties on these instruments. SECP is also examining reducing the turnaround time on documentation requirements and approvals needed for listing of corporate debt.

Finally, the secondary market of TFCs is quite illiquid given the small volumes, a buy-and-hold mindset (reflecting lack of expertise in trading debt instruments – this is particularly true in many pension and provident funds – and lack of competition), absence of market makers, and a lack of fresh supply of long-term instruments.

[7] 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.

A committee is now deliberating on most of these issues and is expected to provide a set of recommendations to promote the debt market. In the to interim, the recent revival of PIB auctions with the announcement of 30 years PIB float gives an indication of the Government's inclination to develop the long-term yield curve. In parallel, promotion of *Sukuk* issues alongside efforts to evolve a new SLR eligible Shariah compliant government security i.e. Bait ul Mal certificate should add to the range of instruments available.

Few Lessons learnt from the East Asia Bond Markets

Recent initiatives of East Asia to promote its fixed-income securities market offer some interesting perspectives. In most cases, the impetus for growth in fixed income securities came from growth in primary government debt of different tenors whose regular sizeable auctions and a wide network of primary dealers has helped in the evolution of a proper risk free bench mark for a wide range of the maturity spectrum which helped the private debt market to accurately price instruments. Governments have generally pre-announced their intent to issue bonds, to allow market participants to formulate their strategies and construct their portfolios. This along with effective secondary markets and a well established physical infrastructure to enable clearing and settlement of securities has resulted in attracting the interest of both the investors and intermediaries in the market, and has led to enhanced market liquidity. Singapore has succeeded in developing a yield curve ranging from the short end of the yield curve to 15 years, while in Korea and Malaysia there is still limited liquidity in issues of more than 5 years; in the former absence of the short term t-bill has meant absence of the short-term benchmark.

In Malaysia and Korea, where the bond market is much better diversified among government, corporate and financial institutions than in the region on average, the issuers of bonds are concentrated at the high-end of the credit quality spectrum. In Malaysia, about 40% of the bonds issued have local ratings of triple A, and another 40% with issuers of double A ratings. In Korea, some 80% of the bonds issued are single A or above. This at times has resulted in a large number of quasi-government issues – which usually have an implicit or explicit support of government guarantees. Rating Agencies play an important role in determining the credit risk and thus the spreads for corporate bonds. Local rating agencies exist in most of the East Asian countries, and their penetration in domestic markets is relatively high.

The Singapore bond market has also seen a greater diversity of issuers in the market. Prior to 1998, property companies dominated the SGD corporate bond market, accounting for about 70% of total issuance. Now the issuer mix is more balanced. The issuers come from various industries such as engineering, manufacturing, food, logistics and transport. Another significant trend in Singapore has been the growth of Structured Debt Products, such as asset securitized debt, credit linked debt, equity linked debt, convertible debt and other structures, which together constitute almost 60% of the total SGD debt issuances in 2004.

Conclusion

Going forward, there is a broad recognition in Pakistan that fixed income market development is a key agenda for the next phase of the financial sector reforms. Besides alleviating the key impediments of the government securities market highlighted earlier, new approaches and instruments need to be promoted to enhance the depth and accessibility of the fixed income market.

In this context, there has to be recognition that banks benefit in a number of ways from debt market development, and equally importantly, they can be used to reinforce bond market development. For instance, banks can promote the supply of bonds in the market through issuance of bonds to supplement their liquidity beyond their deposit base which then helps them to meet client's financing requirements in addition to financing Tier II capital which facilitates eventually their compliance with Basel II requirements. Moreover, banks' ability to pack off and spin their nonperforming loans as recapitalization or junk bonds allows them the space to lend more by relieving them of these bad debts.

Banks are often among the most important issuers, holders, dealers, advisers, underwriters and guarantors in the market. Given the skewed nature of their balance sheets with maturity mismatch issues, banks can also 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.

In parallel, the supply of debt issues would receive an added impetus as the Government launches some of the strategic large scale infrastructure initiatives and addresses some impediments to housing finance. The Infrastructure Project Development Facility (IPDF) and the Public Private Partnership (PPP) approach of allowing the private sector to bid for and execute the design, building and operating of large-scale public projects will be critical to evolve infrastructure finance structures. Not only will this help arrange financing for infrastructure projects, but add to the demand for fixed-income bond issuances and increase the pool of assets available for securitization.