Future and Prospects of Bond Market Development in Pakistan: A Review

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Abstract
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 very much limited to bank loaning and issuance of equity stocks. There is a frantic need to disseminate apposite information to reassure the potential investors in household and institutions, in order to make them convinced that the investment in local bond market is a rational decision and it will maximize their portfolio returns. Small and medium sized issuers, 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.

Keywords: Bond Market Development, Emerging Economies, Yield Curve, Investment, South Asia

1. Introduction
Development of efficient financial markets is important for strengthen the financial sector and sustainable economic growth. Highly liquid and tradable domestic financial markets provide different financing and investment opportunities for investors (Fabella and Madhur, 2003). Financial markets are classified in terms of time period or time duration. Market consists of securities having less than 1 year maturity period are called as money market like treasury bills,
saving accounts, certificate of deposits, REPOS etc. whereas securities having maturity period of more than 1 year will be traded in capital markets for example stock market and bond market.

Earlier, corporation can acquire funds from three different sources: retained earnings, equity and bank borrowing. Each of them has its own merits and demerits. According to Pecking order theory if firm has an opportunity to invest in a positive NPV project then at first he has to use its own retained earnings. After that instead of selling shares in market, which gives negative signal to investors, he has to raise funds through debt. If still there is a need for cash then it will be acquire through selling shares. But after 1990s Asian financial crises and 9/11 U.S incident, corporations are in search of new financing opportunities that reduces their risk and decreases cost of capital.

In late 1990s corporate bond plays a significant role in stabilizing financial systems and economic growth. It emerged as an alternative option for acquiring funds form large number of public at the market rate (Nozue, 2007). Bonds consist of paper having a stated amount of coupon rate, maturity time and face value. It is categorized as debt because of its interest feature and superior nature at the time of liqation. It gives the buyer a claim on firm’s income – interest income and face value at the time of maturity. From an issuer’s point of view, during low interest rate period bonds provide them a cheap source of finding. It also reduces the banks spread by providing favorable returns by pressurizing banks to increase their returns on deposits and savings and during the period of rising interest rate it reduces the purchaser rollover risk by issuing fixed interest bond. Hence, well-organized bond market provides new investment opportunities, enhances efficiency of resource allocation and reduces systematic risk.

In Pakistan, the development of money market and bond market was initiated in late 1990s after the liberalization reforms; however, Pakistan bond market is at its initial phase and has a very slow pace of development, just 1% of GDP, as compared to other countries (Hameed, 2006). Like other emerging market, most of the debt financing in done through bank borrowings. With the brief importance of bond market, further this study explains the current status of Pakistani bond markets and major impediments faced by it.

2. Role of the Bond Market in the Domestic Economy

2.1 Domestic Bond Markets in Asian Economies

Prior to the financial crises of 1997, the financial systems of Asian economies possessed the following characteristics, which were typical of the early stages of development: heavy dependency on the banking system, and a more distinct unevenness of information between borrowers and lenders. This dependant “one-pillar, bank-dominated financial system hold many risks, like possible efficiency losses, limited options available for investors and borrowers, increased systemic risk, and limited efficient pricing of risk by the financial system (Plummer and Click, 2003). Therefore, other financial intermediation vehicles, including equity and fixed debt markets, was used as meaningful way to diversification.

Turner (2002) has pointed out the some advantages to the government bond markets in emerging economies such as helping to fund budget deficits in a noninflationary way, and enhancing the effectiveness of monetary policy. In fact, government bond markets have been used for the
The conduct of monetary policy by many central banks. There are manifold interests of central banks in the development of bond markets. Central banks operate as agents for the government in different aspects of the management of government debt. They supervise clearance and settlement systems, and they are liable for the stability of the financial system as well as directly supervising the banking system.

Turner (2002) suggested two basic reasons to pursue development of the bond markets in emerging economies. Firstly, local debt markets generate market interest rates that reflect the opportunity cost of funds at each maturity levels. Secondly, the existence of tradable instruments helps effective risk management and efficient diversification. The first is essential for proficient investment and financing decisions, while the lack of the second one may cause mismatches that involve excessive risks, as liquid markets help financial market participants to hedge their exposures. Along with these, costs of intermediation may be lowered and the financial system may become more efficient and stable.

Furthermore, there are more instantaneous reasons for bond market development, which includes financing fiscal deficit, sterilizing large capital inflows and giving private borrowers access to long-term finance which may be from capital markets or mediated by banks. For instance, corporations need to finance long term investment projects expected to yield returns in long run, while households may use long mortgages to acquire residential properties. Institutional investors need to hold long-term debt, and these institutions may be seen as key to the development of bond markets. However, holding a high proportion of assets in government bonds by these institutional investors can create a captive market, and may effectively deter other investors (ibid).

2.2 Pakistan Debt Market

With the independence of Pakistan, the stock market and SBP starts to perform its operations. At that time financial system of Pakistan was very weak. Then with the passage of time private sector starts to develop that in 1970s acquired by government. This trend increases in period of 1970-1990s when private sector is almost shrunk and government take control. Then post 1990s time period consists of financial liberalization reforms that were initiated to reduce the Government deficit.

At that time with the privatization reforms, Government starts to issue fixed income securities to pool funds form public for reduction of government deficit. Government borrows on tap instruments having predetermined rates. Captive Finding was provided by SBP that was restricted later on by increasing the statuary liquidity requirements and cash reserve requirements. So as whole fixed income market for government securities was not properly developed that could provide benchmark yield for corporate securities.

The first long term bond issued in 1992 thus giving an opportunity to corporation to issue a bond by taking that long term yield curve as a bond. Hence a series start in 1995 when the first term Finance Certificate was sold in market then later on in 2000 and Pakistan Investment bonds are sold by Government. But due to the limited supply of government’s securities a representative long-term yield curve had not formed which constrained the development of corporate bond market.
Market Treasury Bills (MTB) is short term debt issued by the government to raise funds for less than 1 year at a risk free rate. These securities can be sold in the secondary market. In addition to it, government of Pakistan had launched Pakistan Investment bonds in 2000 for long-term financing. These bonds are issued for the tenor of 3, 5, 10, 15 and 20 years of maturity. There also exists secondary market for these securities. Government has started national saving schemes for retail investors. Another one is term finance certificate. TFC are issued by corporation for a specified time period at both fixed and floating interest rate by both financial and non-financial institutions. Returns in these securities are changed with the maturity and credit risk of the issuer.

According to the detailed World Bank report in 2009, the domestic bond outstanding was 25.16 percent of the GDP, equivalent to $32.41 billion. This consists of mainly government bonds, as the corporate market is yet to develop. Currently, Outstanding T-bills are roughly Rs. 700 billion. Banks hold Rs. 658 billion worth of short term paper and the remaining six percent or Rs. 42 billion are held by corporations. Outstanding PIB amount is Rs. 425 billion, out which, Rs. 250 billion or 60 percent of holding is with non-banks and corporations. Of the remaining Rs. 175 billion, approximately Rs. 40 billion is held in held-to-maturity (HTM).

Bonds worth Rs. 95 billion are in 15 years tenor and beyond, they are not traded in the interbank market and are mostly subscribed by insurance companies, pension funds or held by corporations as investment of gratuity or provident funds. The daily interbank average PIB trading volume is roughly Rs 25-30 billion. Daily Treasury Bills outright trading volume is not even Rs one billion. This clearly reflects a serious lack of depth in the market. Corporation that hold 60 percent of the total PIBs do not trade in bonds and hold the paper as investment in long term securities. Therefore, to increase market activity, government institutions need to play an active role in developing secondary market by increasing two-way trading activity, otherwise bond market will never grow.

3. Development of Bond Market in Pakistan
The literature on future and prospects of bond market development is vast and growing (Herring and Charusripitak; 2000, Luengnaruemitchai and Ong; 2005, and Leanardo; 2000). Difference researchers have found difference impediments and proposed solutions to boost the process of bond market development. However, we will discuss here only the prospects and impediments which apply directly to emerging market of Pakistan.

3.1 Developing Benchmark Yield Curve
Due to little trading of government and corporate bonds long-term yield curve had not established that had limited the trading of private bonds. There are two main reasons for non-existence of yield curve. First, because of government ownership the rate of return is very low as it is not market driven. However market demands higher rate that’s why most of the auctions bids are rejected. Further on, Institutional investors and banks are pressurized to invest in these securities even at low interest rate. Even if they invest they are less inclined towards its trade and stay it with them until it held to maturity. Secondly, because of less supply the prices of bonds increases, this increase in price is just due to the supply and demand not because of market attractiveness of these securities. These all factors limited the secondary market for these
A benchmark yield curve is developed by introducing a large number of bonds in the market, increase trading of these securities and through increasing market by making entry easy for both domestic and foreign investors. In 2006 PIBs auction shows a government intention towards the development of long-term yield curve.

3.2 Crowding out by Government Securities
The government and corporations both are pooling funds for the same resources. But the government securities are risk free and providing returns at lower rate. As compared to it the TFC has higher rate of return and contains some risk in it. The return on TFC issued by corporations has a rate of return equal to the Defence Saving certificates by Government which is risk free and have a maturity time period of ten periods. This game of pooling the funds by government and corporation becomes a major hurdle in development of bond market. The government financing through NSS should also be reduced because it crowds out the private sector and distorts the market rate for long term funds. The decision to allow institutional investors into the NSS should be reversed at the earliest possible time because that will divert much of funds available for TFCs to NSS at non-market rates. The rates on NSS should also be steadily reduced because they act as a substitute for benchmark long term rates.

3.3 Market Psyche regarding disclosure requirement
Pakistani investors are more risk averse and due to lack of transparency the corporate debt issued by the corporations are less attractive to traders because of unknown risk inherent in them. So by appropriate disclosure of firm future growth and risk, firms can attract large group of investors at a favorable rate. Availability of data on secondary market transactions plays an important role in making the price discovery process more efficient leading to improved liquidity. Much of the secondary market trading data is already available on the SBP website. This data maintenance process can be further strengthened by providing the data on a historical basis and in a readily usable form. The stock exchanges should make it mandatory for their members to report any debt securities transactions.

3.4 Higher transaction costs
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 investors to invests in the bond market because it further on reduce the rate of returns. And form the issuer’s point of view it increases their cost of capital. In order to reduce the cost of issuing TFCs, the government could reconsider the stamp duty on TFCs.

3.5 Illiquid Secondary Market
Higher transaction cost, thin market, inexperience players, no proper settlement system and little competition all led to a significant decline in the secondary market for bond. Due to high risk and non-availability of benchmark yield curve investors are reluctant to invest in bonds and then further trading. In addition to it, it is difficult to price fixed-income securities having different characteristics, features, covenants, requirements and risk inherent in it. For all this a proper financial analysts are required that are not available in Pakistan. To overcome this problem the government should stop its borrowing from the SBP and place a fresh supply of PIB in the
3.6 Diversifying Investor Base
Market size of bond is very limited and mostly borrowed by bank and institutional investors that prefer a security to hold it until maturity. That will later on restrict the development of secondary market. The spread of bond ownership in limited hands and their avoidance of further sale limit the number of investors. Government should increase the market share by issue new long-term bonds securities having different options according to the types of investors at a market prevailed interest rate so that it would attract a large number of investors.

3.7 Developing the Talent Pool
Along with the diversified pool of issuers and investors, the presence of intermediaries is also crucial in structuring the transactions and providing secondary market support. The government needs to introduce a tax incentive scheme to improve capabilities in the arrangement, distribution and trading of bonds.

3.8 Development of Infrastructure
A well developed and efficient clearing, settlement, registration and trading center should be established for a good bond market that will centralize all buying and selling of securities. However in 1993, the Central Depository Company of Pakistan Limited was created for the settlement and clearance. In addition to it, two credit rating agencies Pakistan Credit Rating Agency (PACRA) and JCR-VIS.

3.9 Legal and Regulatory Structure
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. Explicit rules regarding monitoring and accountability for both issuer or dealers and investors ensures public about safety and protection level of their investments. Regulations of SECP regarding bond issuance is much more complicated and carrying time and cost with it as compared to the bank borrowing. So, a new legal and regulatory structure must be developed according to the market preferences and should be equal for all the issuers. Implicit and relaxed regulation will shatter investor confidence and adversely effect economy. In view of market participants, SECP should maintain a regulatory framework for the monitoring of all the elements of debt security markets. Rapid changes in the rules and regulations have also eroded the confidence of the market. Rules should be settled related the operational independence of credit-rating agencies. In addition to it, SECP should take certain actions regarding the reduction in time of issuance and registration of corporate bonds.

4. Conclusion
Bond Markets are increasingly becoming a significant source of financing for the private and public sectors in Pakistan. Corporate financing in Pakistan, similar to other emerging markets, is dominated by bank loaning and issuance of equity stocks. There are a number of advantages to development a domestic bond market to harmonize the banking sector. These include increased financial stability, more competitive financial sector, more efficient allocation of credit, and a well organized and diversified portfolio of assets. The domestic bond market in Pakistan has
faced marvelous growth since its commencement in 1995. Recently, more and more financial institutions are focusing on the term finance certificate market as compared to non-financial firms. Although the local bond market is growing and issuance of local bonds is increasing over the year; however, there are some impediments to bond market development still exist which includes lack of long term bench-mark rates as a result of thin secondary market for sovereign bonds, crowding out of the government securities and some administrative barriers in term of high trading cost.

There is a yet lot to do by the regulators to support the local bond market development. This can be promoted by regularly issuing local currency bonds at market rates regardless of financing needs, concentrating issuance on multiple lengths of maturities and reducing borrowing from unfunded sources. The liquidity of the bond market could be enhanced by strengthening data and useful information dissemination regarding corporate bond transactions, providing a REPO facility for corporate bonds, and allowing short selling. Finally, transaction cost in terms of stamp duty and administrative costs should be reduced to make bonds issuance more cost effective.
References


