DEVELOPMENT OF BOND MARKET IN PAKISTAN

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Introduction

Bond market development in the emerging economies is a challenge for issuers, intermediaries and regulators; particularly in South Asia, where the corporate capital raising is limited to bank loaning and issuance of equity stocks. There is a need to disseminate apposite information to assure the potential investors that the investment in local bond market is a rational decision and it will maximize their portfolio returns. Issuers of corporate bond, while they are issuing bonds in domestic market, must communicate useful information so that general public acceptability and credibility may be gained. Moreover, role of the regulators of capital markets in developing the appropriate infrastructure for local bond market and developing the benchmark yield curve also needs to be enhanced. Households and small investors can actively participate in the corporate bond market through mutual funds (income fund category) as it allows them to employ professional knowledge and expertise, diversify their investment portfolio and at the same time manage liquidity requirements.

Bond Markets Worldwide

The US bond market is the largest securities market in the world. As per data published by Bank for International Settlements, the value outstanding on this market has doubled in the decade up to 2010 to USD 35 trillion. Mortgage-backed bonds accounted for around a quarter of the total or some USD 8.5 trillion. Treasury bonds accounted for USD 8.8 trillion, corporate debt USD 7.5 trillion, with majority of the remainder in Federal Agency securities and municipal bonds. The US corporate bond markets have long been an important source of capital for issuers, with daily trading volume of USD 16 billion and more than 400 mutual funds investing in US high-yield bonds. Corporations use the funds they raise from selling bonds for a variety of purposes, from building facilities to purchasing equipment to expanding their business. Although Europe's corporate bond markets are less developed than in the US, Europe is gradually moving towards a US style bond market as many small and mid-sized companies are increasingly diversifying their funding sources. The number of mutual funds focused on European high-yield debt have doubled to 34 over the past three years, and between them they now manage around USD 10 billion of retail investors' funds. Demand from investors for corporate bonds remained strong in 2010 due to low interest rates and high inflation meaning these bonds offered more potential for high returns than some other forms of investment.

Pakistan Bond Market

In Pakistan, the development of money market and bond market was initiated in late 1990s after the liberalization reforms; however, Pakistan's bond market has developed at a slow pace as compared to other countries. Like other emerging markets, most of the debt financing is done through bank borrowings. According to State Bank of Pakistan (SBP) and Securities and Exchange Commission of Pakistan (SECP) the domestic bonds outstanding were 30 percent of the GDP, equivalent to PKR 5.8 trillion as of June 2012. This consists mainly of government bonds, as the corporate market is yet to develop. Government bond market gained momentum after the introduction of Pakistan Investment Bonds (PIBs) in 2000, which helped to streamline the auction of Government Securities and to develop secondary market for the Government Paper. SBP introduced selective Primary Dealer System (PD) in 2000. In 2001 KIBOR/KIBID rates were introduced to provide inter-bank call money curve. Outstanding T-bills are roughly PKR 2.4 trillion as of June 2012 out of which banks hold 75 percent worth of short term paper. Outstanding PIB amount is PKR 974 billion, out of which 52 percent of holding are with banks.

Corporate Bond Market

Foundations of the corporate bond market were laid in 1995 with the first issue of Term Finance Certificates (Packages Limited for PKR 232 million). Since 1995, issuance of listed TFCs has totaled approximately PKR 120 billion. As of March 2012 a total of 131 corporate debt securities were outstanding with an amount of PKR 500 billion (including listed TFCs, Private Placed TFCs, Sukuks and Commercial Papers). A combination of factors resulted in the issuance boom in the recent

past. Amongst these were the de-regulation of the banking sector, lower interest rates, availability of benchmarks for both fixed and floating rate debt, active inter-bank trading markets in government securities, coming of age for mutual funds, etc. Corporate bond market in Pakistan is smaller in comparison to many equivalent rated economies although the situation is improving. Development of Islamic Money and Sukuk market is a new phenomenon that gained recent importance with the induction of six full-fledged Islamic Banks and numerous conventional banks indicating to conduct Islamic banking business in Pakistan; however the size of Sukuk Market is presently very small. To facilitate organizations to raise short term funding, Commercial Papers have recently been allowed but the market has yet to take its roots.

Commercial Paper (CPs) is an unsecured tradable instrument used by corporate entities to raise short term working capital funding i.e. up to 9 months. It is usually sold to financial institutions which have an appetite for short term Money Market instruments. SBP and SECP issued guidelines in 2003 for investment in commercial papers in order to facilitate the development and growth of these papers in the country and to encourage active participation of banks/DFIs in this area. The Corporations can issue CPs on attaining criteria i.e. equity of the corporate is not less than PKR 100 million, minimum credit rating of the issuer should be A- for short term and A for long term, it should have clean Credit Information Bureau (CIB) report and as per the latest balance sheet report, the company maintains a minimum current ratio of 1:1 and a debt equity ratio of 60:40. CP market is at a very nascent stage in Pakistan. Packages Ltd was the first company to raise working capital through CP. There is a need to revisit the minimum equity criteria in light of experience gained during 2008 financial crisis and to raise it suitably in order to have more public confidence in such issue.

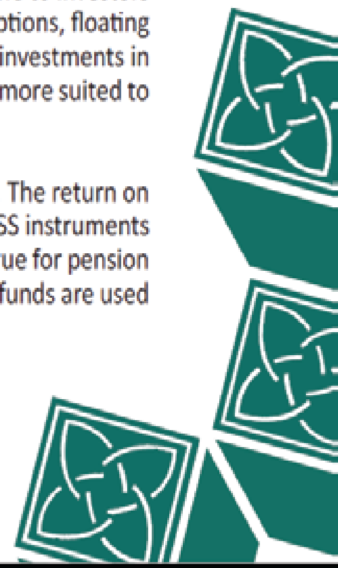
Bond Market Development in Pakistan and Limitations

One of the major reasons of fewer issuances of bonds is the administrative and transactions costs faced by the company at the time of issuance and trade. Higher transaction costs in terms of issuance and listing fee, trustee fee, advisory fee, rating fee, stamp duty and taxes on bonds discourage many companies from obtaining financing through this medium as it increases their cost of borrowing. Furthermore, thin market volumes and improper settlement system have hampered the development of secondary market for bonds. To attract a large number of domestic and foreign investors, Bond market should have a proper legal and regulatory framework having defined rules and regulations relating to the issuance, settlement, registrations, payment and selling of securities. SECP should maintain a regulatory framework for the monitoring of all the elements of debt security markets. Rules should be settled related the operational independence of credit-rating agencies.

An encouraging indicator of Pakistan's corporate debt market is the relatively broad spectrum of issuers. Since the inception of Term Finance Certificates issuers have hailed from a wide range of industrial classifications including leasing companies, sugar manufacturers, textile mills, chemical manufacturers, synthetic fibre manufacturers, refineries, cement manufacturers, commercial banks, investment banks, telecommunications firms, gas companies, and pharmaceutical companies etc. The breadth of issuers coupled with the economic growth that Pakistan has witnessed in most of the above industries bodes well for the future of the corporate debt market. Investors in corporate debt have also been of diverse backgrounds. The largest volume of investment typically comes from the financial sector including players such as commercial banks, investment banks, mutual funds, and insurance companies. Some interest is now being seen from large public sector funds and government entities. Also included in the investor base are employee provident, gratuity, and pension funds. Charities and trusts also invest from time to time. Individuals remain a very small category although it is hoped that this segment will grow as time passes.

One of the more encouraging developments in the Pakistani corporate debt market has been the innovation in the structure of the instruments. Over the years, a number of features have been introduced in the structure of debt instruments in Pakistan and these features have been successful in making corporate bonds more marketable to investors while retaining benefits for issuers. Some noteworthy features have been the introduction of call and put options, floating coupons, caps and floors, conversion options, perpetuity etc. The introduction of these features has made investments in TFCs an easier decision than before. Investors are now more easily able to pick and choose the instruments more suited to their cash flow requirements and interest rate outlook.

At present, the government and corporations both are competing with each other on raising the resources. The return on TFC issued by corporations has a rate of return almost equal to the Defense Saving Certificates and other NSS instruments issued by Government, that has become a major hurdle in development of bond market. This is especially true for pension funds and provident funds where they end up investing heavily in government securities. As a result, these funds are used to finance government deficits instead of positively impacting the country's growth and development.



Bond Market Infrastructure / Legal and Regulatory Framework

SBP manages Government Securities market on behalf of the Government of Pakistan, whereas SECP regulates the Corporate Bond Market. Both are autonomous bodies. Government Securities are exchanged through depository of SBP or through its Public Debt Offices in case the security is in physical form. Equities and corporate bonds are exchanged through computerized books maintained by Central Depository Company constituted under Central Depositories Act, 1997. Funds are transferred through clearing system catered by SBP. Securities are held and transferred in accounts maintained at Central Depository Company of Pakistan on delivery versus payment arrangements for Corporate Securities. State Bank depository is providing settlement arrangements for Government Securities. National Clearing Company of Pakistan Ltd (NCCPL) is presently providing settlement for equity trading and would undertake Corporate Securities cash settlement in future.

For government securities issuance, profit payment and redemption, State Bank Act 1956, Banking Companies Ordinance 1962, Public Debt Act, 1944 and Public Debt Rules, 1946 are the relevant laws. For equity and corporate bonds issuance, Company Ordinance 1984, Trusts Act 1882, SECP Act 1997 and Securities and Exchange Ordinance 1969 are relevant. The work is in hand with the Banking Commission for bringing reforms in banking laws and SECP for modifying Capital Market Laws. In order to ensure quick recovery of bank loans from defaulters, the Federal Government has established 29 Banking Courts throughout Pakistan in terms of Section 5 (1) of the Financial Institutions (Recovery of Finances) Ordinance, 2001. There is an urgent need to revisit our regulatory and legal framework to ensure that these provide adequate protection to investors. We have witnessed that in the event of default the issuers do not even provide financial information to bond holders. The recovery process is also extremely slow. SECP has taken some measures by introducing Debt Securities Trustee Regulations but much more needs to be done.

2008 Financial Crisis and Its Implications

Financial year 2008-2009 was a peculiar year for mutual fund industry of the Pakistan. The size of mutual fund sector in Pakistan peaked at PKR 406 billion on April 2008 but declined to PKR 227 billion as of June 2009. Until 2006, Equity funds had dominated the mutual fund industry constituting nearly 70% of the industry size. Then the Income funds gained traction and exhibited phenomenal growth resulting in nearly 50% share of the industry by the first quarter of 2008. A key factor that leads to this growth was investment by commercial banks in Income funds. Subsequent to this rapid evolution, the industry encountered economic strains and industry size contracted by more than 40% in the next 12 months. The Income funds size plunged from PKR 175 billion in April 2008 to PKR 85 billion in June 2009, witnessing a decrease of more than 50%.

As of October 2008 out of total assets of PKR 118 billion of income funds, 50% of such assets were represented by TFCs. Owing to dormant market conditions and liquidity crunch, there were negligible trades in the secondary market in the TFCs held by the mutual funds. Therefore, the pricing mechanism for determining/declaring the fair value of TFCs, based on quotation of three brokers in terms of volumes, became defective. The value of TFCs taken by mutual funds for determination of NAV and for issuance and redemption of units also appeared to be non-existent and did not reflect fair value of assets of funds. An undue advantage was caused to the unit holders who were exiting the mutual funds at that point in time. Similarly, new unit holders were reluctant to enter into the fund as they were at a disadvantage as the issuance unit price did not reflect the fair valuation of assets. In November 2008, SECP instructed all AMCs to apply an arbitrary discount based on the ratings of the instruments to all TFCs and Sukuks held by the mutual funds to calculate NAVs. This resulted in overnight declines in NAVs of all income funds which shook investors' confidence.

The financial turmoil and liquidity pressure adversely affected companies and the corporate bonds (i.e. TFCs) issued by them defaulted on their repayment. However, in absence of any uniform provisioning criterion, some of the fund managers holding such defaulted TFCs abruptly adjusted their NAV downward by creating provisions against such TFCs in different ranges from 10% to 100% at different times without having any pre-approved and disclosed provisioning policy. Such discretionary provisioning treatment for the same TFC held by different fund managers resulted in diverging values. This not only adversely effected the investors' perception but also triggered the overall redemption pressure on the industry.

The liquidity crunch coupled with dormant debt market, forced the fund managers who had significant debt securities exposure, either to delay or in a few worst cases dishonor the redemption requests of the investors. Some securities had to be sold at considerably high discount rates causing substantial erosion in the NAV of these funds. Although the debt market was never active, the unprecedented redemption pressure exposed the fund managers who were maintaining incongruent assets profile against the six days redemption structural feature of the open end funds. It may be mentioned that at many jurisdictions during the financial crisis, the central banks or Ministry of Finance supported the mutual fund

industry by providing them liquidity. In Pakistan, despite the Ministry of Finance announcement to guarantee any borrowing by mutual funds against the security of "A" or higher rated TFC, borrowing was not provided to mutual funds.

Pursuant to the above issues the regulator and the mutual fund industry in a collaborative effort came up with an initial approach to value and share information related to illiquid corporate debt that was held as an investment as part of collective investment schemes. The objectives behind this approach were:

a) First, to ensure that all members of the industry used a consistent basis to arrive at the value of an asset and the Net Asset Value (NAV) for a Fund;
b) Second, to create a process where all classes of investors in a Fund receive fair treatment with no class receiving an unfair advantage at the cost of the other.

The Corporate Debt (TFC) valuation and trading problem in Pakistan can be reviewed from a range of related aspects which include:

1. The quality of credit underwriting performed by the investors at the time of issuance or purchase.
2. The ability of a market to trade and price a security on a daily or frequent basis.
3. The ability to independently value a security.
4. The absence of designated and effective market makers.
5. The ability to clearly track and disseminate information related to default and credit event across the banking system, the central bank, the securities and mutual fund industry as well as the securities regulator.

Non-transparency and ineffectiveness of the price setting mechanism creates additional long term issues for the mutual fund industry. Investors who suffered losses on account of mispricing or mispricing adjustments stayed away from mutual funds as an investment avenue. Hence, long term investors who did not have the bandwidth or the capacity to track the timing and informational problem tend to stay away from mutual funds. Therefore, the overall growth, volume and trading levels within the industry are then completely dependent on a small group of investors.

Bonds Automated Trading System (BATS)

Earlier, the Stock Exchanges used the same trading platform for Bonds as was available for the equities. As a result the secondary market for TFCs remained fairly illiquid and trading of listed and unlisted TFCs was carried out at Over the Counter (OTC) market as a result of direct negotiation between buyers and sellers through brokers. In 2009, the SECP issued a circular pursuant to which, the transactions by the mutual funds in both listed and unlisted TFCs are reported to MUFAP which also carries out the pricing of TFCs in accordance with the methodology prescribed by the SECP in the said circular. However, there is no central platform for reporting of transactions outside the mutual fund industry. The absence of an active trading platform and the unavailability of complete trading information at one central portal have resulted in inefficiencies in the price discoveries of listed TFCs and created misbalances in the market since the mutual funds follow the pricing calculated by MUFAP, while the other market participants do not have a transparent pricing medium and MUFAP's prices do not reflect the trading information of the entire market. It is worth noting that commercial banks use the prices quoted on the exchanges for calculating fair values of their investments in listed TFCs and the quoted price or the trade price whichever is lower is used for this purpose. As evident, currently the prices quoted on exchanges do not represent the correct market value of listed TFCs.

As a result of coordination between MUFAP, KSE, CDC and prominent market participants, in 2009 a separate trading platform developed specifically for trading of debt securities was introduced by KSE with the name of Bond Automated Trading System (BATS) which aimed to provide a trading interface suited to the needs of debt market participants with appropriate risk management and pricing mechanisms and sought to remove the anomalies present in the previous model. This new initiative would provide the issuer with convenient liquidity generation and alternative means of raising debt capital, while the investors would have yield premium opportunity and investment options in diversified instruments. The TFCs would provide a broader base to the capital market, enabling investors the choice of going into debt or equity and create much needed depth in the capital markets.

The BATS Regulations which were approved by SECP in September 2009 prohibited the negotiated deals or off-market transactions outside BATS. However, exemption is being granted by SECP for this restriction for last one year, thereby allowing the off-market transactions in the listed TFCs. Simultaneously SECP also made it mandatory to report all transactions in listed TFCs executed outside BATS to the stock exchanges and restrictions were imposed in Central

Depository System (CDS) upon transfers of listed TFCs which did not meet the above condition. Subsequently, the reporting system of KSE was improved which now provides the facility of real time reporting of off-market trades as compared to the previously applicable system of reporting at the day end. Hence, the first stage of debt market development is completed which represents development of a centralized reporting platform for all trades in the listed debt instruments.

Debt Securities Trustee Regulations

As part of its mandate to develop the debt capital market in Pakistan, the Securities and Exchange Commission of Pakistan (SECP) approved the Debt Securities Trustee Regulations, 2012 (Trustee Regulations), which will provide guidance to the trustees in discharging their responsibilities under the Trust Deeds. The purpose of these regulations is to effectively regulate affairs of the debt securities trustees and similar regulatory frameworks already exist in various developed and emerging markets.

There have been cases where Debt Securities Trustees have not actively discharged their obligations (as has been the case where company was financially weakened by investments/loans to associated undertakings and purchase of shares of loss making, non dividend paying associated companies from sponsors against the covenants of the trust deed and the trustee did not take any action).

Under the regulations, registration with the SECP has been made mandatory and only scheduled banks, development finance institutions and investment finance companies can act as debt security trustees. The role of trustees in the issues of debt securities is of a critical nature as they safeguard the interest of the debt security holders. The regulations will enable the trustees to play their role more proactively, which will help building investor confidence and lead to corporate debt market development. The regulations empower the trustees to (i) regularly monitor payment of profit/mark-up/interest to the debt security holders and redemption of the securities; (ii) regularly monitor maintenance of the security, if any, backing the debt instrument; (iii) ensure that compliance with the provisions of the Trust Deeds, particularly their covenants, are adhered to; and (iv) monitor that the debt security holders' complaints are resolved by the issuers.

The Trustee Regulations incorporates a number of suggestions made by MUFAP. However, it is necessary that the Regulations should allow access to information to investors, particularly trust deed and related documents, annual accounts and quarterly accounts. Moreover in the event of default the investors should be provided financial and operative information on a monthly basis. All such information should be provided to the stock exchanges where the security is listed and the Commission. Further, these information can be hosted on the website of the issuer and trustee.

Amendments required in Listing Regulations

Although the listing regulations of the KSE address the requirements and conditions to be met in case of listed securities, the regulations are mainly focused on equity instruments with very few provisions addressing the issues pertaining to the debt securities. As a result, no proper regulatory framework exists at present for listed debt instruments which may help in safeguarding the investors' interest. There is a strong need to increase transparency in the issue and trading of Debt Securities and ensure that Issuers meet all their obligations under the listed Debt Securities, with the Exchange acting as a Front Line Regulator in governing the issuance and servicing of debt based instruments.

The existing regulations need to be further strengthened with respect to debt securities to overcome following shortcomings:

- Essential Information and undertakings at the time of Issue;
- Issuer/ Trustee obligations to provide trust deed and important information not specified;
- Issuer/ Trustee not obliged to reveal price sensitive information pertaining to the Issue;
- No provisions binding the Issuer or its Senior Executives to inform and explain to the investors reasons for default and proposed remedies via a meeting;
- No check on gross violation of loan covenants;

Conclusion

In order to develop the bonds market in Pakistan the following measures need to be considered:

- Development of BATS as a centralized reporting platform for all trades in listed debt instruments for efficient price discoveries of listed TFCs.
- Introducing provisions pertaining to debt securities in the listing regulations of the stock exchanges to increase transparency and safeguard investors' interest.
- Further strengthening the Debt Securities Trustee Regulations by introducing prudent amendments which will allow trustees to play their role more proactively and help build investor confidence.
- Establish reforms in the existing legal systems allowing quick resolution of the claims on defaults held by investors of debt instruments.
- Build investor confidence through awareness programs at MUFAP level and educate investors on the bond market in Pakistan.
- Enhancing the minimum standard for issue of commercial paper. Both the minimum equity and rating of issuer needs to be raised.