Challenges & Constraints Faced by Bond Market in Pakistan

Research Paper

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Abstract

The focus of the study will be to examine the prevailing situation of the bond market in Pakistan and to study the factors that influence the bond market. A well-developed bond market proves that the financial sector is sound and stable and hence an attractive investment opportunity. The bond market of Pakistan is in an underdeveloped state, which is triggered by a number of factors. These factors have been looked upon in the paper. Amongst the major ones are: open market operations, investor base and primary and secondary markets. Other key factors include, unstable yield curves, lack of technological infrastructure, unstable monetary schedule and unfair competition by government securities such as NSS. We have concluded from our research that the bond market in the country is not fully functional and that the state bank of Pakistan along with the government will have to take steps to develop the fixed income securities market. The paper also serves as a guideline as to the actors of the bond market, that is the authorities and the market participants and also sheds light on what factors need to be taken into consideration to foster the growth of the bond market. The recommendations at the end of the paper focus on the solution to this dilemma.

Contents

Introduction

The Asian region has seen increasing economic growth in the recent years, which largely is a result of the contribution from financial sectors. Although a majority of the funding comes from financial sectors, equity markets have some portion to chip in as well. However, the growth of the bond market in this region, particularly in Pakistan, has been sluggish. Compared to other emerging nations like China, Hong Kong, Malaysia and Singapore, the corporate bond market in Pakistan is far behind.

By the end of March 2010 Pakistan's total public debt had reached to Rs. 8160 billion in comparison to a Rs. 14668 billion GDP. The financial market development has had two major phases: the initial phase lasted till 1990, while the second phase is considered from 1990 till present (Arif, n.d.). The linkage between economic growth and the performance of financial markets such as the stock and bond markets has been touched upon by various authors (Hameed, 2006). The overall development of the economy is tied with the stability of the financial sector. The attractiveness of any market is determined by how well a country's financial sector is developed which in turn is determined by the functionality of the bond market. The study of the debt market is therefore a vital component for the research. A number of factors have a direct effect on the progress of fixed income securities. These factors will be analyzed in order to look into ways that may be helpful in improving the performance of the debt market of Pakistan.

Companies make use of different funding sources to meet their financing needs. Bank borrowing and equity financing are among the commonly used sources. However, some companies also get financing from using their retained earnings and issuing corporate bonds.

Government securities, T-bills and Pakistan investment bonds are the instruments that make up the bond market in Pakistan. In addition to that corporate bonds and debt issued by statutory corporations is also considered an important pillar of the bond market.

We restrict our study to the only to longer-term bonds and their relevant data. The aim of this study is to analyze the current bond market in Pakistan. The research paper starts with the literature review, followed by discussion about the impediments facing the debt securities market and analysis of the bond market in Pakistan, explaining what are the influencing factors related to this concept, and recommendations are provided at the end through which the bond market can be developed.

Literature Review

The bond market in Pakistan has been the focus of various studies. Although authors have discussed various attributes of the bond market, the focus remains on the factors that lack in Pakistan's financial sector and that are vital in the development of the bond market of the country. The bond market comes under the securities market; which are based on the corporate sector and the government sector. In Pakistan, the government debt instruments in the securities market comprises of Pakistan Investment Bonds (PIB’s) and treasury bills .

Short-term securities in Pakistan are sold through auctions conducted by the state bank of Pakistan. PIB's however are sold at par with fixed yields. Growth of the bond market can be triggered to affect various things such as increase competition for the banking sector, improving the stability of the financial sector, and create an alternative source of long-term financing. The focal reason however is usually stated to be to create investment opportunities for institutions or for liquidity purpose (Harwood, 2000).

The development of the financial sector is correlated with the economic growth of a country; and a vibrant bond market translates into an enhanced financial sector (Hameed, 2006). Pakistan is still, however, far behind in the development of its financial sector in comparison to other emerging nations like Hong-Kong and China. While these countries have high Bond market as a percentage of their GDP, Pakistan is having problems keeping up the number in single-digits (Arif, n.d.). The concept of corporate debt is not new to the country. Pakistan's corporate debentures date back to the 1960's and 1970's when they used to be traded on the stock exchange (Harwood,2000). The Government securities constitute of the largest volume compared to the other two. Stating again, the bond market of Pakistan includes debt instruments which are issued by the government, corporate entities and statuary corporations. The highest volume however is of government securities compared to the other two.

Before making an investment decision several factors have to be taken into consideration. These include 1) the term to maturity, 2) the redemption features like call and put options and 3) credit ratings of the bonds (Mankani, 2002).

A number of other reasons are pointed out as to be the cause of the lack of fertility of the bond market in Pakistan. These include the lack of benchmark rates; crowding out of the private sector and lack of good administrative control. The crowding out effect occurs because there is a limited pool of funds available for lending. This pool is sought by the government as well as the private sector alike. Lending is however preferred to the government as it is risk-free. Moreover, a supporting regulatory framework is crucial for the proper development of the bond market (Hameed, 2006).

The yield on government bonds is usually seen to be a benchmark for determining the market rates. This is not a suitable procedure in Pakistan however, as the market demands higher interest rates as those offered by the government which is witnessed by the lack of successful PIB auctions in the past couple of years. Small volume of issue, minimum trading and sometimes the security itself are factors that limit the liquidity of a security which is another obstruction to the growth of the bond market. Other authors have given importance to the proper implementation of open market operations and monetary policy and to increase the investor base in the country to foster growth of the bond market (Arif n. d.).

The bond market in Pakistan lags behind those of the developed countries. To achieve the goals of financial stability and economic growth, flourishment of the Pakistani bond market is imperative.

Research Methodology

The analysis and findings presented in this paper are based on comprehensive secondary research. Secondary sources of information that have been used in the research include the internet, online newspaper articles and magazines; related to finance and economics. Official websites of financial institutions, like SBP and KSE, as well as of regulatory authorities, SECP, have also been consulted for authentic information. The nature of the research is qualitative. The paper is accompanied with visual charts and graphs, which elaborate the findings of the research.

Hypothesis

H_0: Bond market in Pakistan is facing challenges.

H_1: Bond market in Pakistan is not facing challenges and can be recognized as a developed market.

Findings & Analysis

This section of the paper focuses on the research findings and also analyzes significant trends. We first discuss the current situation of the debt market in Pakistan, which helps to identify the challenges faced by the market and how they hinder the development of a healthy bond market. In view of authentic data and analysis, we present a set of recommendations aimed at the improvement of the dynamics of the Pakistani bond market.

Money Market dynamics and Monetary Operations

To effectively overcome the challenges faced by the debt market, it is imperative that the money market functions well. The key determinant of a healthy money market is the sound functionality of its monetary operations. One of the essential measures is to strengthen the fixed income securities market. This is possible only if there is adequately confident investor base. Stability in market rates is a contributing factor in establishing investor assurance and is hence a significant variable. Monetary operations and money market go hand in hand. They must be consistently framed to achieve unified goals.

Reserve Requirement

Increase from the government in liquidity ratios acts as a challenge for the development of fixed income securities market. The government has constantly been increasing liquidity requirements in the past. However, this trend was somewhat changed when the government made a policy of keeping a fixed CRR and SLR in the years 2000-2006. This was meant to give leverage to banks. The recent economic downturn negatively influenced this area as well. SBP had to increase the reserve requirements, resulting in reduced ability of financial intermediaries to invest in fixed income security market. The problem of high inflation and immaturity on the part of international banks are the vital events causing this change in policy.

Volatility in Over Night Rates

Volatility in O/N rates negatively influences the functioning of money market. To restrict and control the variability of O/N rates, resulting primarily after the stock market crisis, SBP had established a ceiling and floor for lending. Moreover, this implies that banks can engage in an overnight repo transaction with the SBP at fixed rates. There have been variations in the rates set as ceiling and floor since then. However, as on October 9th 2011, floor and Ceiling level for the O/N interest rate corridor are at 9 percent and 12 percent respectively.

Issuance of Debt Instruments – Regulatory Framework

In several developed and emerging markets regulatory framework and schedule for managing affairs of Debt issuance already exists. Debt Securities Trustees play a crucial role not only in protecting the interests of debt securities holders but also in the growth of the corporate debt market. Pakistan's debt market suffers from lack of disclosure and scheduling. For example the targets of the 3, 6 and 12 months T-bills auction held every two weeks, are announced only two days before the auction. Similarly PIBs are scheduled to be issued every quarter but are issued in very trivial amounts. Owing to these issues, the stock exchanges and the Mutual Fund Association of Pakistan also called for regulating the DST affairs.

A vital step has been taken this year towards development of a healthy corporate debt market in Pakistan. SECP has approved the Debt Securities Trustee Regulations (DST Regulations). As per the DST Regulations, registration has been made compulsory to act as trustee and only scheduled banks, development finance institutions and investment finance companies can act as Debt Securities Trustees.

Long Term Yield Curve

In Pakistan, developing short term yield curve has never been an issue as the supply of short term instruments has remained steady. However, developing long term yield curve poses problems because of the small size issues and varying supply of long term instruments. A crucial factor in developing a fixed income market is establishing long term yield curves, as it can improve the investor's confidence in long term investments. However, there have also been issues in short term yields because of market issues due to liquidity crisis after collapse of international credit markets.

Investor Base Diversification

Undoubtedly **Diversified Investor Base** plays a significant role in the development of a sound debt market which lowers the volatility in market yields and cost of debt. However, in Pakistan there is very little attention paid to this area. Pension Funds and Life insurance Co., Mutual Funds, retail investors and individuals who are considered a prominent investor class contribute less to securities market in Pakistan whereas active investors are commercial banks. Lack of investor's awareness is a factor that hinders the development of a diversified investor base. Mutual fund industry which is known to be the backbone of fixed income instrument whereas in Pakistan, it concentrates investment in equity markets, which was center of attention historically.

Furthermore as government can afford higher rates in comparison with other corporations, issuance of National Saving Scheme has given unfair competition to fixed income securities.

Bond Automated Trading System (BATS)

KSE introduced **Bond Automated Trading System (BATS)** which became effective from 2^{nd}, November; 2009.This initiative by KSE was taken to provide price discovery and transparency in the trading of TFCs, which earlier was not possible because of buyer-to-buyer change of hands. Also BATS aimed at providing the issuer with convenient liquidity generation while the investors with investment options in diversified instruments. In the first phase, TFCs were listed and traded at KSE. There were a total of Twenty Four TFCs to be traded at BATS out of which twenty two were of listed companies, while the remaining were of non-listed companies including Pakistan Mobile Communications Limited and Pak Arab Fertilizers. This system provided efficient electronic infrastructure for secondary market debt training.

Underdeveloped Infrastructure

One of the obstacles in the growth of an efficient bond market in Pakistan is its **Weak infrastructure**. Lack of Effective electronic trading slows down the transfer process, creating asymmetric information and inefficient price discovery which in turns limit the participation in debt market.

Lack of Regulatory Foundation

Another impediment in the development of bond market in Pakistan is the **Legal and regulatory framework** which relies on Securities Act framed in 1944 for Government Securities business, so it does not provide complete legal base to the business. Secondly, the current Act does not allow the market participants for mitigating their risks and in enhancing their returns. So in Pakistan this area needs attention.

Secondary Market

The basic mechanism and functioning of debt market depends upon the volume traded in **secondary market**. In Pakistan, overall trading volume in secondary market had not been lucrative due to above mentioned factors. The situation can only improve if Government of Pakistan consistently keeps on supplying the instrument.

Credit rating agencies

However, **Credit rating agencies** acted as a catalyst in furthering the development of Pakistan’s corporate debt market. Now investors have assurance and comfort that the credit risk of the issuer has been evaluated by professional rating agencies which enables them to weigh the risk-return of corporate debt.

Recommendations

- SBP should maintain a stable discount rate which would enable investors to predict movements in expected long term rates. This stability in yield curve results in high investor’s assurance and establish a long term fixed income market.

- Government should either bring down rates on NSS schemes or link them to KIBOR. ‘These would reduce threat to corporate debt from falling prices in secondary markets. A long term policy should be established on NSS rates which would give further stability to long term yields.

- Regulatory framework for issuance of debt should be developed to improve investor's confidence and steps should be taken to increase accessibility of the trading system and intermediaries.

- Monetary policy, corporate debt requirements and money market operations should all be consistently framed.

- To encourage investments in fixed income securities, tax benefit should be given. Activities that lead to coupon washing should also be eradicated.

- Systems such as BATS should be encouraged and measure should be taken to make them a success.

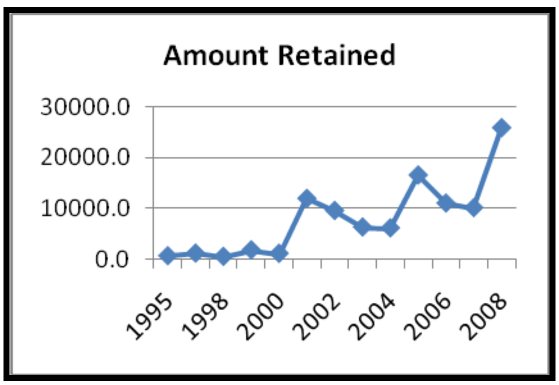
Conclusion

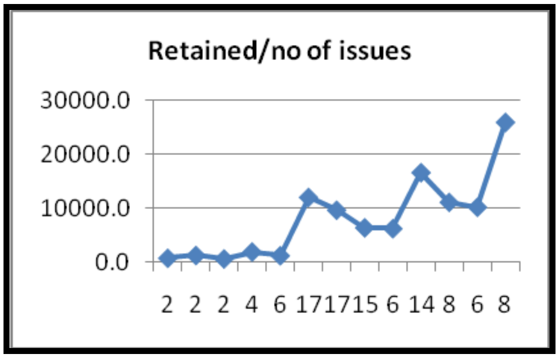
Economic growth and the performance of financial markets are closely correlated variables. If the bond market is not well developed, high cost and uncertainty in businesses negatively affects the whole economy. The TFC market in Pakistan is not very well developed. There are a number of constraints that hamper the development of the fixed income securities market; and the Government of Pakistan and State Bank of Pakistan needs to take ample steps to overcome these issues. Based upon the findings and analysis the null hypothesis is accepted: i.e. the bond market in Pakistan is facing challenges and is not completely developed, and the alternative hypothesis is rejected.

Appendix

Exhibit A: TFC issues

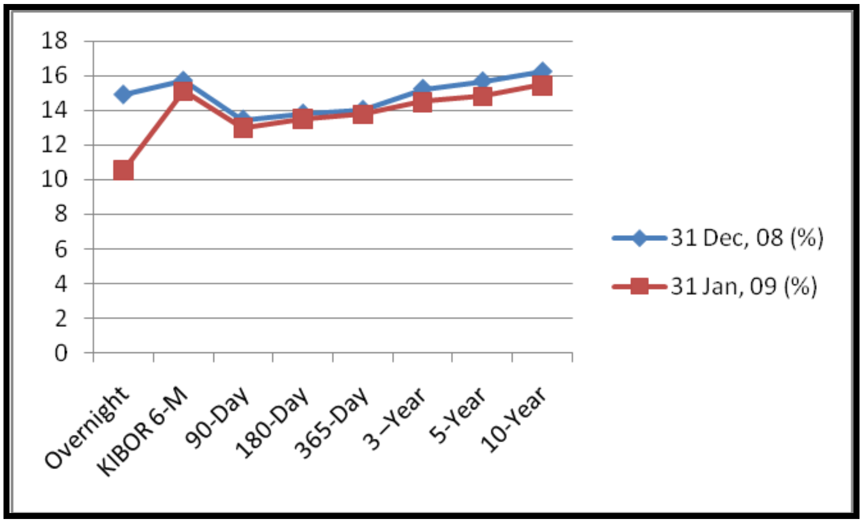
	Rs. In million	
Year	Amount retained	No of issues
1995	732.4	2
1996	1250.5	2
1998	599.9	2
1999	1901.5	4
2000	1207.6	6
2001	12021.4	17
2002	9638.9	17
2003	6389.0	15
2004	6225.0	6
2005	16618.3	14
2006	11111.6	8
2007	10202.2	6
2008	25944.7	8





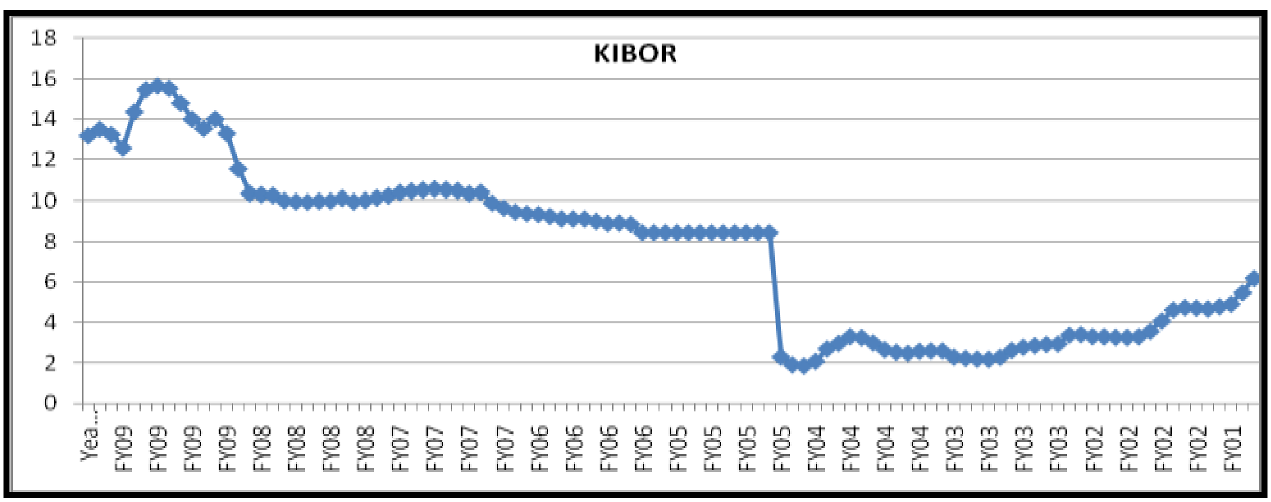
[Source: www.secp.gov.pk]

Exhibit B: Yield Curve



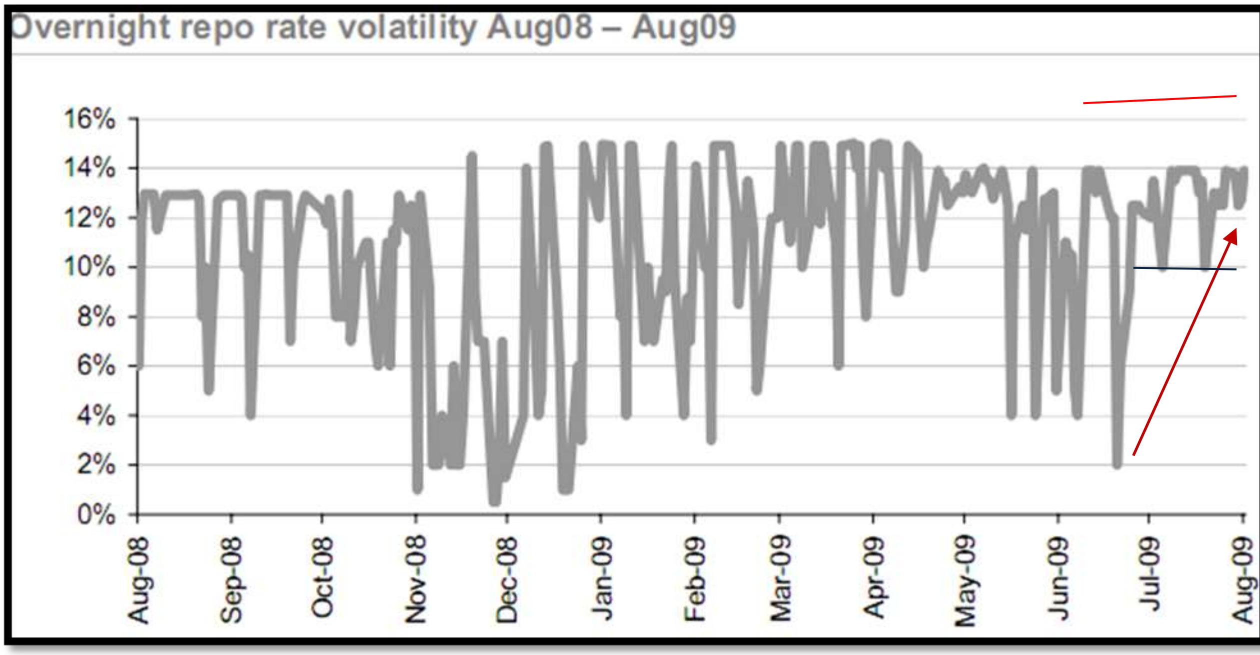
Tenure	31 Dec, 08 (%)	31 Jan, 09 (%)
Overnight	14.9	10.52
KIBOR 6-M	15.7	15.1
90-Day	13.46	12.98
180-Day	13.8	13.5
365-Day	14.02	13.78
3 –Year	15.23	14.48
5-Year	15.67	14.82
10-Year	16.23	15.46

Exhibit C: KIBOR



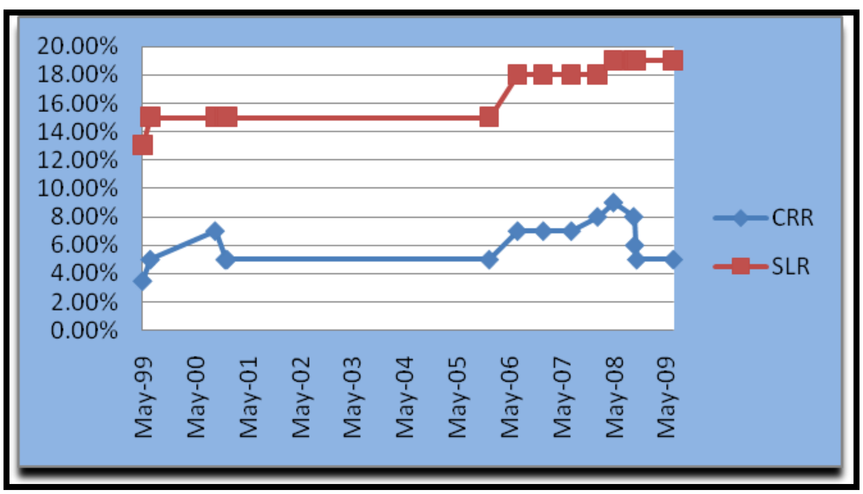
[Source: www.sbp.org.pk]

Exhibit D: O/N Rates



[Source: www.bloomberg.com]

Exhibit E: Reserve Ratios



	CRR	SLR
May-99	3.50%	13%
Jul-99	5%	15%
Oct-00	7%	15%
Dec-00	5%	15%
Dec-00	5%	15%
Jan-06	5%	15%
Jul-06	7%	18%
Jan-07	7%	18%
Aug-07	7%	18%
Feb-08	8%	18%
May-08	9%	19%
Oct-08	8%	19%
Oct-08	6%	19%
Nov-08	5%	19%
Jul-09	5%	19%

[Source: www.sbp.org.pk]

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