"Markets" are important; so is "Participation"

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Modern day historian Niall Ferguson in his book: "The Ascent of Money "narrates that the today's financial world has been the result of four millennia of economic evolution. Money – the crystallized relationship between debtor and creditor – caused the establishment of banks, clearing houses for ever larger aggregation of borrowing and lending. From the thirteenth century onwards, government bonds introduced the securitization of streams of interest payments; while bond markets revealed the benefits of regulated public markets for trading and pricing securities. From the seventeenth century, equity incorporations could be bought and sold in similar ways. From the eighteenth century, insurance funds and then pension funds introduced economies of scale and the laws of averages to provide financial protection against calculable risk. From the nineteenth century, futures and options offered more specialized and sophisticated instruments: the first derivatives. And from the twentieth century, households were encouraged to increase leverage and skew their portfolios in favor of real estate.

The detailed accounts of historical facts, given in that book, demonstrates that economies that combined all these institutional innovations – banks, bond markets, stock markets, insurance and property-owning democracy – performed better over the long run than those that did not, because financial intermediation generally permits more efficient allocation of resources than, say, feudal or central planning. For this reason it is not wholly surprising that the Western financial model spread around the world, first in the guise of imperialism, then in the guise of globalization. From ancient civilization to present day modern economies, in short, the rise of money has been the driving force behind human progress: a complex process of innovation, intermediation and integration that has been as vital as the advance of science or the spread of law in mankind's escape from the backwardness. In the words of former Federal Reserve Governor Frederic Mushin, "the financial system is the brain of economy.....It acts as a coordination mechanism that allocates capital, the life blood of economic activity, to its most productive uses by businesses and households. If the capital goes to the wrong uses or does not flow at all, the economy will operate inefficiently, and ultimately economic growth will be low."

Pakistan is not at all alien to these financial institutions. Let's scrutinize the state of affairs of these important financial institutions in the light of the recent assessment by the Securities and Exchange Commission of Pakistan (SECP) as provided in the Capital Market Development Plan (2016-18) issued in June 2016. The Plan has commented on collective national savings trait and performance of these institutions as under:

Savings Culture: The capital market is still not a popular mode of investment amongst the general public, due to which the market is not performing at the optimal level. The biggest challenge in this regard is increasing investor awareness, easy access, nationwide participation, and building investor confidence. The culture of savings and investment has not been promoted nationwide in the past. The past five years' average savings rate as a percentage of GDP in Pakistan was relatively low, i.e. 13.92% as compared to 31.9% for India, 29.7% for Bangladesh and 24.5% for Sri Lanka.

Banks and Non-Banking Financial Institutions: Vibrant and stable financial sector and capital markets play a critical role in the economic growth of a country. This, however, is only possible in the wake of a wide range of savings and investment products being available to meet the risk appetite of investors and the funding needs of borrowers. Unfortunately, this is not the case in Pakistan where the banking and non-banking financial sectors have not performed up-to the mark on this account. Even the banking sector despite having dominant position and privatization has not come up with major innovative products to adequately meet requirements of both depositors and borrowers at the grass root level. Investment in government paper continues to dominate the overall balance sheet of the banking sector while credit to private sector is limited to well-established corporate houses, leaving a large segment of small and medium size enterprises (SMEs) starved of funding.

The Plan highlights that the non-banking financial sector, second to banks in importance, also presents a bleak picture, not only in terms of financial assets, but also with regard to participation and outreach to the general public. The figures for the non-bank financial market participants provided in the Plan depict a tremendous need to increase awareness and outreach. In the stock market, there are only around 250,000 investors, which is around 0.125% of the total population, a vast majority of whom are based in the three large cities, while asset management companies and stockbrokers have limited presence in few major cities. With over 60% of the population living in the rural and semi-urban areas, the capital markets have negligible outreach there and even in the urban centers it is limited to the principal cities of Karachi, Lahore and Islamabad.

Stock Market: Despite being one of the best performing markets of the world for many years, the Pakistani capital markets as compared to other markets has a very small investor base. The capital markets will remain underdeveloped as long as the savings rate remains low. Also, the bulk of savings are drawn away by the Government and banks, the former carrying a "risk-free" status, while the latter primarily being used for payments, as depicted by the fact that total deposits over one year amounted to only 10.66 % of the total deposits with the banks, as of June 2015.

Debt Market: The debt market also remains largely inactive and underdeveloped, unlike other jurisdictions, because of which risk-averse investors have stayed away from the capital markets.

In the context of capital markets, the low number of investors has an adverse impact on liquidity and market efficiency. Small number of active investors leads to problems like low volumes, difficulty in fund raising by companies seeking capital, inefficient price discovery and consequently impaired investor confidence.

Following table show comparative standing of Pakistan in the league of other nations:

S.No	Particulars	Pakistan Figures	Pakistan Ranking	Top Country Name	Top Country Figures
1	Population	193 million	6th Largest	China	1,382 million
2	GDP	USD 270 bln	41st	United States	USD 17,946 bln
3	Per Capita Income	USD 5,000	131st	Qatar	USD 132,099
4	Human Development Index	0.538	147th	Norway	0.944

Low economic indicators and the lowest rankings globally may be attributed to our lack of advancement in finance. We as a nation failed to reap the benefit of financial innovations and resulting economic development. Above bleak figures, particularly Human Development Index, are an urgent call to tackle one of the great development challenges – providing decent work and livelihoods for all citizens of Pakistan; with 64 percent of its population below the age of 30, it is vital for Pakistan to invest in gainful employment for young people and ensure that the workforce adapts to the rapidly changing demands of today's world.

Those who are at the top of the ranking have developed robust financial institutions and benefited from it. They have encouraged savings culture, mobilized savings to productive sectors and attained national prosperity. We have institutions then where are we lacking? The answer lies in lack of participation by general public due to various reasons.

Before moving forward, let's understand the term "market participant". Market participants include individual retail investors and institutional investors such as mutual funds, banks and insurance companies. Some studies have suggested that institutional investors generally receive higher risk-adjusted returns than retail investors.

A few decades ago, worldwide, buyers and sellers were mostly individual investors, such as wealthy businessmen, usually with long family histories to particular corporations. Over time, markets have become more "institutionalized"; buyers and sellers are largely institutions (e.g. pension funds, insurance companies, mutual funds, index funds, exchange-traded funds, hedge funds, investor groups, banks and various other financial institutions).

The rise of the institutional investor has brought with it some improvements in market operations. There has been a gradual tendency for "fixed" (and exorbitant) fees being reduced for all investors, partly from falling administration costs but also assisted by large institutions challenging brokers' oligopolistic approach to setting standardized fees.

Direct participation occurs when any of the above entities buys or sells securities on its own behalf on an exchange. Indirect participation occurs when an institutional investor exchanges a stock on behalf of an individual or household. Indirect investment occurs in the form of pooled investment accounts (mutual funds), retirement accounts, and other managed financial accounts.

The historical trends in developed economies depicts that the direct ownership of stock by households rose slightly or remained flat during last few decades. However, indirect participation in the form of retirement accounts (equivalent of Voluntary Pension Schemes in Pakistan) rose significantly during the same period. The differential growth in direct and indirect holdings can also be attributed to differences in the way each are taxed. Investments in pension funds and other investment vehicles such as mutual funds, the two most common vehicles of indirect participation, are mostly taxed only when funds are withdrawn from the accounts; dividends are taxed but at lower rates. Conversely, the money used to directly purchase stock is subject to taxation as are any dividends or capital gains they generate for the holder. In this way the current tax regimes in majority of the jurisdictions including Pakistan incentivizes households to invest indirectly at greater rates.

The vibrant financial institutions are key to economic progress and prosperity. Also mere existence of these institutions does not guarantee development; participation is important. The recent successful participation has been led by institutional investors such as mutual funds or pension funds etc. If the goal is to achieve higher standard of living and prosperity then both the Regulator and the leaders of mutual fund industry should be on same page. Only they hold the key of the door which leads us to the bounties of prosperity and respectful standings in global comparisons.

In order to meet the challenges enumerated above, a concerted effort needs to be made on several fronts, i.e. creating awareness amongst masses about capital markets; ensuring accesses to availability and outreach of capital market infrastructure institution and products; instituting legal, regulatory, structural and governance reform for the market, self regulatory organizations (SRO) and intermediaries; introducing measures to restore investor confidence through improved compliance and enforcement; and giving incentive to promote corporatization and listing, to name the most important each of these is equally important and need to be developed / introduced side by side, so that they supplement each other, and cohesively contribute to overcoming the challenges, faced by the financial sector of Pakistan in general, and the capital markets in particular.

Realizing the need to formulate a comprehensive strategy to meet the challenges faced by the Pakistan's capital markets, the SECP initiated work on formulating a capital market development plan (CMDP) outlining strategic objectives and initiatives for coming three years. The said plan broadly focuses on introduction of key structural reforms for SRO and intermediaries, revision of existing law and framing legislation for new products, measure for encouraging new listings and increasing market depth, liquidity and outreach, development of vibrant depth, derivative and commodity markets, and measure for investor awareness and protection. The plan provides participants with clarity as to the vision, the objective and initiative for the capital markets. The plan ensures that the Pakistani capital market is well position to play its effective role in supporting the overall economic growth and development objectives of the country, while being dynamic enough to meet the challenges of globalization and external competition.