Articles

Growth in Stock Market Capitalization and Mutual Funds' Assets

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Chairman Securities and Exchange Commission of Pakistan (SECP) has very rightly stated that "a vibrant and robust capital market has a pivotal role in the economic growth and development of a country." The SECP has undertaken a series of reforms for "development of equity, derivatives, debt, commodities markets and measures for improving governance, risk management, efficiency and transparency in capital market operations."

Though Pakistan Stock Exchange (PSX) is among the best performing stock exchanges, its contribution to economy is very low. This is evident from the PSX's low market capitalization and small number of new listings every year. Level of domestic savings is the key to the development and growth of capital markets; foreign investors only play a supplementary role. Unfortunately most of the policies in Pakistan are not designed to promote long term domestic savings.

Size of Country's Capital Markets strongly correlated with size of the Mutual Funds' Assets:

There is strong evidence that countries with large stock market capitalization to GDP ratio also have large long term mutual funds (including pension funds) assets to GDP ratio. A prerequisite to the growth of mutual funds industry is the level of domestic savings and access to supply of tradeable stocks and bonds. Globally both the size of long term mutual funds' assets and listing on the stock exchanges have increased supplementing each other. The size of the global mutual funds' assets have increased from $4 trillion in 1993 to $28.9 trillion in 2013. Some countries, like Chile, experienced a very sharp increase. This large and unusual growth that was more than three hundred per cent over the 2002 – 2012 period, happened as Chile liberalized the number of investment options open to its pension funds. Comparing it with listings, there were 23,000 stocks listed world-wide in 1990 that increased to 40,000 in 2012. Active participation of mutual funds in the capital markets provides the markets with much needed liquidity. This also helps in price discovery. If securities are traded infrequently, which is the definition of illiquid market, valuation will become very challenging.

Ratio of Locally Domiciled Fund Industry Assets to GDP:

US investors over the last few decades shifted away from direct investment in securities to investment through mutual funds. In past two decades the shift was over $6.5 trillion. In Europe similar shift has been noted. The European Central Bank has reported that households have increasingly favored investment through mutual funds rather than direct investment. As per 2012 data, long term fund assets as a percentage of GDP amounted to 64% in USA, 45% in developed Europe and 86% in Australia. In contrast it was 4.8% in Mexico, 4.7% in India, 4.4% in Poland and 4.2% in China. In Pakistan the ratio of long term fund industry (i.e. excluding money market funds) assets to GDP was 1.11% in 2012. This ratio has improved to 1.44% in 2016. If we compare Pakistan Stock Market Capitalization to GDP ratio in the same period it has improved from 17.55% to 25.64%.

Growth of Long Term Mutual Fund:

In past two decades mutual funds have shown strong growth. The mutual funds growth also has correlation with capital markets growth. As stated above stock market capitalization has also increased during the above period. Several factors lead to growth in Global Mutual Funds' assets.

- Greater household demand for diversified professionally managed investment product.
- Household sector has switched from direct investment to investment through mutual funds
- Strong Mutual Funds and Capital Market Regulations
- Availability of Deep and Liquid Capital Markets
- Efficient capital markets
- Superior returns
- Pass-through tax status that avoided double taxation
- Tax deferral in many jurisdictions allowing for capital accumulation
- Economic development
- Defined Contribution pension plans allowing participants to invest in mutual funds

As the economy grows all type of financial intermediaries grow, but mutual funds being a superior product tends to grow faster. These factors could in next fifty years lead to substantial increase in mutual funds' assets. The growth of mutual funds and pension funds could lead to improvement in savings rate and deployment of these savings in the economy in a most efficient manner. Mutual funds will be better able to meet potential demand if countries have appropriate regulatory frame work, robust capital markets and individual account-based contributory pension plan. As per 2013 Q3 figures, out of total $28.9 trillion mutual funds' assets 43% are invested in Equity, 25% in Bond, 12% in Mixed, 16% in Money Market and 4% in other categories. In Chile, following the consolidation of the fully funded private pension system introduced in 1981, the housing financing was able to take off decisively.

Measures Needed for Growth of Capital Markets in Pakistan:

Pakistan has a robust capital market infra-structure and adequate regulatory frame work. Pakistan Stock Exchange is also amongst the best performing stock exchanges in the world. Still the capital market capitalization and mutual funds' asset to GDP ratios are low. For growth of the capital markets, Pakistan needs to promote domestic savings; foreign investors can only supplement the growth.

Stock Market Capitalization: The policy objective should be to increase quality new listing of equity securities. Government should encourage new listing as well as increase in market float. A 5% tax rebate for listed companies which meets minimum market float of 40% of paid up capital will encourage companies to be listed on stock exchange. Secondly the Government should encourage bonus shares as it increases the supply of shares in the market. Issue of bonus shares is splitting of shares and not the distribution of income in the hands of shareholders, therefore there should not be tax on bonus issue. A small tax rebate can always be justified for listed companies, being required to follow code of corporate governance and disclosure requirements prescribed by the SECP and are less prone to tax evasion. Development of corporate debt market should also be encouraged. Government may also consider issuing of infra-structure bonds (related to specific project) or municipal bonds. These may be rated instruments. Institutions issuing such bonds should adhere to a properly laid code of corporate governance that may be prescribed by SECP.

Mutual Fund Assets: There is a correlation in the growth in mutual funds' assets and stock market capitalization. As stated above mutual funds' assets as percentage of GDP is very low. There is tremendous opportunity for growth, if right policies are put in place.

Assets under Retirement Savings Schemes: Information about assets of retirement funds of some of the selected countries are given as under**:**

Countries	US$ in billions
USA	21,779
UK	3,204
Japan	2,746
Canada	1,525
Australia	1,484
Netherland	1,378
Germany	427
France	151
India	94
Pakistan	101 million

**Source: Willis Towers Watson - Global Pension Assets Study Report 2016*
Pakistan Data from Organization for Economic Co-operation and Development (OECD)

The above data pertains to 2015, but Pakistan's figure is of 2014. Further, Pakistan overall data is not available, as many entities that are not listed on the stock exchange are probably not covered in this data. Low assets in Pakistan are due to lack of pension cover and unfunded schemes on pay as you go basis. Except for Voluntary Pension Schemes (VPS) which is regulated by SECP, this sector is unregulated and governed under Companies Ordinance and related Rules by SECP and Income Tax Rules. These laws are not comprehensive and loosely drafted to cover a few areas of management of occupational retirement schemes. A program to regulate occupational retirement schemes by SECP was shelved after the eighteen amendment in constitution that has made occupational retirement schemes a provincial subject. A revisit to the constitutional amendment and practical difficulties is necessary. In most jurisdictions, pension regulation is a federal subject. In Pakistan too management of retirement should be regulated at federal level by either SECP, State Bank or a new regulatory body, set up for regulating occupational retirement funds. State Bank with its outreach may have advantage over other regulators in regulating the occupational retirement schemes. Reforms in this sector are urgently needed to improve the governance, to increase the size of assets under management and to increase the number of persons under pension cover. Unfunded schemes in the private sector should be funded, whereas for Government a time line should be drawn during which funding level should be gradually increased.

Taxation Issues: Taxation of mutual funds is more complex than for stocks, because mutual funds are **pass-through entities** — the mutual fund does not pay income taxes/ capital gains tax on its income/ transactions; instead, the tax consequences of the transactions are passed through to the investors. The investor will typically receive the cash dividend on its investment on which Trustee has deducted the income tax. Investor can also redeem his/ her investment and realize a gain or loss on the transaction. In case of gain, the Trustee will deduct capital gains tax and pay the net amount to the Investors. There is a withholding tax system in place that requires Trustee to deduct tax that is due from unit holders before payment is made. The Pakistan Tax law requires the mutual fund to distribute at least ninety percent of its income, excluding capital gains. Income of VPS is not subject to income tax/ capital gains tax. In connection with income tax laws and based on recent experience with tax administration, following suggestions are proposed.

- For clarity and ease in administration, Income tax provisions relating to investment in mutual funds, REIT and VPS may be covered under separate schedules to the Income Tax Ordinance.
- For long term mutual funds (i.e. excluding money market funds), it is proposed that there should be no requirement for distribution. This will help accumulation of capital. However, as and when the mutual funds are redeemed these may be subjected to capital gains tax.
- The limit for four years holding period for capital gains may be removed for mutual funds as well as securities traded on the stock exchange.

- The capital gains may be calculated on average cost, rather than FIFO method for mutual funds as well as securities traded on stock exchange, as averaging gives a true reflection of cost.

- Tax credit on new investment in securities should be on long term basis and not for two years. It is imperative that investors should be encouraged to save during the working life and build capital assets and not for just two years.

- For VPS, instead of Government allowing tax credit on investment, the Government may allow at certain fixed rate top-up to acquire additional investment in units. This will help to mobilize investment in VPS from overseas Pakistanis also who are not tax payers in Pakistan and do not avail tax credit. The Government may either pay the amount of top-up in VPS in the same year or issue five years bonds in favor of VPS, bearing mark-up at market rate. This practice has been very successful in many countries and introduced in 2016 in slight modified form in UK.

Summary:

- There is a correlation between stock market capitalization and mutual funds' assets.
- If we want to increase the size of the capital market, we should promote national savings. Reliance on foreign investment should be only to the extent that it can supplement.
- Pakistan's Capital Market Capitalization to GDP ratio and Mutual Funds' Assets to GDP ratio is low.
- There should be tax incentive for new listings and for companies maintaining 40% minimum free float.
- Government may promote debt market. Corporate, Infra-structure projects and municipal authorities may be allowed to issue debt securities/ bonds; these must be rated instruments. SECP may prescribe code of corporate governance for all entities offering debt securities at stock exchange.
- Bonus shares are not income and as such should not be taxed. Government may encourage bonus issue as they increase market free float.
- There should be separate schedules in the Income Tax Ordinance to cover provisions for investment in Mutual Funds, REIT and VPS.
- For long term mutual funds (other than money market funds) there should be no requirement for distribution. However, there should be capital gains on redemption.
- Four years holding period for capital gains may be removed. Capital gains should be worked out by applying average cost of securities.
- Tax credit on new investment in securities should be on long term basis. It is imperative that investors should be encouraged to save during the working life and build capital assets.
- Pakistan must promote retirement savings. The Regulation to govern and regulate occupational retirement savings should be a Federal subject, rather than provincial.
- Private sector unfunded retirement schemes should be funded as soon as possible. Government entities may also fund the retirement schemes over a period of time. During this period funding level may be gradually increased.
- For VPS, instead of tax credit, Government may top up at certain fixed rate. This amount may be utilized to buy additional units in VPS.

Source of data:

- *ICI Global*
- *Housing Finance in Chile: Primary and Secondary Mortgage Financing by Claudio A. Pardo*