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Research paper

Why bond market couldn't thrive in Pakistan

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Abstract

Fixed income market has recently emerged in Pakistan. Onward 1990, prolusion of government securities paved a way for corporates to come forward with their debt papers and long term yield curve came in to existence by introducing FIB's in 1992 followed by issuance of first Term Finance Certificates (TFC) in 1995. The TFCs' coupon rate exhibits a wide range of different fixed and floating coupons related to numerous interest rates containing the discount rate, the Karachi Inter-bank Offer Rate (KIBOR) and Pakistan Investment Bond (PIB) rates. The SBP launched electronic trading platform for fixed income securities on 11th January, 2010 with the intention of improving the functioning and profundity of primary and secondary markets of sovereign bonds. The data available reveals that through this platform, the cumulative trading of sovereign securities touched 66% of the overall trading volume till the end of 2010 relative to 58.0% in January, 2010. In its initial stage, the E-bond platform provided the complete trading of sovereign bonds like T-bills, PIBs and Ijarah Sukuk. The other type of fixed income securities like repo, FRAs and swaps facilitated in subsequent phases.

Keywords: *Bond; Coupon Rate; Fib's; Tfc's; Kibor.*

1. Introduction

The bond market is a place to issue and trade debt securities. Primarily, bond market is involved in the trading of government and corporate debt instruments and facilitates channelizing capital from investors to the issuers, who need capital for their projects, expansions and proceeding operations. Most of the business in bond markets takes place over-the-counter using planned electronic networks and consists of primary and secondary markets. However the stock market attracts more media observance, in developed countries bond market is many times larger than the stock market and is critical to the ongoing operation of the government and corporations.

The major reason for the development of corporate bond market is that they generate an alternative channel of external financing for the corporate sector in addition to equity stocks and banking loans, which improves financial stability and functionality of credit allocation. This source of funding has been called in the words of Allan Greenspan, former Fed Reserve chairman as a spare tire for the economic system.

The corporate bond market provides competition that is likely to decrease the spread between the interest rates on checkable deposits and advances in the banks framework. SBP shows its concern on the wide spread in the bank sector and private debt market could be used to deal with this issue. A corporate bond market can also induce the banking sector to pay higher rates on deposits by offering higher returns on investments.

Life insurance and pension fund companies are assisted by corporate bonds in matching the assets and liabilities because their liabilities are long term. If a standard yield curve is assumed, lower returns are offered by short term securities as compared to long term securities. For example better returns would be offered by a pension fund if it could make investment in long term instruments relative to rolling over short term papers till the payment is due. Finally, diversification is possible by investing in corporate bond market as it offers a wide range of assets with varied time horizons and levels of risk. By offering more choice, the investor would be able to better match their risk preferences and returns which won't be possible in the absence of corporate debt market.

Fixed income market has recently emerged in Pakistan. Onward 1990, prolusion of government securities paved a way for corporates to come forward with their debt papers and long term yield curve came in to existence by introducing FIB's in 1992 followed by issuance of first Term Finance Certificates (TFC) in 1995. The real pace accelerated onward 2000, when Pakistan Investment Bonds (PIBs) came into being but the pace is still extremely slow relative to other contemporary markets in emerging group of countries.

1.1. Term finance certificates

The first TFC worth Rs. 232 million issued by Packages Limited in Feb 1995 led the corporate bond market of Pakistan to a robust growth experience. TFCs are issued by both public and private firms as well as financial and non-financial institutions. The TFCs' coupon rate exhibits a wide range of different fixed and floating coupons related to numerous interest rates containing the discount rate, the Karachi Inter-bank Offer Rate (KIBOR) and Pakistan Investment Bond (PIB) rates. Presently, these TFC's with outstanding amount of Rupees 24 billion have been transferred to Power Holding (Private) Limited (PHPL).

1.2. Global comparison

The borrowing from banks, issuance of equities and issuance of corporate bonds are three important sources of external financing for firms. The selection of financing depends upon numerous factors such as firm's preferences, institutional and policy factors and its cost. In emerging markets, banks dominate private sector financing with an estimated share of 81% of total financing as shown in the following table.

Table 1: Private Sector Financing

	Equities	Bonds	Bank Loans
	In Percent of Total		
Pakistan (FY05)	27.79	8.80	63.41
Emerging Markets	7.12	11.80	81.08
Asia	8.10	6.67	85.23
Central Europe	12.36	22.36	65.28
Latin America	0.32	42.90	56.79

Similarly, bank loans form the primary source of financing for private enterprise in Pakistan. In Latin America, the private sector rely mostly on bonds, which represents 42% of total financing. In Pakistan, this number is 8.8%, similar to percent share of bond in Asia but no match for bond financing in Latin America or United States. The share of Pakistan's corporate bond market in total financing and as a part of GDP is lower than average suggesting a significant room for growth in this sector.

2. Literature review

According to Arif (2007), the areas that are essential for the development of bond market are:

1) Money Market and Monetary Operations
2) Issuance Strategy, Market Access, and Debt Management Framework
3) Developing Benchmark Issues
4) Investor Base
5) Primary Market
6) Secondary Market
7) Settlement Infrastructure
8) Legal and Regulatory Framework
9) Taxation Policy
10) Linkages of Sub national/Private Sector Bonds with Government Bond Market
11) Sequencing of Development

The fiscal policy of a country plays a vital role in the development of bond market, while bond market delivers signals relating to the judgmatic running of fiscal policy. This mutual relationship fosters in a sound governance environment regarding suitable regulatory and legal system.

Just like other Asian countries, the major contributors of financing in Pakistan are deposits and public bonds, while corporate bonds constitute a trivial portion with the total listings at Rs. 69.7 billion (GDP's 0.5%) at the end of FY10 (Table: 2).

Pakistan Investment Bonds (PIBs) continue being the longest tenor government bonds supplying the bench mark yield curve for corporate issuances. On the other hand, risk free investment options are provided by National Savings Schemes (NSS) with upto ten years tenors to retail and institutional investors. Vibrant debt market in Pakistan is important to promote the efficiency and stability of financial assets and the functioning of monetary policy effectively (Hameed, 2007).

Table 2: Listed Corporate Sector Outstanding Debt

Million Rupees				
Year	No. of Issues	Maturity	Issuance Size	Outstanding TFCs
FY95	1	Feb-00	232.4	232
FY96	2	Jan99-Oct00	750.0	982
FY97	1	Dec02-Jan03	1,000.0	1,982
FY98	2	Dec03-May04	974.3	2,957
FY99	3	Jan03-May04	1,439.3	4,146
FY00	3	Jan03-Jan05	897.5	4,811
FY01	11	Mar04-Jun06	5,735.2	10,046
FY02	17	Dec04-Jun07	10,110.5	18,814
FY03	22	Jul06-Dec08	10,660.8	28,141
FY04	6	Nov06-Dec10	3,370.0	29,737
FY05	13	14-15Mar13	15,825.0	38,259
FY06	8	Nov10-May14	9,975.0	44,394
FY07	8	Jul11-Dec14	11,200.0	47,170
FY08	7	Feb13-Feb18	22,500.0	62,200
FY09	2	Oct-13	6,100.0	66,350
FY10	2	Aug-19	5,500.0	69,775
FY11	-	-	-	68,900

2.1. Obstacles in the growth of a corporate debt market

Even though the enactment of capital market reforms brought some advancement in the performance of corporate debt market, it still lacks profundity. Some of the hindrances in its progress are:

1) Interest Rates on NSS Certificates

The NSS instruments offer zero risk interest rates, substantially higher than the returns on private bonds therefore provided a fair competition for corporate debt market, so the yields on NSS were lowered and aligned to the sovereign long term bonds.

2) Disclosure Requirements

In Pakistan, a sizeable chunk of business entities are family owned and are reluctant to disclose information leading to reduction in listed companies, while largely privatized public sector businesses are among the newly listed entities. Even though most of these businesses benefit from financing facilities, they are hesitant to register on the exchange markets because they fear they will lose control. These entities don't want to share information or any disclosure requirements or essentials of corporate governance. The e-CIB database record reveals that the number of company borrowers which includes partnerships is 21,072 on Sept.2010 as compared to 56,774 of private limited firms listed on SECP which shows their preference to utilize internal resources to fulfill their funding requirements (Financial Stability Review, 2010).

Such mindset not only harmfully effect the progress of the debt market but also was baneful for the financing buildup of the private region as getting loans from banks is widely used choice for mobilizing funds. In an ideal environment, a company before taking loans from banks, should evaluate several options for mobilizing finance by issuing new equity, quasi equity, long-term debt securities (TFCs) and commercial paper, which are short-term debt securities. As the corporate sector lack willingness in diversification of their sources of funds, it also is a hindrance in the growth potential of the private firms.

Table 3: Sources of Corporate Financing

Amount in Billion Rupees			
Year	Banks	IPO*	TFC*
CY02	525	0.1	4.7
CY03	607	2.5	19.5
CY04	873	21.7	0.0
CY05	1076	9.8	6.6
CY06	1270	3.0	3.0
CY07	1520	4.9	4.0
CY08	2016	6.9	12.6
CY09	2065	1.1	0.0

Source: SBP and KSE

*The IPOs and TFCs issued by financial institutions are not included.

3) Lofty Transaction Costs

A major impediment particularly in the initial period is the escalated issuing costs as well as listing and taxation expenses. This was the main reason, why the issuance of TFC was discouraged. A rationalization of listing costs along with withholding tax duties and stamp costs has been under process with the collaborative efforts of KSE and SECP.

4) Deficiency of Secondary Market in Liquidity

The secondary market of TFCs is illiquid although the primary market gained some improvement. Several factors are responsible for the illiquidity of the secondary market including small number of issuing volumes, hesitancy among investors due to lack of experience in trading bonds, absence of competition and lack of new issuance of sovereign securities.

2.2. Initiation of electronic bond trading platform

The SBP launched this platform for fixed income securities on 11th January, 2010 with the intention of improving the functioning and profundity of primary and secondary markets of sovereign bonds. Prior to its establishment, interbank market was used for trading all securities through terminals dealing individually or through phones without any real supply of information, which resulted in delaying deals, inefficiency of price mechanism, increased liquidity risk and unproductive usage of liquidity. Making real-time information available relating to yields and turnover helps the issuer of securities in finding demand of their paper and making better financing judgment. Improvement in liquidity and reduction in liquidity premium as a result of price discovering process helps in attracting more buyers to the market. The liquid yield curves progression for several market segments will also result (Eichengreen et al, as cited in sbp bulletin 2010).
Just as Bloomberg subscribers don't have to pay for additional broker commissions with frequent usage resulting in narrow spreads. It enables banks to transfer government securities from their books generating funds for corporate credit with a widening investor base. With the passage of time, this will also help developing ABS market in Pakistan as people get more comfortable with instruments providing fixed income which will result in more capacity for banks to lend. The data available reveals that through this platform, the cumulative trading of sovereign securities touched 66% of the overall trading volume till the end of 2010 relative to 58.0% in January, 2010. In its initial stage, the E-bond platform provided the complete trading of sovereign bonds like T-bills, PIBs and Ijarah Sukuk. The other type of fixed income securities like repo, FRAs and swaps facilitated in subsequent phases. Money market will become more effective with the full-fledged operating E-bond market.

3. Suggestions and recommendations

In the light of the above discussion, a few factors are discussed here which could potentially help in developing a well-functioning bond market in Pakistan.

3.1. Role of Banks

The banks can play their role to develop a debt market as they have a virtual monopoly to provide funds to all economy sectors. The banking sector is greatly among the most significant issuing agencies, asset holders, security dealers, advising agents, underwriters and guarantors in the financial market. The banks can resolve their natural problem of skewed balance sheets due to maturity mismatch issues by issuing long-term debt. They further can deal with their risk profiles in environment of fluctuating interest rates now by employing sophisticated tools of risk management like Interest Rate Swaps (IRS). Banks can also meet their capital adequacy condition by issuing subordinated bond that also benefit banks to be reputed as tier capital.

3.2. State bank of Pakistan's role in the promotion of secondary market trading

The SBP plays a critical role to promote secondary market for bond trading by implementing monetary policy effectively. By reducing the short-term rates volatility together with credible policy stance, central bank can increase investor confidence while supporting the portfolios maturity transformation of financial institutions. Stability in money market interest rates helps in fostering repo activity and fasten the yield curve as trade shifts to long term maturities.

3.3. Development in the interest rates term structure

By dealing with normal problems in the primary market, elevating secondary market trading activity and easing free entry and exit of issuers and investors in the market, the term structure of interest rates can be developed. By conducting auctions of Pakistan Investment Bonds (PIBs) on regular basis from May2006 helped drastically in this manner. Two issues, which are high on a policy agenda of a country especially in East Asia and Latin America are development of debt markets and improving the capacity of government and corporate sector borrowers in issuing bonds denominated in domestic currency. Like other Asian economies, the government's inclination in developing the long term yield curve is evident in its initiation of PIB auctions. GoP's maturity profile can be increased by regularly making PIB auctions which will also contribute in the development and extension of the yield curve and generating the desired liquidity in the secondary market.

3.4. Development of investor base

The presence of desired investor base is another factor critical in developing primary and secondary markets of bonds. Right incentive should be provided by the regulatory bodies in encouraging the individual and institutional buyers for investment and trading in debt securities. Commercial banks, DFIs and brokerage houses together constitute State Banks's primary dealing system help in increasing the investor base of sovereign instruments to companies, pension funds and retailing parties. For ensuring functional trade activities and liquidity, a broad base of investors with differing risk preferences, maturity periods and trade motives must be developed. Moreover, credit rating agencies can play a significant role in instilling confidence among the buyers to understand the credit risk elements.
In conclusion, the key suggestions for emerging markets are strengthening macroeconomic policies, strengthening corporate governance, ensuring disclosure requirements, encouraging growth of institutional buyers and strengthening debt market infrastructure.

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