May, 2011

Medium Term Strategy / Five Years' Plan
July 2011 to June 2016

Mutual Funds Association of Pakistan

MUFAP
MUTUAL FUNDS ASSOCIATION OF PAKISTAN

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MUFAP Vision and Mission Statement

Vision

To have collective investment as the preferred investment solution for investors and financial intermediaries;

Mission

Contributing to a strong national economy by encouraging savings and improving the opportunities for achieving personal financial independence; encouraging adherence to high ethical standards by all industry participants; providing services that improve the regulatory framework; advancing the interest of funds and the fund managers; and promoting public understanding of mutual funds and pension funds;

Policy Objectives

a) To promote collective investment to build wealth, with the growth of economy;

b) To define and maintain high professional and ethical standards in all areas of operation of the mutual fund industry;

c) To enhance the professionalism and standards of research so that they are in line with international best practices;

d) To promote education of investors on investment and investment management industry;

e) To bring about improvement in the legal, regulatory and fiscal environment in which its members operate;

f) To promote the role of fund managers and participating in securities market initiatives;

g) To promote tax deferred long term savings opportunities and ensuring fair tax treatment for fund investors;

h) To work with the Securities and Exchange Commission of Pakistan to promote best business practices and code of conduct;

i) To work with Government, Regulators and other organizations for creating level playing field and practices;

j) To develop a cadre of well trained agent distributors and implement a training and certification program;

k) To disseminate information on mutual fund industry and to carry out studies and research directly and/or association with other organizations;

l) To act as pressure group to bring about improvement in corporate governance.

Market Based Financial System

The financial market plays a critical role in the economic development of a country. By transferring resources from the savers to the borrowers, it directs the resources from the idle to the productive sector, thus accelerating investment activities in the economy. Financial market essentially involve the allocation of resources, acting as the brain of the entire economic system; if they fail, not only will the sectors' profit be lower than would otherwise have been, but the performance of the entire economic system may be impaired. There is a close relationship between the capital accumulation and the process of economic development. The banks and non-bank financial intermediaries could create the supply of investment avenues that exceeds the desired savings and thus influence the rate of growth of the economy. There is a distinction between financial system based on the capital market and one based on credit. While in the former, the main source of long-term business finance are securities, in the latter it is credit with banks playing the crucial role. In a system based on the capital market, the capital market plays the leading role in allocation of savings and investment. The efficiency of the financial market, however, depends on the existence of active and efficient financial intermediaries in the system. These intermediaries also play an important role in the elimination of market imperfections, arising out of the non-dissemination of information on borrowers. Distortions in the market can be eliminated or eased by several institutional devices, including financial arrangements, such as issuing market for securities, besides financial intermediaries. These are expected to embody the essence of integrity and entrepreneurial drive is well balanced by a strong sense of fiduciary responsibility; that is the reason the financial regulations have always been a part of economic and financial market development.

The shift from a credit-based system to a financial system has promoted savings' instruments based on capital market; insurance, pension funds and mutual funds are increasingly playing the central role. The role of mutual funds and pension funds structured as mutual funds have attained greater importance due to their operational flexibility and transparency, because they provide better return to investors and also serve as sophisticated market clearing agent. Mutual funds play a dynamic role in mobilizing savings by issuing units and channeling the funds in the capital market into productive investment. Besides providing depth to the market, they provide support to the corporate sector and assist in the process of financial innovations. The scope and efficiency of mutual funds depends on the basic economic structure, the interrelationship between the financial and real sectors, the institutional arrangements and the policy environment.

Economic Environment in Pakistan

The country was confronted with financial crises, due to sharp plunge in foreign exchange reserves, downgrading of its credit rating, reduction of foreign private capital flows, decline in industrial output and adverse law and order situation. Pakistan was on the verge of defaulting on its foreign debt obligations. The country took intermediate measures, including fiscal contraction, currency devaluation, monetary tightening and resort to IMF financing. In order to resolve the issues on a more permanent basis and move to the growth path, the country has to undergo structural reforms, focused on taxation, financial sector, governance, investment in education, health, infra structure and energy sectors and capacity building of law enforcing and regulatory institutions. The resources required to undertake structural reforms should be raised internally from an equitable taxation and savings.

Mutual Funds' Statistics

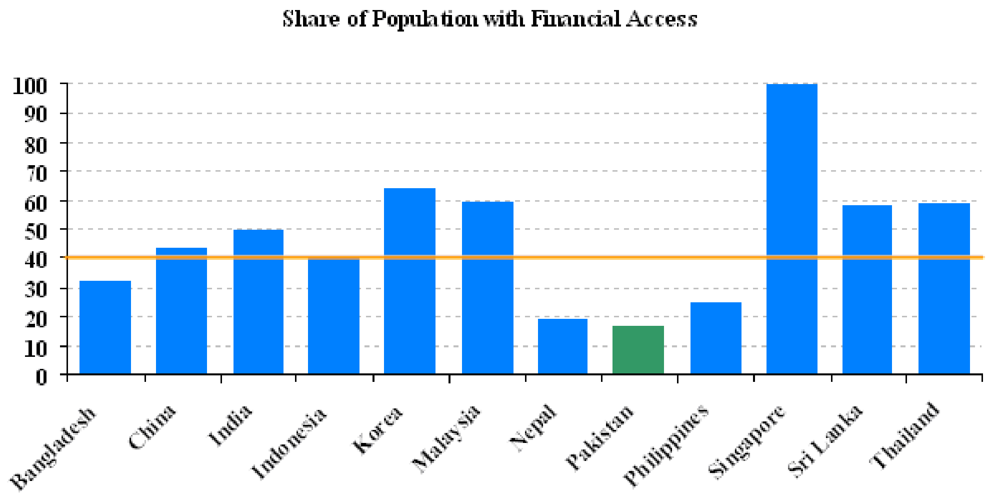
In his book, "Reforming the Taxation and Regulation of Mutual Funds, A Comparative Legal and Economic Analysis", John F. Cogan, Jr. Professor of Law and Economics at Harvard Law School has stated that over the past 50 years, mutual funds have become the primary way middle class Americans invest, 44% of US households own fund shares up from 6% in 1980, but down from its peak at 48% in 2001, 33% of all families earning between $25,000 and $50,000 invest in mutual funds, half of households owning funds earn less than $75,000 and over a quarter of all retirement plan assets are held in mutual funds.

The statement above may not be exactly reflective of future potential as the growth in mutual funds largely hinges on expansion in the overall financial markets, which then leads to awareness and better access for everyone. However, following the footsteps of global predecessors and exploring new frontiers can gradually lead the Mutual Fund Industry to such avenues.

The mutual funds have been around for a long time, dating back to the early nineteenth century. The first modern day mutual fund was opened in America in 1924 but the great depression of 1930s had stalled the growth of mutual funds like many other economic activities. It was in the 1990s that mutual funds became the main engines of saving mobilization as also the mainstream investments in the USA and the world. In India and other emerging and developing economics as well, the mutual fund sector has made significant progress in 90s and thereafter. Pakistan was in the forefront in pioneering the initiation of mutual funds from amongst the developing countries with the introduction of National Investment (Unit) Trust, an open end mutual fund in 1964, which was followed by the Investment Corporation of Pakistan launching closed end funds starting from 1966. The mutual fund industry grew with the opening provided to the private sector to launch open-end mutual funds in 1994. The mutual funds have not been able to make inroads towards attracting household savings and for this reason the investors in mutual funds and asset under management (AUM) as per cent of bank deposits has remained low. Presently there are 26 Asset Management Companies managing over 140 open end/ closed-end funds and nine Voluntary Pension Schemes, launched by five licensed Pension Fund Managers.

Financial Services' Industry

Structurally mutual funds are in resonance with economy of any country due to wider access to investment horizons. This flexibility and agility is a unique opportunity in itself. "Financial Services" together with "Technological Services" is one of the most sought after business in Asia with immense growth potential and sustainability. The rationale for "Financial Services" sector is reflected in the following graph illustrating percentage of population with financial access in various countries in South Asia and East Asia, including Pakistan.



Source: Bringing Finance to Pakistan's Poor: A Study on Access to Finance for the Underserved and Small Enterprises by Tatiana Nenova, Cecile Niang with Anjum Ahmad, January 5, 2009

The median for countries (like Bangladesh, India, Indonesia, Korea, Philippines and Sri Lanka) with economic features and structures similar to that of Pakistan is around forty percent (40%) (of total population having financial access), whereas only seventeen percent (17%) of

Pakistan's population has access to formal financial institutions. This implies that there is at least an upside of around twenty percent (20%) (around thirty-nine (39) million Pakistanis) in Pakistan which can be tapped and brought in this opportunity zone, which not only serves major impetus for growth for banking sector, but also other financial institutions like Asset Management Companies (AMCs).

Savings Rate and Growth of Mutual Funds' Industry in Pakistan

Following latest trends available from the 'Financial Stability Review – FY10" published by the State Bank of Pakistan (SBP) shows that mutual funds continue to grow immensely.

Accumulated Savings (FY01 to FY10)

As at June 30, 2010

	FY01	FY02	FY03	FY04	FY05	FY06	FY07	FY08	FY09	FY10
Accumulated Savings (Stock)	2,511	2,771	3,252	3,690	4,183	4,686	5,477	6,133	6,816	7,795
Deposits of Banking Sector	1,264	1,411	1,671	1,975	2,405	2,772	3,310	3,701	4,045	4,595
Investment in NSS	762	847	982	984	940	934	1,000	1,094	1,361	1,586
Currency in Circulation	374	434	494	578	66	739	839	981	1,152	1,295
Deposits of NBFIs	80	41	40	47	48	61	56	41.3	13.9	21.9
Mutual Funds	12	19	45	85	103	135	228	274	204	258
GP Fund	18	19	20	22	22	44	43	43	40	40

Source: Financial Stability Review FY10, SBP

Growth in Accumulated Savings (FY01 to FY10)

As at June 30, 2010

	FY01	FY02	FY03	FY04	FY05	FY06	FY07	FY08	FY09	FY10
Accumulated Savings (Stock)	7.8	10.3	17.4	13.5	13.4	12.0	16.9	12	11.1	14.4
Deposits of Scheduled Banks	11.4	11.6	18.4	18.2	21.8	15.3	19.4	11.8	9.3	13.6
Investment in NSS	6.5	11.1	16.0	0.2	(4.5)	(0.6)	7.1	9.3	24.4	16.5
Currency in Circulation	5.3	15.8	14.0	16.9	15.1	11.1	13.4	17.0	17.4	12.4
Deposits of NBFIs	(12.3)	(48.6)	(2.2)	16.2	3.4	26.0	(7.8)	(26.2)	(66.3)	57.8
Mutual Funds	(5.9)	56.7	132.1	88.1	21.6	31.2	69.0	19.8	(25.4)	26.7
GP Fund	(2.0)	1.2	5.3	9.9	1.0	103.9	(2.6)	(1.9)	(5.7)	(1.3)

Source: Financial Stability Review FY10, SBP

Despite the small size of the sector, the industry's potential cannot be negated as it managed to increase its share in GDP, whereas all other sectors were not able to compete in relation to the growth versus the GDP of Pakistan.

Accumulated Savings as Percentage of GDP (FY01 to FY09)

As at June 30, 2010

	FY01	FY02	FY03	FY04	FY05	FY06	FY07	FY08	FY09	FY10
Accumulated Savings (Stock)	60.3	62.9	67.4	65.4	64.4	61.7	62.9	59.6	53.5	53.1
Deposits of Scheduled Banks	30.4	32.1	34.6	35.0	37.0	36.5	38.0	36.0	31.8	31.3
Investment in NSS	18.3	19.2	20.4	17.5	14.5	12.3	11.5	10.6	10.7	10.8
Currency in Circulation	9.0	9.9	10.3	10.2	10.2	9.7	9.6	9.5	9.0	8.8
Deposits of NBFIs	1.9	0.9	0.8	0.8	0.7	0.8	0.6	0.4	0.1	0.1
Mutual Funds	0.3	0.4	0.9	1.5	1.6	1.8	2.6	2.6	1.6	1.8
GP Fund	0.4	0.4	0.4	0.4	0.3	0.6	0.5	0.4	0.3	0.3

Source: Financial Stability Review FY10, SBP

The vision for realization of growth potential by the Mutual Funds Industry rests on the inherent distinguishing features in its structure, which make mutual funds a lucrative and dynamic investment vehicle for individuals as well as institutional investors.

Pension Reforms

Savings

In an article, "Revenge of the glut", Paul Krugman, a noble laureate says that "the international economic crisis is the revenge of the global saving glut. After the Asian financial crisis of 1997-98, the Asian countries began protecting themselves by amassing huge war chests of foreign assets and exporting capital to the rest of the world. For a while, the inrush of capital created the illusion of wealth in these countries, just as it did for American home owners; asset prices were rising, currencies were strong and everything looked fine. Bubbles always burst sooner or later, and yesterday's miracle economies have become today's basket cases."

Pakistan's economy suffers from low savings and low tax to GDP ratios. Pakistan has depended excessively on overseas capital infused in the economy through stock exchange and privatization program, which for a while sustained the balance of payment and economic growth. Pakistan has not succeeded in creating a savings and tax culture to provide strong base to the capital market and economic growth.

As a % of GDP	Investments	Savings
China	48%	54%
Bangladesh	24%	39%
Nepal	30%	38%
India	35%	34%
Malaysia	14%	31%
Thailand	22%	30%
Sri Lanka	25%	24%
Indonesia	31%	23%
Pakistan	19%	22%

Source: World Bank Website

Retirement Savings

Pension affects society in two ways; it provides the retired segment with income to support them and it promotes long term savings by the younger, economically active strata of the society and through its funding encourages the development of financial and capital markets.

Pension reforms are becoming necessary all over the world as the present pension systems (the defined benefit (DB), pay-as-you-go systems), generally being used in the world are no longer affordable with current & future demographics of the countries. The DB systems in most countries worldwide are under intense financial pressure and are either under or un-funded. Low retirement age in many countries exerts financial pressure and hampers labor participation and lack of tax incentives do not motivate the individuals toward personal savings.

The global trend in pension policy is shifting toward more funding, more private management, more regulation, more defined contribution (DC), and more individual responsibility or choice. DC type schemes allow greater labor market mobility, a key factor in encouraging economic growth.

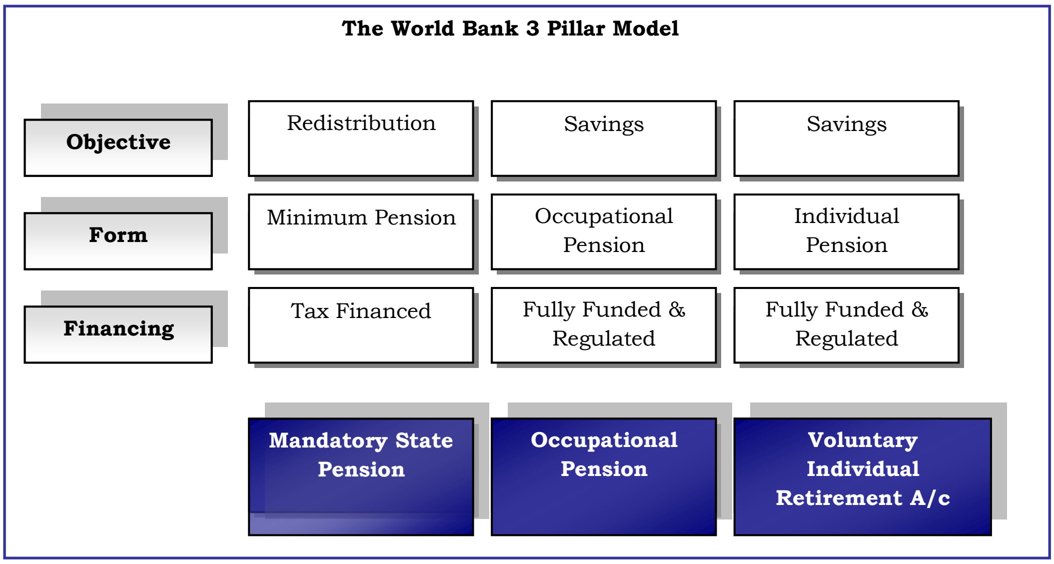
The poor government record on investment and service provision has led to more private management. Simultaneously, increasing financial literacy, the failure of sponsors to keep DB promises, and low and declining returns from old schemes have led to a trend towards more individual responsibility or choice. Also low retirement age in many countries exerts financial pressure and hampers labor participation and lack of tax incentives do not motivate the individuals toward personal savings, and with improving health conditions, people are living longer post retirement and the trend of retirees living independent of their children is also increasing. This has also led to the question as to what percent of income one should save during working life to meet the financial need during retirement?

Chilean Experience – Pension Reforms

Chile established its personal retirement accounts system in May 1, 1981, which offers workers choice to opt out of the government system with a full payroll tax and put it in a personal retirement accounts. When they reach their retirement age of sixty-five, they can decide to buy annuities or keep the ownership of the money saved in their personal pension accounts. The money is inherited if they die early. The system has proven to be sustainable. Chilean workers by vast majority opted for their own private accounts, rather than old pay-as-you-go system, which depended on demographic changes, political decisions, length of lives, and many other variables. The end result is privatization of pension, but it is the workers who decided not the government.

It is difficult to try to define benefits for everyone in the system. Government can favor certain groups, such as the poor and the disabled groups. Promising the result without knowing the future of fertility rates, expectancy of life and many other exogenous variables leads to the creation of unsustainable liabilities and may result in the failure of such a retirement system in the long run.

The retirement system in Chile is based on World Bank defined (1994) multi-pillar system.



THE FIRST PILLAR: Three elements make the first pillar; first component is welfare-based, second component is the state-guaranteed minimum pension and the third component is National Pension Funds, which administers the old PAYG defined-benefit program, which is closed to new entrants.

THE SECOND PILLAR is based on a mandatory contributory defined contribution plan. Workers who belonged to the old PAYG system were asked to choose between remaining in the old system or to move to the new system. The new system was mandatory for new workers except self-employed workers. This has an important impact on coverage rates.

THE THIRD PILLAR works like the second pillar, but it is a voluntary system. It covers workers who want to accumulate more capital for their retirement period. This capital is not liquid and should be invested during a long time.

Results of the Pension Reform

Olivia Mitchell, Executive Director of Wharton's Pension Research Council, provides four reasons for the popularity of the Chilean new pension system; that the system replaced the old state one, which went bankrupt due to corruption and insolvency, that the new system is based on an individual accounts, which is better protected against political risks, that the Government guaranteed a minimum pension and finally, the model has worked well for over 25 years.

i. Increase in National Savings and Investment:

After the establishment of a funded pension system, pension assets grow very rapidly. As a result, social precautionary savings, as well as national savings, increased substantially with more money becoming for capital market investment. In Chile, after the pension system reform in 1981, the ratio of social precautionary savings to GDP jumped from 1.9 percent in 1984 to 3.8 percent in 1994, and the ratio of national savings to GDP increased from 13.6 percent to 26.8 percent. Managed by professional institutions, the precautionary savings can be sufficiently mobilized and are beneficial to the optimization of resource allocation and economic growth.

ii. Enhancement of Financial Competition and Finance Deepening:

The growth of pension funds represents a challenge to the dominant position of commercial banking and is beneficial to the expansion of financial markets, and hence their liquidity and efficiency. A case in point is Chile in 1984 when the stock and bond markets were virtually negligible compared to 1997 when the capitalization of these two markets were US$7 billion and US$80 billion, respectively. At the end of 1998, 63 percent of government bonds, 54 percent of mortgage bills and banking notes, 16 percent of bank deposits, and 10 percent of stocks were held by pension funds.

iii. Acceleration of Financial Innovation:

The development of mortgage bonds, corporation bonds, and public agency bond markets in both Chile and Argentina has been largely attributed to pension system reforms.

iv. Reinforcement of Financial Regulation to Achieve Better Protection of Investors:

The safety and profitability of pension funds are critical to the pensioners' benefits and social stability, thus posing increasing demands for sound financial regulation. Several years ago, in Chile, Argentina, and other countries where the pension systems were being overhauled, concrete steps were taken to strengthen information disclosure, fiduciary duty and a crackdown on insider trading, and out-of-line self dealing so as to achieve better investor protection.

v. Stabilization of the Securities Market and Modernization of Trading System:

Because of their long-term investments and predictable trading styles, pension funds are stabilizing forces in securities markets. During the 1988-1992 period in Chile, the stock market variation coefficient – the ratio of the variance of monthly average returns of the market index to monthly average returns – was only 1.92, far lower than that of Mexico (2.44), Argentina (3.25).

Recommendations

i. Retirement Schemes in Pakistan:

Retirement savings does not enjoy as much attention in Pakistan as it does globally. There is no concept of utilizing these savings for funding development projects that may result in lasting benefits. The role of these schemes has been limited due to their flawed and antiquated structure marked by tax anomalies. With rules enabling pre-retirement withdrawals and with minimum regulatory oversight, these schemes are unable to achieve their objectives. It is recommended that the Government may undertake measures for bringing pension reforms, as stated in following paragraphs.

ii. Funding of Government's Pension Liability:

The Government Pension is unfunded defined benefit and paid from the current budget as "pay as you go" (PAYG). The pension liability and payment from the Government budget is increasing every year. Other countries are facing similar problems and they have come to the conclusion that such liability cannot be sustainable in future. The answer to these problems could lie in replacing defined benefit (DB) with defined contribution (DC) system, funding the liability and reducing the pension benefit or increasing the contribution. The conversion of DB into DC is difficult to implement for existing employee; it is possible for the new entrants to the service.

The Punjab and Sindh Governments have created fund, in which amount is being transferred from yearly budget allocation. The objective is to use the fund to meet the pension liability of the provincial Governments, reducing payment from the budget. The Punjab Government has converted some of its service departments into corporation, whose pension will be funded and to be paid by these corporations. Some measures have also been taken by KP Government to fund their liabilities on these lines. The Federal Government has also been considering on these lines.

Recommendations are as under:

- The actuarial liability of Federal, Provincial and Local Governments may be worked out each year and disclosed in their respective budget.
- New incumbents in the service may be offered pension under DC with the Pension Fund Manager in the private sector.
- The various provincial Governments are considering establishing their own fund over a period of time from which they propose to meet part of the pension liability. The investment of theses fund is an important issue, which should be transparent and care should be taken so that the investment is not subject to any political influence. To eliminate the risk of political influence of these funds, it is suggested that these funds may finance infra structure projects and Government may issue infra-structure bonds.

iii. Regulating Pension Schemes:

Outside the Government Retirement Schemes, the private and public sector (state owned) organizations are offering post employment retirement benefits to their employees. These schemes have to be approved and registered with Commissioner of Income Tax (CIT). The investment of private sector schemes are made according to the provisions of the section 227 of the Companies Ordinance, 1984 and related Rules, in case of entities established as company under the Companies Ordinance and provisions of outdated section 20 of the Trusts Act, 1882 in case of organizations other than companies. The investment policies of the public sector (state owned) organizations are laid down in their constitutive documents and applicable laws.

It is important that the retirement schemes accumulate till retirement and after that subject to commutation of an amount to allow for certain expenses, the remaining amount may be invested under an income plan or annuity to generate income during retirement. The schemes need to be portable. This way, on leaving the job, a person's retirement scheme will not be discontinued.

Other than the requirement of registration with CIT, the retirement schemes are not regulated. All retirement schemes have common objectives and operative procedure; it makes little sense to be governed and regulated under different laws and by different regulators. All such schemes should be governed under one law and regulated by the Securities and Exchange Commission of Pakistan (SECP).

Due to an amendment in SECP Act, the National Assembly has authorized SECP to regulate all pension schemes, except those offered by the Government or Government entities. SECP should now proceed with the legislation in this direction, which will involve repeal of a large body of laws, rules and guidelines and frame new laws, rules and guidelines to replace these. SECP will have to draw a road map in consultation with FBR, Finance Division and various other Government Departments. SECP will also need to build the capacity to undertake the task.

iv. Promoting Retirement Saving Through Tax Incentive or Mandatory Requirement:

World over, Governments have promoted retirement schemes either through tax incentives or making retirement savings mandatory. The tax incentives mostly take the shape of an EET tax structure, that provides tax deferral at the point of contribution to the scheme and during the period the amount is invested. However withdrawal or pension payments are subject to tax at applicable rates. Considering that Pakistan has a large population of 170 million people, with large section living below poverty line and with little propensity to save, application of universal mandatory provision, however urgent and important it may be, is not practical for the time being. It is considered that application of a limited mandatory provision and tax incentive uniformly applied to all retirement schemes will induce savings and growth of retirement funds. Section 12(6) of The West Pakistan Industrial and Commercial Employment (Standing Orders) Ordinance, 1968 makes it mandatory for all industrial and commercial establishment employing twenty or more workmen to provide them gratuity, provident fund or VPS. It is proposed to extend the provision in law to make it mandatory for employer with twenty or more employees to offer retirement benefits. It is also recommended that for self employed individuals earning annual income in excess of Rupees 1,500,000/= minimum contribution of ten percent income to retirement scheme shall be mandatory.

v. Voluntary Individual Savings:

The contribution retirement savings schemes managed by employers or VPS at twenty percent of the salary to the retirement schemes will barely provide enough income to meet expenses after retirement. If one wants to be financially self sufficient and to take care of post retirement medical care, higher education of children or marriage expenses additional voluntary savings will be required. The Government should encourage individuals to save additional amount, through tax incentives. The voluntary saving could be in form of additional contribution to VPS, life insurance or medical cover or investment in new issues under section 62 of the Income Tax Ordinance. The tax credit allowed for voluntary savings should be on long term basis and uniformly applied across the board.

vi. Measures taken by Government towards "Pension Reforms":

The Government has taken a number of measures, towards pension reform in the country.

These are not comprehensive measures and lacking in many respects. There is also no clear cut road map for implementation.

Measures	Comments
Notification of VPS Rules in 2005, issue of license to four AMC to offer pension funds in 2007;	• *Tax Anomalies between VPS and Occupational Savings Schemes not removed, as a result VPS has not taken off;* • *In presence of presumptive tax regime, no incentive for self employed to invest in VPS;*
Funding of Government pension liability;	• Only Punjab and Sind Governments have established pension funds; Funding only small part of total liability; • No decision to induct new entrants in a funded DC system;
Amendment in SECP Act in authorizing SECP to regulate all private sector and Government corporation;	• Government entities not included for regulation by SECP; • Action on implementation to bring retirement schemes under SECP regulation yet to be taken;

For a meaningful progress towards pension reforms, which could result in substantial increase in assets under management of all retirement funds, five years road map is required. For SECP to perform as a regulator capacity building of SECP will be necessary.

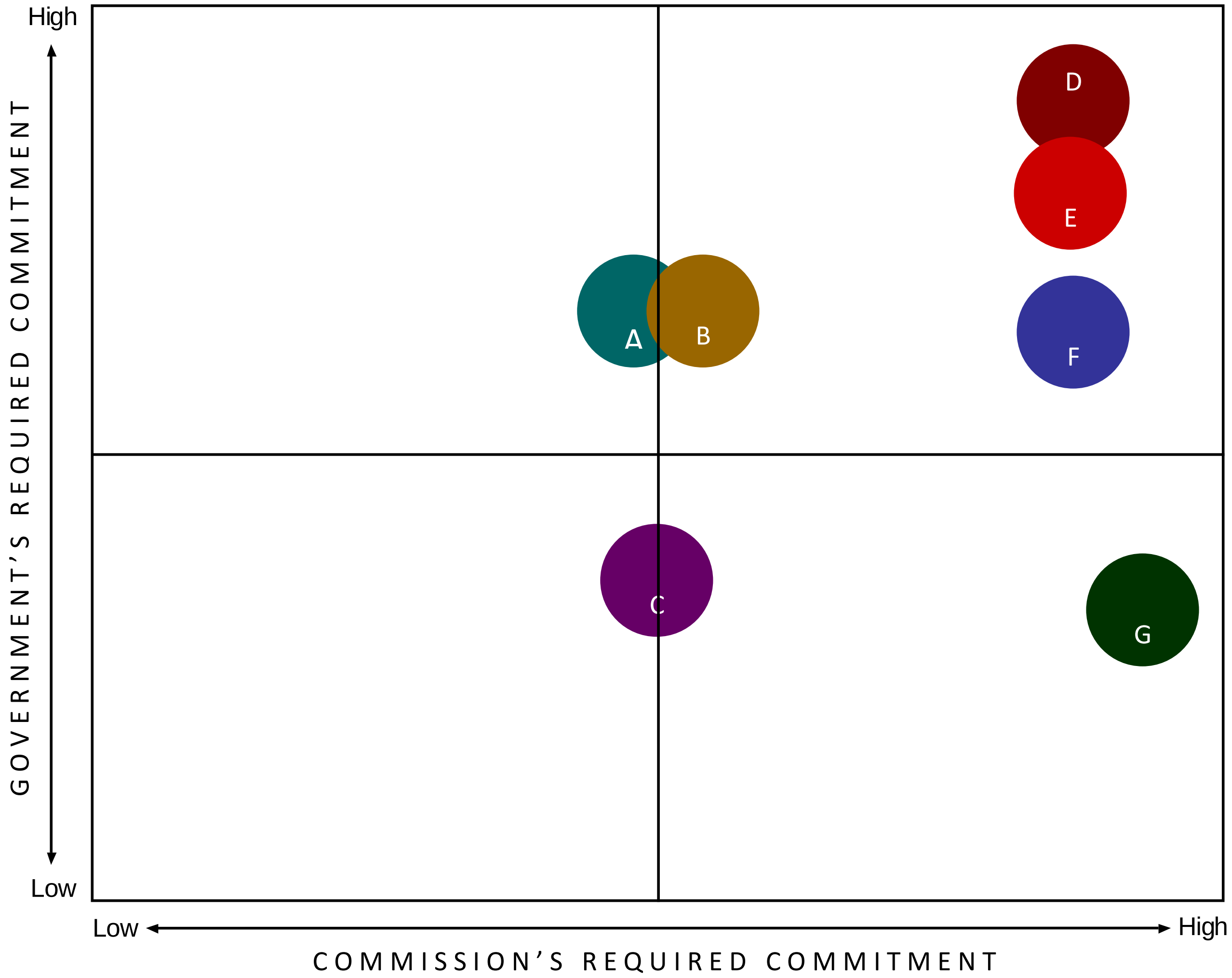
It will also require improvement in governance at the level of regulator, stock exchanges, pension fund managers, investee companies and improvement of auditing standards. The capacity building of SECP and governance is separately dealt in this document.

vii. Commitment required for "Pension Reforms"

For pension reforms the Government and the Regulator has to show commitment. This program can be undertaken in phases and some of the phases are relatively easily implementable. A matrix showing Government and SECP commitment required for each phase is attached below. The tax incentives for long-term savings (A), removal of tax anomalies (B) and amendment in SECP Act (C) have neutral impact on revenue of the Government and can be easily implemented. Regulation of "Companies Managed Retirement Schemes" (G), by SECP will require commitment and resources from SECP, but in so far the Government is concerned, the required commitment level will be low to medium. Other phases of the pension reforms, stated at (A), (E) and (F) will require high level of commitment and resources both from the Government and SECP.

It is suggested that SECP may draw a detailed time-line. Those steps that can be taken easily need to be taken. For those steps that are difficult in implementation there should be a road map.

Matrix showing level of Commitment Required from Government and SECP in implementing the various phases of Pension Reforms



- **A.** Tax Credit for long-term savings
- **B.** Removal of Tax Anomalies of Retirement Schemes
- **C.** Scope of SECP Regulation
- **D.** Mandatory Retirement Savings / Funding of Government Schemes
- **E.** SECP to Regulate Retirement schemes of Government Entities
- **F.** SECP to Regulate Retirement schemes of Private Entities
- **G.** SECP to Regulate Retirement schemes Managed by companies

Savings and Related Issues

Individual Savings

The initiative to improve rate of savings and provide fair return to investors will demand working on a range of issues with other stake holders including the Government and regulators. Individuals are the key savers in any country including Pakistan. There are about Rupees 5 trillion in bank deposits earning as average rate of around 6% p.a. Since inflation has mostly been in double digits, and presently hovering around 14% p.a., there is very little incentive for individuals to save. Money market funds are presently offering a return of around 12% p.a., which although still less than inflation, is much higher than bank deposits. Equity mutual funds have also historically provided a much higher return over the medium term versus bank deposit rate and inflation. Thus, growth of mutual fund industry will provide better return on savings and provide incentives for savings.

The mutual fund industry in Pakistan has already marketed its products to large corporations regarding sales of their products. However, the key challenge at present is how to approach the Small & Medium Enterprises (SMEs), High Net-Worth (HNW) investors, and the retail market. Accessing these market segments require large expenditures on setting up offices around the country and hiring a large work force. This is difficult to do considering the low management fees on which the AMCs operate. The bank-owned AMC are utilizing the branch network of their sponsor banks to market mutual funds. However, success will only be achieved in due course of time as the knowledge and awareness level of investors improve.

Educating the Investors

To improve awareness among investors that there are several investment options available in the market place, and making investors aware of the risks and rewards associated with such investment avenues. SECP and MUFAP need to make combined efforts to improve public awareness of investors about various types of mutual funds. Since most mutual funds categories have offered and are expected to offer a higher rate of return than bank deposits over the medium term, investors will be more inclined to save and invest in such funds rather than consume. MUFAP will work on developing networks relying on conventional sources such as media and out-of-box ideas to structure alternative platforms.

Graphical illustration of framework of channelizing savings into investments either directly or via intermediaries

Improving Savings / Investments in Pakistan Via Mutual Funds

Savings → Intermediaries → Investment

Savings

Individuals:

The return on bank deposits is much lower than inflation. Therefore, the savings rate is low.

Retirement Funds:
Compulsory requirements for corporate / GOr / GOP entities to contribute and fund employee retirement Schemes. This is must to improve the savings rate.

Corporate are also savers at times.

Factors to improve savings:

- Improve returns
- Educate investors on investment options
- Provide more investment options
- Economic growth with low inflation

Intermediaries

- Banks
- Central Directorate of National Savings (CDNS)
- Insurance Companies
- Mutual Funds
  - Money Market Funds
  - Income / Bond Fund
  - Balanced Funds
  - Asset Allocation Funds
  - Stock Funds
  - Real Estate Mutual Funds
  - Infrastructure Funds
  - Venture Capital / Private Equity Funds
  - Commodity Funds
  - Currency Fund
  - Distributors

- Attributes of Intermediary:
  - Professional Expertise
  - Cost efficiency
  - Tax efficiency
  - Diversification
  - Liquidity

Investment

- Money Market
- Bond Market — Govt, Corpora, Infrastructure, Bond
- Stock Market
- Real Estate Market — Rent, Development
- Derivative Market
- Commodity Market

- Key Features of Investment Avenues:
  - Price Discovery
  - Documentation
  - Regulations
  - Transparency

Investment Options

Today there are a large number of mutual funds in Pakistan that invest in conventional and Shariah Compliant money market, income, balanced, asset allocation, and equity fund categories. However, the Investment universe need to be broadened to also include sector funds, style funds, real estate funds, private equity funds , venture capital funds, infrastructure funds – both debt and equity, commodity funds, currency funds, etc. In India, presently there are about 1000 mutual funds of which 30% are specialized funds. In Singapore there is a common Code of Collective Investment Schemes issued by the Monetary Authority of Singapore. The code maintains the simplicity and flexibility as rules for non-specialized schemes are the same for all asset classes. Further, there are specific sections in the code only for specialized funds dealing in property, gold, currency, derivatives and capital protected series. This makes the code highly effective and efficient.

MUFAP will strive to create alternative products out the same asset class universe whilst increasing available asset classes and derivatives.

Reducing Cost of Intermediation

The bid-ask spread in banks is very high in Pakistan at around 7% that lowers the return for the deposit holders, thus discouraging savings. The cost of intermediation is much lower in mutual funds at around 2% p.a. However, it is still high by international standards and needs to be brought down further to improve return for investors, thus persuading them to transfer their money to mutual funds. The competition has already resulted in significant reduction in management fees, where the average fee on money market funds is around 1% p.a., and on other funds is around 2% p.a., which is much lower than the 3% p.a. allowed by SECP. However, SECP fee and CDC fee still remain very high by international and regional standards and need to be brought down to improve cost efficiencies. The average mutual fund size in India is around INR 6.4 billion and the Registration fee charged by the Regulator is INR 2.5 million, which amounts to 0.04%. The average mutual fund size in Pakistan is around Rs. 1.6 billion, and the Registration fee charged by the Regulator is Rs. 1 million, which amounts to 0.06%. Similarly average annual service fee charged by the Regulator in India on a mutual fund of up to INR 5 billion size is 0.005%, whereas the average annual service fee changed by the Regulator in Pakistan on a mutual fund ranges from 0.075% to 0.095% according to category.

Pricing and Tax Anomalies Nation Savings Schemes (NSS)

The biggest impediment in the growth of the mutual fund industry in Pakistan is NSS. National Savings Schemes are rated AAA as the Government of Pakistan is the issuer of such schemes. The weighted average rating of the banking sector in Pakistan is AA. The weighted average rate of return on all deposits of banks is around 6% p.a., whereas the rate of return on NSS is around 14% p.a. This is against the basic principle of Investments, which is lower risk investment earns a lower return and higher risk investment earns a higher return. In order to remove pricing and tax anomalies on NSS, MUFAP recommends the following:

- The schemes should be targeted towards small savers and similar to India institutions should not be allowed to invest in NSS;
- Rates should be linked to the bank deposit rates as is the case in India and not with sovereign bond yields;
- Penalties on NSS should be raised substantially to reduce interest rate risk for GoP;
- Higher tax rates slabs should be applicable on all NSS and bank deposits based on the income level and tax bracket of the saver;
- Investment limits for Behbood Saving Certificates should be reduced to PKR 1 million

and manipulation be stopped by developing a centralized database system and properly verifying the identity of the saver;

- Rate of Return on Behbood Saving Certificates and Defence Saving Certificates, both having a 10-year maturity, should be in line with 10-year bank deposit rate, which is presently about 11% p.a.;

- The above measures will help GoP save about Rs 100 billion per annum on account of reduced debt servicing costs and higher tax and penalties receipts;

- Know Your Client (KYC) requirements be applicable to NSS as well as they are applicable to bank and mutual funds. This will help reduce money laundering and improve transparency and documentation of the economy;

- Even if GoP gradually reduces NSS rates and raises penalties, it will still be able to attract the target amounts as banks / mutual funds returns are substantially lower than NSS rates.

Bond Market

Bond Automated Trading System (BATS)

Bond Automated Trading System (BATS) has been introduced in Pakistan in 2009. SECP has taken a major step for the development of the bond market in Pakistan and making it compulsory for all bond holders to trade through BATS from April 2011. In order to further develop the bonds market, companies should be encouraged to issue listed TFCs in the future rather than take the route of privately placed TFCs. One major reason that several companies quote for issuing privately placed TFCs is that SECP takes a very long time in giving them the necessary approvals. We propose to SECP to announce that any company applying for approval of listing of TFCs will be given such approval (or denied) within a 15-day period. When a company applies to SECP for approval for listing its TFC it has already obtained a rating from a Rating Agency. It is therefore not the job for SECP to start evaluating the company, not it has the capacity to do so. Generally sophisticated investors purchase TFC, such as banks, mutual funds, provident funds and high net worth individuals. The Rating Agency has already conducted the fundamental analysis of the company and has accordingly issued its rating. Thus, SECP should expedite the approval process, which will help in the development of the bond market, which in turn will help in the growth of the income fund industry.

Listing Regulations of Stock Exchanges

Historically the "Listing Regulations" were made with a view to cover the requirements of "equity securities" and investors in equity securities. If bond market is to be developed, the stock exchanges need to amend listing regulations to cover provisions for bonds, TFC and sukuks. The provisions should cover among things the following:

(i) Qualification and Responsibility of Trustee;

(ii) Availability of up-to-date Trust Deed and other legal documents on the web-site of the issuers and the Trustee;

(iii) Availability of quarterly, half yearly and yearly accounts on the web-site of issuers and the Trustee and supply to investors on request;

(iv) Payments of mark-up and principal installments;

(v) Provision regarding sensitive information;

(vi) Restructuring, default and similar matters;

(vii) Mandatory on issuers that in the event of non-performance they would post monthly report on the web-site about the financial position of the Company and simultaneously provide the information to the stock exchange.

Legal Recourse

There is a need to review the legal system to simplify the procedure so that legal recourse is simple. Quite often the large banks are not interested in pursuing legal actions as they prevail on the issuers to settle their dues. Small investors are left high and dry. It is proposed that where the issuer has not performed, the stock exchange, SECP and the SBP should intervene and be pro-active to ensure that the management is genuinely making efforts to resolve the problems facing the Company. Where such is not the case and the non-performance is due to financial irregularity, legal action must be taken jointly by the investors. A culture of non-payment of dividend in case of equity securities and non-performance in case of debt instruments has been prevalent in the country for quite some time. This culture will not help development of the capital market. Stock Exchanges, SECP and SBP have a responsibility and they must not shrink from it.

Real Estate Investment Trust

Real Estate Investment Trust (REIT) Regulations, 2008 was notified on January 31, 2008. This is another product introduced by SECP (VPS being another), which has not taken off. In Pakistan, the Real Estate business suffers from lack of transparency. It is understood that before the notification of the Regulation, SECP held discussions and negotiations with the provincial Governments to streamline the laws relating to real estate. At one stage a high level committee was also formed consisting of representatives of SECP, Provincial Governments and Ministry of Finance to review laws relating to real estate and to suggest measures to bring transparency in the business of real estate. This was an exercise in futility and SECP without waiting the need for reform in this sector went ahead with the notification of the Regulation. A reform in the laws and practice of Real Estate sector is necessary not only for successful launch of REIT, but to document the undocumented sector of the economy and to minimize the tax evasion, which is channeled through this sector. The needed reform will be helpful for this sector as if properly regulated there will be inflow of capital in this sector. As stated in Pension Reform, the commitment of Government (and here it includes Provincial Governments as well) is needed, without which no progress is likely.

The reform in laws and practices in real estate sector should cover the following areas.

(i) Land record;

(ii) Registering and regulating the brokers;

(iii) Review of taxation laws, particularly “duty on transfer”; higher tax on transfer resulting in declaration of transactions at lower values;

(iv) Ensuring real estate transaction through banking channel. Mandatory upon banks to report transactions to Government;

(v) Bringing real estate brokers in tax net.

Besides above, which are major impediments in the development of REITs, there are other issues, which were highlighted by MUFAP in the email, dated May 1, 2010 to the then Chairman, SECP, Mr. Salman A. Shaikh and copied to Executive Director Mr. Asif Jalal Bhatti and Directors Mr. Hasnat Ahmed and Mohammad Rashid Safdar Piracha.

The current requirements of minimum equity of the REIT Management Company (RMC), REIT scheme and minimum 20% of REIT scheme units to be held by the RMC are extremely high and will restrict the industry to a few large wealthy business groups and land developers. MUFAP has proposed that the requirement of minimum equity of RMC should be Rs.200 million and REIT scheme should be Rs.1 billion. MUFAP has also proposed that the minimum requirement on RMC to hold units of REIT scheme should be restricted to 5% of outstanding units for a minimum period of 3 years.

The management fee (1% for Developmental REITs on the initial REITs fund size and 3% of annual operating income for Rental REITs) is very low. This will limit the industry to those investors who set up RMCs to (i) benefit exclusively from the tax-free status of REITs; and/or (ii) make money through pricing mechanism. For, those who wish to manage the business on their managerial and technical skills. MUFAP has proposed that the RMCs should be allowed to charge a maximum fee of 5% per annum on the Net Asset Value of the REIT, and also charge up to 15% of out-performance versus a pre-defined benchmark as agreed with the Trustee.

MUFAP has proposed that the existing AMCs be allowed to launch REIT schemes as a separate asset class. Internationally almost half of the REIT schemes have been launched by AMCs. AMC in general has the basic human and physical infrastructure in place to launch REIT schemes. However, they should be required by SECP to substantiate their business plan to develop the requisite capacity fully before they are allowed to manage REIT schemes.

Borrowing against REITs assets plays an integral part in the growth and profitability of the REIT industry. Not allowing any leveraging is against the international practice and will impede the growth of the industry.

Rental REITs may carry a high level of risk and therefore in case of pure developmental REITs, the public offer, if any, should be limited to only to qualified & sophisticated' investors as may be defined by SECP.

Corporate Governance

Corporate Governance is a series of systems and processes aimed at protecting the stake of all stakeholders in an organization. This includes among other things ethical practices, division of authority, checks and balances, risk mitigations, transparency, responsibility and accountability. Corporate Governance applies across the board to all organizations, including companies, financial institutions, public sector organizations as well as Regulators and pillars of Government.

In Pakistan, corporate governance is debated at public forum, we even have a governance code, which is a part of the Listing Regulation of the stock exchange and we have an institute dedicated to the corporate governance. But unfortunately the reality on the ground does not reflect the ideals of those who believe that good governance is the critical factor for success, sustenance and growth of business. Had this not been the case, we would not have encountered Bank of Punjab and Crescent Investment Bank and numerable cases, where before the episode came to public knowledge (in case of Bank of Punjab through newspaper reporter), the board of directors, auditors and rating agencies had all given clean bill of health to the these entities. In all such cases noise is made but then after it has died down, it is business as usual. In Pakistan, there is a long history of mismanagement, unethical practices and poor governance, particularly of financial institutions, that have failed. NDFC, Mehran Bank, BEL, Indus Bank and Network Leasing are among the long list of organizations indulging in mismanagement, unethical practices and poor governance. The Walker Review in UK has stated that the boards generally met the characteristics of good governance, yet failed to perform effectively. The emphasis should be on real performance rather than creating a façade of good governance.

Good governance governs the relationship between the managers and shareholders of the corporations, as well as stakeholders like employees, pensioners and local communities - ensures transparency, fairness and accountability. When this trust is undermined, lenders and investors lose their appetite for risk. Under these circumstances we cannot expect the investment in the capital market or in securities that invest in capital market. A new generation of corporate governance is emerging, which aims at governance for sustainability. The concept is based on three principles, that an entity is the full value chain, there is a complex „partnership" to which oversight is needed and performance to be measured and that Boards need to reflect different stakeholders interests.

In relation to capital market, there is a chain of entities, as listed below, where good governance is necessary to repose investors' trust.

i. The Government

ii. Securities and Exchange Commission of Pakistan

iii. Stock Exchanges

iv. Auditors/ Rating Agencies

v. Companies listed on stock exchanges

vi. Issuer of debt securities

vii. Asset Management Companies/ Pension Fund Managers

viii. Companies managing employers' retirement funds

ix. MUFAP/ PICG/ ICAP

The SEC (of USA) publishes in its Annual Report a comprehensive list of its responsibilities and measures the performance against the benchmark. It is encouraging that SECP also gives a detailed list of its activities and performance measures. Stock Exchanges that are front line regulators should cover in detail in the annual report all relevant issues with regards to non-compliance. Some of these issues are insider trading, manipulation of prices, non-performance in case of debt securities, delisting, new listing and investors" complaint. Other institutions should also cover the performance review in the Annual Reports and disclose the conflict of interest.

Annexure

Annexure "A" (Pension Reforms)

Objectives	Comments	Implementation				
		1st year	2nd year	3rd year	4th year	5th year
Mandatory legal requirement to offer funded retirement schemes for salaried and self-employed	Mandatory for organizations employing 20 or more persons to offer retirement benefits to employees on the lines of West Pakistan Ordinance	Legislation	Mandatory provisions for listed companies	Mandatory provisions for public companies, Large organization s, employing one hundred or more employees	Consolidation Phase	Mandatory provisions for all organization s employing twenty or more employees
Scope of SECP Regulation	Amend SECP Act to include Government entities, like KPT, WAPDA, but not Government	Legislation				
Removal of Tax Anomalies in Retirement Scheme	Amendments in Income Tax Ordinance, 2001	Through Finance Act, 2011	Through Finance Act, 2012 (Review)			
Tax Incentives for long term savings	Amendment in section 62 of the Income Tax Ordinance	Through Finance Act, 2011				
Legislation for SECP to regulate Retirement Schemes	SECP to prepare a Road map for legislation and implementation including capacity building	Companies to be covered in the first stage		All private sector entities other than companies to be included		Government Corporation s and entities to be included

Annexure "B" (Savings and Related Issues)

Objectives	Comments	Implementation				
		1st year	2nd year	3rd year	4th year	5th year
MUFAP Codes (*MUFAP Advertising & Communications Standards for Mutual Fund Industry of Pakistan* and *Code of Qualification for Investment Facilitators and Distributors of MUFAP*	*Finalization and approval by SECP*	*	*			
Rationalization of current taxation laws to provide incentives for investment in businesses and capital markets rather than low risk interest bearing instruments	MUFAP to work with SECP, FBR and MoF	*	*	*		
Creation of enabling environment for mutual funds to access government corporations and departments	Government owned/ controlled Corporations with large sums of cash available should be allowed to invest in money market funds		*			
Educating Investors	Developing networks relying on conventional sources such as media and out-of-box ideas to structure alternative platforms	*	*	*	*	*

Annexure "B" (Savings and Related Issues)

Objectives	Comments	Implementation				
		1st year	2nd year	3rd year	4th year	5th year
Increasing Investment Options and creation of alternative products		*	*	*		
Reducing Cost of Intermediation	Fee charged by SECP and CDC are pretty high, The competition has resulted in significant decrease of management fee	*	*			
Removing Pricing and tax Anomalies on National Savings Schemes (NSS)		Link rates to bank deposit rates and raise penalties. Impose investment limit in BSCs	Higher tax rates should be made applicable on all NSS	Develop centralized database system and implement KYC		
Developing the Bond/ TFC Market	SECP to encourage issuance of listed TFC's Review of listing regulations with a view to incorporate provisions for debt instruments, transparency and investors' protection	*	*			

Annexure "C" (Bond Market)

Objectives	Comments	Implementation				
		1st year	2nd year	3rd year	4th year	5th year
BATS Trading	Commenced	*				
Listing Regulation	Amendments	*				
Legal Framework	Review and Implementation	*	*	*	*	*

Annexure "D" (Real Estate Investment Trust (R.E.I.Ts))

Objectives	Comments	Implementation				
		1st year	2nd year	3rd year	4th year	5th year
Amendments in REIT Regulations	MUFAP Recommendation	*				
Review of Real Estate Laws And Practices by A committee of Provincial Government. SECP and MoF	Objective is to Make the Real Estate Transactions transparent	*	*			
Review of Real Estate Tax Laws Particularly Relating to Transfer Duty on Sale	Objective is to Ensure Transaction to be Registered at Genuine price	*	*			
Regulation of Brokers	To ensure fair Deal to buyer And seller	*	*	*	*	*

Annexure "E" (Corporate Governance)

Objectives	Comments	Implementation				
		1st year	2nd year	3rd year	4th year	5th year
Auditing Standards	Review with ICAP – issues with regards to inadequate disclosure of profits and measures to be taken	*	*			
Capacity building of stock exchanges	In order to undertake the enforcement as front line regulator	*	*			
MUFAP Code of Ethics & Standards of Professional Conduct for Asset Management Companies	Finalization and approval by SECP	*				
Performance Measurement	Annual Performance Measurement of all entities connected with capital market	Finalization of performance measurement criteria	Implementation			
Capacity building of the Regulator	To take up additional responsibility of occupational savings scheme and to bring improvement	*	*	*	*	