

Development of Fixed Income Bond Market in Pakistan

I. Private Debt Market in Pakistan:

BACKGROUND:

- The lack of Corporate Bond markets, and their corollary, Secondary financial markets, constrains the potential of investment finance available in Pakistan. An underlying cause is the absence of a benchmark yield curve, i.e. the lack of progressive maturities of Government debt, in volumes sufficient to support the issue and trading of Fixed Income instruments by the corporate sector.
- Compared with other Emerging markets, Pakistan has among the lower ratios of Financial Assets as a % age of GDP.
 - Financial Assets (FAs) are defined as the monetary value of Bank deposits, Government domestic debt, Private debt, and Equity markets.
 - According to a report by McKinsey, the global ratio of FAs to GDP averaged 315% in '05, up from 110% in 1980. Ratios exceeded this level in some Emerging markets, e.g., Singapore and Malaysia; while China, Chile, South Korea and Thailand have a ratio well in excess of 200%. The Philippines and India stand at around 160%.
 - In Pakistan's case, FAs add up to about 100% of GDP, of which Bank deposits and Equity markets represent 36 % each, and Government 27%. Private debt amounts to under 1%.

Pakistan is therefore relatively under-leveraged as an economy. On the one hand, this situation reflects prudent national fiscal and monetary management; on the other, it points to underexploited capacity available to support economic growth.

PRIVATE DEBT MARKET:

- The fastest growing global FA segment has been Private debt (money market instruments and Corporate bonds), increasing from 14 % of total FAs in 1980, to 27% in 2005, while Banking assets have reduced from 45% to 27%.
- Private debt in Pakistan remains under 1% of GDP and consist of Term Finance Certificates (TFCs), issued largely by Commercial banks to meet Basel regulatory requirements. Money Market instruments, such as

Commercial Paper, Warehouse receipts, Bankers Acceptances etc, do not exist.

- TFCs are closely held, and do not trade. They are floating rate instruments, and exposed to rate re-pricing. The absence of a liquid, benchmark yield curve has ruled out the evolution of a Fixed interest rate market.
- Pakistan faces rising Infrastructural development expenditure, and the residential Mortgage market is growing very fast. Both Infrastructural finance, and Mortgage, markets, need fixed rates to evolve.
- Commercial banks in Pakistan will be hard pressed to make significant contribution either to the levels of Infrastructure finance envisaged in the MTDF, or to the progressively increasing requirement of Mortgage finance, without recourse to asset sale, i.e., Securitization of their loans; the inherent Asset-Liability mismatch given the current maturity profile of Bank liabilities in Pakistan, where 98% of deposits are under one year tenor, would make any sizeable assumption of long term assets unsupportable.
- In addition to reluctance to assume tenor risk, Banks may be faced with simple liquidity constraint. Banks are already operating at Asset/Deposit ratios close to the 75% cap placed by the SBP. Future room created by growth in the monetary base is most likely to be pre-empted by the needs of the rapidly growing and highly profitable Consumer debt segment, with Corporate and SME requirements taking much of the remaining balance.
- So Banks will need active secondary markets, both the deal with asset-liability profile mismatches, and for liquidity reasons. Without fixed rates, the development of Securitization and liquid secondary markets cannot be viable. Fixed interest rate loans will also be necessary to support plant and machinery investment by the Corporate sector.
- The alternatives would be to take the risk of borrowing on a floating basis, or to borrow at fixed rates in foreign currency.
- As the current experience of the Textile industry shows, floating rate borrowings for long term investment pose serious risk to profit margins in rising rate scenarios.
- Unhedged foreign currency borrowing may present similar, and possibly higher, risk.

II. Contribution to Financial Development of Private Bond and Securitization Markets:

The growth of private Bond and securitization markets in Pakistan would reduce financial cost to borrowers/Issuers, produce additional resources for investment, and provide market oversight of risk.

Such evolution would:

- Leverage the financial system through supplementing Bank lending;
- Lower cost of funds for Companies with Investment grade Rating potential;
- Address funding rate risks for long term Borrowers, involved with industrial Projects and Infrastructure, by providing long term, fixed interest rates, d, and assist the emergence of a Mortgage market;
- Help develop all kinds of tradeable Debt securitization;
- Make available liquid Financial instruments, at above bank Deposit rates, to both Domestic and Offshore Investors,;
- Through daily Bond/Fixed Income paper price movements, provide national Economic Managers with early signals on Credit quality;
- Provide “spare tire”, i.e. shock-absorber, for credit risk in the market; Banks, as leveraged institutions, would face a multiplied reduction in their outstanding loans, if losses caused any erosion of Capital, whereas a broadly distributed Bond market could simply take the losses with no second-round impacts.

III. Development of Government Paper Yield Curve:

There are a variety of ways in which the underlying pre-condition of a liquid benchmark rate of Government paper can be realized.

Quite simply, PIBs can be issued in substantial volumes (replacing TBs initially, to restore balance in Govt. debt profile) through a pre-announced, Auction based system via Primary dealers.

However, to have a reasonable market volume in PIBs outstanding may involve a longer period of time than is desirable. Present PIBs are only 10% of Bank deposits by volume, and would have to, proportionately, more than double, to provide the necessary peg points for the benchmark yield curve

One way in which a ready stock of benchmarked paper, corresponding to a variety of future maturities, can be achieved, is through the progressive conversion of NSS schemes.

This can be done without changing the terms of all the paper currently outstanding, by re-issuing future paper in the form of PIBs or equivalent, and corresponding to the maturity requirements of Investors.

There may be no need to change the other framework of the schemes, either in their Institutional structure, or in their social objectives, depending on the options chosen.

The re-issued Bonds may be custodised with a Central depository, or with the SBP, and be available for lending to Market intermediaries, for a small fee. Borrower would then 'short' the paper, to initiate a fixed term loan.

It is also proposed that the instrument re-issued bear market risk if encashed prior to maturity, except for special categories of investors.

NATIONAL SAVING SCHEMES

		Rs. In Billion	%
<u>Accounts</u>		119	15.49%
<u>Certificates</u>		649	
of which			
DSCs	296		38.54%
SSCs	140		18.23%
Behbood	143		18.62%
Other	70		9.11%
	<u>649</u>	<u>768</u>	<u>100.00%</u>

PUBLIC DEBT OUTSTANDING

	Rs. In Billion Jun 06	%
<u>Permanent Debt</u> of which	500	
PIBs	303	13.19%
Prize Bonds	166	7.22%
Other	<u>31</u>	<u>1.35%</u>
	<u>500</u>	<u>21.76%</u>
<u>Floating Debt</u> of which	940	
MTBs	430	18.71%
MTBs (rep. of cash)	<u>510</u>	<u>22.19%</u>
	<u>940</u>	<u>40.91%</u>
<u>Unfunded Debt</u> of which	858	
NSS	768	33.42%
PLI	70	3.05%
GP Fund	<u>20</u>	<u>0.87%</u>
	<u>858</u>	<u>37.34%</u>
GRAND TOTAL	<u><u>2298</u></u>	<u><u>100.00%</u></u>