Shamshad Akhtar: Pakistan's capital markets – mobilizing for growth

Keynote address by Dr Shamshad Akhtar, Governor of the State Bank of Pakistan, at the Pakistan Capital Markets Conference organized by Pakistan Business Council and IFC, Karachi, 5 September 2006.

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Good Morning everyone. At the onset I would like to thank Mr. Saleem Raza for inviting me to speak at this conference, and I would also like to acknowledge all the distinguished participants.

A lot has been done in Pakistan in terms of financial sector reforms. These reforms have been substantive both in the banking sector as well as in capital markets. We have implemented what you may call the 'first generation of reforms' and now we are positioning ourselves for the next ten years. I think there is need to give another jolt to the system and enhance, broaden and deepen the reforms. The first phase has yielded positive results and we are reaping the benefits of that phase. It is in the context of the second generation of reforms that we need to put together all the ideas that come out of international evidence and structure the way forward. This I believe is very important and I hope that today's forum will give us the opportunity to debate these issues because it's all about policy choices, and we have to choose a route which is more conducive for Pakistan.

Personally I am fascinated and amazed by the changes in the global financial landscape. I think if effectively exploited, these opportunities will augur well for emerging markets in general, and for Pakistan in particular. A few points to note:

(i) First, capital today is more mobile than it ever has been and can be readily deployed internationally. I say this because after the East Asian crisis there has been a lot of emphasis on capital flows and their resurgence. Just looking at the numbers from IIF, private capital (net) flows to emerging markets surged in 2005 to $400 billion[1] with 55% by way of equity flows (almost three fourths being FDI and remaining portfolio investment) and 45% private credit flows via commercial banks or other Financial Institutions.

(ii) Within this overall global framework there are certain dilemmas, and one of the major issues is that of global imbalances. These imbalances have changed the global and financial market dynamics. Emerging market economies, traditionally the recipients of foreign capital, are a source of net foreign capital outflows and collectively finance the large and growing U.S. current account deficit. More importantly, the accumulation of East Asian reserves and their rise to US $1.7 trillion reflects the real potential of this region to self-finance its requirements and to offer other Asian economies capital, the source of which otherwise has been, in case of South Asia, the industrialized West. So I see the opportunities for Pakistan, to first of all tap the overall pool of resources and within that context, also start looking towards the East Asian region where there is a substantial surplus of available resources.

(iii) Third, the enhancement of overall global liquidity, besides serving capital deficit in parts of the world, has cross-border spillovers and largely stems from growing financial integration, particularly among the G8 countries. The level of integration outside these countries varies and there are theoretical studies which point towards that. The fact of the matter is that the financial world is now much more closely integrated than ever before. The integration of financial systems has played a role in enabling the global imbalances to persist and to be easily financed without blocking growth. However, emerging markets which are capital deficient, with external vulnerabilities, do face the risk of exchange rate fluctuations (because of either the dollar weakening viz a viz other currencies, or internal country dynamics) and asset price volatility because of adverse movements in relative stock prices.

Generally, the global environment remains benign although there was a very hot debate at the recent BIS annual meeting which I attended, where there was a huge concern that expectations of inflationary tendencies remain both at the regional and international level, and consequently most economies have actually tightened their monetary policies, or at least have withdrawn monetary stimulus on a timely basis which would improve the long term global economic growth prospects and

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[1] Institute of International Finance (IIF), March 2006.

interest rate scenario. Moderation of long term interest rates in many ways is central to the pricing of assets, both real and financial. The world wide movement in interest rates, and also in Pakistan, will help achieve a more realistic realignment of prices. This in turn facilitates global financial stability which is critical for emerging markets, including Pakistan, to benefit effectively from capital flows.

These trends that I have talked about offer Pakistan tremendous opportunities, provided that Pakistan pursues and sustains market confidence. Besides political stability, there is need for Pakistan to adhere to its (a) prudent macroeconomic policies, (b) further deepen and diversify financial markets, and (c) to reinvigorate structural reforms that foster productivity gains which will also keep the financial sector alive. These factors are a prerequisite for Pakistan to:

- attract and maximize capital flows;
- mitigate macroeconomic risks stemming from capital flows; and
- develop a well balanced and vibrant financial sector

With this global perspective, I would like to offer some views on financial market development in Pakistan.

Financial market development in Pakistan has, and will remain, the primary driver of economic activity. I always say that we have changed the economic dynamics in Pakistan. Normally the real sector leads financial market development but in Pakistan financial market development has stimulated the real sector**.** Over FY00-06, Pakistan has attained an average economic growth of over 5% which, among other factors, has been helped by the growth in overall credit in the range of 16.1% per annum. Private sector credit growth has actually far exceeded these average growth rates in recent years (average annual growth observed in the range of 18.3%). Bank credit has grown rapidly, serviced diverse needs and ventured into new areas such as consumer financing, which has stimulated the demand for durables. However, over half of the credit still flows towards the large corporate sector and in terms of tenor, bulk of the credit is for less than 1-2 years. Furthermore, private sector credit still does not meet the full requirements of the economy. For example, the investment requirements of the infrastructure sector are enormous which conservatively are estimated to be in the range of US$ 39 billion,[2] and in the agriculture sector bank credit meets perhaps half of the real demand, although its share has grown phenomenally. Across the board credit flows to the corporate sector, infrastructure, and agriculture sector, etc are likely to rise as the investment environment improves further. So what do we need to do here? We need to position our banking sector to deliver these diverse sector requirements.

Does the financial sector have the potential to meet these investment requirements which are critical to stimulate economic growth to achieve above average trends ? My inference is that there is need to introduce more depth and breadth in financial markets. The M2/GDP ratio – an indicator of financial deepening – has grown in Pakistan, but when Pakistan's financial system structure is compared with the structures of the East Asian Economies given in the recently published World Bank report, we get an indication of where we stand in the year 2005 :

- Bank assets as a proportion of GDP in Pakistan are 56% relative to China (200%), Malaysia (162%), Hong Kong (443%), Singapore (185%) and Philippines (61%).
- Equity Market capitalization as a percentage of GDP in Pakistan was 31% in 2005. Although now it has increased to 40% and in fact, went up to 44% in April 2006, but it is still substantially low relative to Malaysia (141%), Thailand (67%) and Korea (90%).
- Likewise, the volume of bonds outstanding as a percent of GDP is merely 5.5% in Pakistan compared to Malaysia (90%), Singapore (68%) and China (27%), although in China the bulk of these bonds are sovereign.

While Pakistan has definitely improved quite a bit, when we compare ourselves to the region, we are still lagging far behind and for me this is where we should strive to make more inroads. In my view, not only is there more room for banking assets to grow, but more fundamentally, there is now need to finally jolt the non-bank financial sector more strongly. It is indeed noteworthy that the growth of KSE[3]

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[2] Conservative estimates, as stated in the Medium Term Development Framework, 2005-2010, Planning Commission of Pakistan.

[3] Karachi Stock Exchange

market capitalization has risen from under 2000 points to over 10,000 points in the last few years, and went on to record highs of 12,274 points on April 17, 2006. Average daily turnover is remarkable, which, at 525 million shares, makes KSE one of the most liquid markets. Likewise the P/E ratio of 9.45 is extremely attractive when compared with average price earning ratios of neighboring countries. Likewise, KSE's dividend yield ratio also offers good prospects relative to other emerging markets. However, I still maintain that Pakistan's capital market lacks sufficient depth, breath and maturity. It is prone to structural vulnerabilities and manipulation. This is confirmed by the decline in the number of listed companies from 762 in the year 2000 to 658 in 2006. Moreover, as I have already mentioned, market capitalization as a percentage of GDP is still low and there are very few listed debt securities.

But there are promising prospects and with various stakeholders' efforts, the stock market has achieved many milestones. The Stock Exchanges have fully automated the trading system with a T+3 settlement cycle. The shares are traded in dematerialized form and settlement takes place in a paperless environment through the Central Depository Company and National Clearing and Settlement System. The recent step of implementing the Unique Identification Number (UIN) will substantially strengthen the disclosure regime and will go a long way in bringing more transparency in trading, work as an effective deterrence against market manipulation, and will be very helpful in investigating and probing any wrongdoing.

Besides the need for broadening and deepening of reforms, we need to further enhance the efficiency of financial markets and institutions to lower intermediation costs**.** By and large, Pakistan's financial sector has performed fairly well within the South Asian context as the system has benefited from the (i) privatization of banks, (ii) consolidation of the banking sector, (iii) strengthening of the prudential regulations for the banking industry; and (iv) introduction and enforcement of corporate governance.

According to World Bank's ranking, Pakistan is marginally behind India in access to finance and efficiency, whereas it ranks the highest in corporate governance in the South Asian region.

Final Ranking of SAR Countries

Description	**B'desh**	**India**	**Nepal**	**Pakistan**	**SL**
Access to Finance	0.57	0.67	0.33	0.55	0.80
Performance & Efficiency	0.51	0.73	0.40	0.70	0.66
Stability	0.50	0.97	0.43	0.68	0.40
Corporate Governance	0.68	0.84	0.68	0.90	0.69
Total	2.25	3.21	1.84	2.83	2.55
Score [Total Points/4 (core indicators)]	0.56	0.80	0.46	0.71	0.64
Rank	**4**	**1**	**5**	**2**	**3**
Source: The World Bank					

The efficiency of the banking system has improved, and can be gauged by the lower intermediation cost, which has fallen to 2.7% relative to 3.4% in the year 2000. Average earning per share (EPS) has increased. Deposits and Assets per employee have also risen. Likewise, the cost to income ratio has decreased to 42% from 72% in the year 2000. Although some of the efficiency indicators have shown improvement but the problem of high spread belies the story. The very high spreads undermine the efficiency of the banking sector.

In the context of the equity market, I believe that the lack of depth and breadth and weaknesses in the price discovery mechanism, with multiple exchange floors and gyrations in equity markets driven by speculative tendencies, undermine the process of stock valuation. The end result is that it is costly for companies to raise capital from stock markets which keeps individual investors, with less appetite for risk, totally out of these markets.

Further enhancement of market depth and liquidity by way of listing of more primary issues, promotion of the secondary market in debt securities and strengthening of regulations and their enforcement would help mitigate perceptions and risks.

Let me now move to another point that I would like to convey. While in Pakistan there is an emergence of interdependence of the banking sector and capital markets, globally, regulatory frameworks allow a more systematic fostering of the financial sector inter-linkages. This has helped to exploit different segments of the financial sector to mutually reinforce and innovate institutions, markets and products**.** In Pakistan, the relationship of the banking sector with the capital markets has many facets and I would like to take a few minutes to talk about that because it indicates some interesting trends.

State Bank has allowed banks and DFIs to establish subsidiaries for conducting brokerage business and some banks have already purchased membership rights of the stock exchanges and have established subsidiaries. Corporate Governance standards of these subsidiaries and their systems and procedures are expected to be much better and advanced than their peers. This will not only improve the image of capital markets but will also encourage other brokerage entities to improve their corporate governance, systems and procedures.

Banks and DFIs have also been allowed to establish Asset Management Companies (AMCs) to float and manage mutual funds. A number of banks have established AMCs and have launched both open-ended and close-ended mutual funds. This clearly will have an additional impact on improving the corporate governance of listed companies since they own substantial holdings, have significant incentive to ensure that the companies invested in are managed properly, have the requisite negotiating powers as well as the expertise to safeguard the interests of minority shareholders.

In addition to this type of inter-relationship between the banking sector and the capital markets, there is another direction in which we have nurtured the relationship. First of all, the prudential regulatory system actually sets the exposure limits of the ownership and cross-share holding and has been set in place to safeguard the interest of the banking sector, which I believe is more stable than the remaining parts of the financial sector**.** In this regard, the following limits have been prescribed by State Bank of Pakistan for banks and DFIs for their activities related to capital markets:

- For lending against shares, banks/DFIs are required to maintain a minimum margin of 30%.
- The total investment in shares has been capped at 20% of the equity in case of banks and at 35% in case of Islamic banks and DFIs.
- The investment in a single company by any bank/DFI has been limited to 5% of their equity.
- The total exposure which a bank can take on a single company in the shape of direct investment in its shares or by lending against the security of its shares has been capped at 30% of the paid-up capital of the company.
- Banks/DFIs are also required to obtain prior approval from State Bank if they wish to invest in any company in excess of 5% of their own paid-up capital or 10% of the capital of the company.

The reason why I have mentioned these details is because I wanted to show what this prudential regulatory structure has resulted in. Empirically we know that direct investment in the shares of listed companies has grown from approximately Rs. 16 billion in December 2001 to Rs. 38.9 billion by December 2005. Likewise, financing against quoted shares has grown from under Rs. 5 billion to approximately Rs. 39 billion over the same period. The bulk of the liquidity in the capital markets is in the form of CFS[4] or what was earlier called as *Badla*.

(Rs. Million)

[4] Continuous Funding System

Year	Dec 2001	Dec 2002	Dec 2003	Dec 2004	Dec 2005
Financing against Quoted Shares	4,598	7,371	13,393	35,506	38,872
Investment in Shares*	16,132	23,164	29,797	24,623	36,370

Another important statistics worth quoting is that financial institutions represent one fourth of the total market capitalization. The reason why I am going through all of these statistics is to illustrate that there is a regulatory framework that guides this interdependence and defines the regulatory architecture, and moreover, there is a movement towards greater interdependence and inter-linkages. But is this sufficient or should we do something more? What lessons can we learn from international markets?

In other jurisdictions and particularly in developed markets, the relationship between the capital markets and banking is much deeper and clearly more interdependent. This has encouraged the development of the mechanism for risk sharing and risk transfers, such as derivatives and securitization, which allows proper financial leveraging by enhancing the risk-bearing capacity. Of course emerging worries about the associated risks and their different dimensions have motivated a fundamental rethinking of the Basle capital adequacy standards, regulations and supervision. Besides complexities of capturing and estimating all types of risks, concerns regarding contagion of volatility in one segment of the market to another, have motivated BIS to define more elaborately the requirements for safeguarding the financial sector by introducing stringent prudential regulation, restraints on counterparty exposures, using joint conglomerate supervision systems to keep a vigilance on risk exposures and, verifying the corporate governance standards by trying to keep them as uniform as possible.

Now where do we need to go from here? I think there are two important messages that I would like to convey. The first basically relates to the need for re-examination of the legal and regulatory framework. This brings me to a 2002 paper of mine which I had presented in Japan. At that time there was a big debate after the financial crises on what Asia needs to do to diversify its financial sector. One of the major stresses was on the need to nurture more systematically the interdependence of the capital markets and the banking sector.

International evidence suggests that in United States, amendments were made in banking laws which were seen as a way to enable the US banks to remain globally competitive. Adopting this new law resulted in ending 60 years of segregation of activities of banking and securities markets. The US congress recognized that many of the arguments raised in successfully segregating both the activities in the past were no longer credible. So although the new law in the United States today enables banks through financial holding companies' structures to engage in security market activities through an affiliated brokerage firm, nevertheless the banks are still prohibited from directly engaging in retail securities. Financial holding companies and subsidiaries engaged in brokerage activities are required to register with the US Securities and Exchange Commission. Where brokerage affiliates operate on bank premises, they are required to notify the customers that their securities products are not insured by the Federal Deposit Insurance Corporation (FDIC) and that these are not deposits or other obligations of the bank and are subject to investment risks. Securities affiliates of the bank may also engage in underwriting as long as certain funding and capital restrictions are satisfied.

In most continental European countries, the banking legislation does not distinguish between the commercial and investment banks. Any institution authorized to operate as a bank may offer a wide range of financial services. Banks must comply with standard prudential requirements while engaging in these activities and universal banks may also be able to control the equity participation in the industrial firms. The implementation of the relevant European Union directives and the rise of mergers and acquisitions between banks, securities companies and insurance companies support the universal nature of European banking.

The US and European banks are able to offer sophisticated financial products, establish international conglomerates putting pressure now on Asian banks to improve the product offerings in their own markets. Although universal banks already exist in many Asian countries, in general, Asia lags behind in this aspect. Not all Asian countries permit universal banking. For example in China, the law strictly segregates banking and securities related activities based largely on the conflict of interest concerns and unique situations arising from the Government's dominant role in the banking sector and the securities markets, both in the capacity of owner as well as regulator.

To me whether we take this route or that route, it is important for us to have some reflection because we need economies of scale, and we need credit diversification and efficient delivery of financial services. In order for us to compete, we need to look at the other structures. Similarly, we all know about what has been going on in the insurance and pension system as reforms there have been delayed so much that I feel that we should now look at more innovative structures. Before we delve into any of these areas, as regulators, we need to reflect about which regulatory framework would be appropriate.

Finally the other point which I want to talk about is the need for us to be risk-takers in the financial markets. As a central bank, I feel that we have done our job by introducing the necessary regulations and the framework for derivatives and products of that nature. These regulations provide guidelines for transacting OTC derivatives in the country and currently permit three types of derivative transactions:

1. Foreign Currency Options (FX Options),
2. Forward Rate Agreements (FRAs) and
3. Interest Rate Swaps (IRSs).

So far we have managed to grant the status of the authorized derivatives' dealers to three banks: Standard Chartered Bank, Citibank and United Bank Limited.

The use of financial derivatives is a recent phenomenon in Pakistan and the first such real derivatives transaction took place in August 2003 which was a Rs. 100.0 million FRA. During the last one and a half years, the derivatives market has grown considerably. Besides the plain vanilla products as mentioned a minute before, the market is slowly and gradually moving towards more complex and exotic structures. All approvals are reviewed & approved under specific transactional approval process by the Derivatives Approval & Review Team (DART) at SBP. I know that some people would like to see this fast tracked and we have taken steps to do so. Though the specific transactions approved thus far are more complex and include variations of Cross Currency Swaps (CCS), IRS with embedded option, etc, the total volume in derivatives is still very low. In FX options the Pak rupee equivalent is merely 177 million and FRAs 9.650 million and so forth. The numbers are still very small despite having grown substantially. The point of going through these statistics is to highlight that there is a lot of work to be done in this area.

In conclusion, I would like to say that Pakistan has phenomenal opportunities in what has been going on globally in terms of private capital flows in terms of the savings that exist due to reserve accumulation in the region. Secondly, we have to be proud of what we have achieved but at the same time we need to remember that there is still a lot more to be done. There are emerging trends of the nexus being developed between the capital markets and the banking sector and other segments of the non-banking sector. However, it is merely a small fraction. Moreover, there are clearly lots of lessons that can be drawn from international and regional experiences of how we can foster these inter-linkages and safeguard these effectively with the appropriate regulatory framework. I believe with us moving towards Basel II, while also positioning ourselves at the central bank with better supervision of the joint conglomerates, we should be able to offer these safeguards and oversee things more effectively. So I would like to encourage this forum to deliberate more on how we can go about nurturing this and what further steps are needed to promote innovation in the markets.

Thank you very much.