Development of TFC Market in Pakistan: Challenges and Prospects

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Abstract:
This paper discusses the need for corporate debt market in the financial structure of a country with a view to find a rationale through the use of cost-benefits analysis framework. An analysis of the corporate debt market of Pakistan has been included to develop models, identify problem areas / factors inhibiting its growth and recommend measures for facilitating solid, sound and strong market in the country. It also includes a financial market maturity model that can be applied to the developing and emerging economies of the world.

1. INTRODUCTION

The bond market is vital to any economy. It raises the capital to build infrastructure, helps promote the economic growth [1], fuels investment that in turn creates jobs, and enhances market efficiency. Theoretically, bonds lower the cost of borrowing and provide an effective channel for savings to feed through. It is believed that the bond market is the foundation of the capital market and plays important role in mobilizing savings into productive investment that promotes economic growth and development.

Pakistani corporate bond market (CB) is only partly developed by international standard. In Pakistan, the Term Finance Certificate takes (TFC) the form of Corporate Bond. The analysis of the market suggests that there is no clearinghouse in the market and trading is done on one-to-one basis.

The history of TFC is not very encouraging. The first TFC issue came in 1994 from Sapphire Fibre Ltd. at 19.5 percent rate of return with maturity period of five years followed by Packages Ltd. (1995) with 18.5 percent and maturity period of five years. At that time, the pricing of these instruments was benchmarked with underlying base rates of National Savings, 16 percent and Discount rate, 15 percent. First ever Islamic TFC came from Al-Zamin Leasing in January 2004 based on the principle of Musharaka. The concept of Islamic TFC was floated jointly by Modarba Association of Pakistan and AMZ Securities duly certified by Dr. Muhammad Zubair Usmani of Jamia Daarul Uloom Karachi as being compliant with the principles of Islamic Shariah [2].

TFC market in Pakistan reflected maximum issuances of 9.54 billion rupees during the year 2002 and by 7.98 billion rupees in the year 2001 (Figure 1). March 2000 and onwards witnessed increase in TFC issues probably due to the policy change by the Government whereby the institutional investors were prohibited from buying

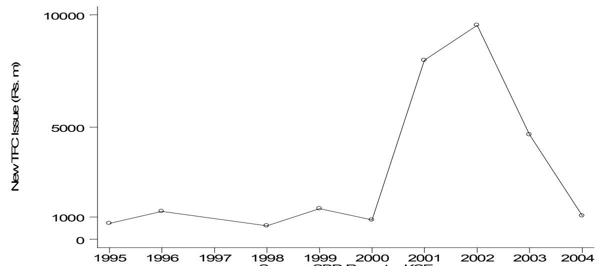

Figure1. New TFC Issues in Pakistan

National Savings Scheme (NSS) instruments. This reinforces the hypothesis that institutional investors are very important in the development of the Corporate Debt Market. Since 1995, fifty seven issues came to the market despite public policy intervention. This also shows lack of interest on the part of the issuer and modest borrowing desire from them. In the initial years, there was no well-established government benchmark against which corporate bonds could be priced.

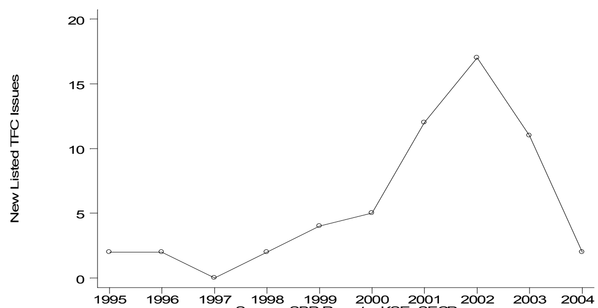

Figure 2. New TFC Issues in Pakistan

Maximum number of new TFC issues also came in the year 2002 (Figure 2). Primary market of Corporate Debt in Pakistan showed sizeable activity during the period 2001-2003 (Figure 2). It is expected that the market will pick up further during the current calendar year.

No compiled official data is available for the TFC market in Pakistan. The TFC market size has, however, reflected an increase over the years. It stood at 28.308 billion rupees by February 2004, which constitutes 0.826 percent of GDP. When taken in terms of percentage increase, it seems impressive but not comparable with the Asia Pacific economies. All in all, the Pakistani TFC market is still premature and practicing learning-by-doing approach.

A comparison of Indian and Pakistani Corporate debt market reveals the fact that our market is less developed and struggles to seek a leveled ground. An analysis of sample data for the years 1999-2001 for the two markets suggests that the new Indian Corporate Debt Market issuances during this period remained at an average of 3.41 percent of GDP per annum compared with new TFC issuances in Pakistan at 0.105 percent of GNP (Table 1).

Table 1. Growth of Corporate Debt Markets in South Asia

Year	Indian CD Issues* (IR bn)	Pakistani CD Issues** (PKR bn)	Indian CD Issues*** (% GDP)	Pakistani CD Issues*** (% GDP)
1999-00	658	0.896	3.43	.03
2000-01	711	5.128	3.4	.16
2001-02	710	4.06	3.39	.12
2002-03		12.501		.36

Sources:* http://www.debtonnet.com;
** Karachi Stock Exchange (http://kse.com.pk) ; SBP Annual Reports various issues;
*** GDP at Current Factor Cost for India is taken from ADB Key Economic Indicators 2003;

2. NEED FOR CORPORATE BOND MARKET

The role of debt market, especially the one for corporate lending came to increased limelight and policy discussions in the aftermath of the Asian Financial Crisis of 1997. Policy makers and economist orchestrated the need for a deep and dense, solid, sound and strong, profound, powerful and potent corporate bond market. This argument augmented by the opinion of Greenspan [3] emerged as an economic school of thought. They are of the view that a strong bond market can possibly mitigate the adverse consequences of a banking crisis and provide an alternative source of financing to the corporate sector in the event of credit crunch. In this framework and in the event of a banking crisis, the corporate debt market takes up and provides the necessary funding to the business ventures thereby avoiding harm to the real economy. Economists and policy makers subscribing to this view are inclined to recommend support to the debt market with a view to develop strong market conditions even through subsidies and favorable tax and other concessions vis-à-vis the banking sector. This view is further strengthened by the performance and demonstration of the US corporate debt market during the two banking crises – one each in 1980s (caused through the Latin American Debt Crisis) and 1990s (caused by bursting of the real estate bubble). Under difficult circumstances, the US banking sector suffered huge losses that limited its capital base severely. These banks in turn curtailed the lending, thereby drastically reducing the bank credits to the corporate sector in USA. During these times of stress, the US domestic bond market provided the required liquidity and long term financing to the corporations shielding the real economy from the banking crisis [4].

Apart from the macroeconomic role of the corporate debt market explained above, there are further advantages associated with a strong and robust market in the microeconomic arena. Such a market possesses the potential to enhance the functioning of financial markets and the economy by reducing and possibly eliminating the maturity mismatch of the lending associated with the banking sector [5].

Banks borrow from their customers and clients in the short term and corporate sector borrows in the long run for business ventures possessing long gestation periods. In the absence of a Corporate Debt Market, these corporations are compelled to borrow from the banks, either local or foreign. At times, the corporations borrow in foreign currency from syndicates of banks or from other markets for meeting its long term financing needs. If the funds are borrowed from banks in foreign currencies, it leads to twin sin of maturity mismatch and currency risk. Eichengreen and Hausmann [6] describe the Asian Financial Crises as result of this twin sin where these economies borrowed in the short term in foreign currencies and funded long term projects. They even prescribe twin solution of dollarization and development of domestic debt markets with a view to avoid the mismatches and enable corporations to borrow from the domestic market. This will avert the danger of over reliance on the banking system and help reducing its monopolistic power. Development of the debt market will foster competition and efficient allocation of resources in the economy in such a framework.

When compared with the financial sectors of the emerging economies and developed west, it transpires that the Corporate Debt (TFC) Market in Pakistan is at a primitive stage. TFCs consisted only 0.31 percent of the total debt of the public and private sectors in the economy in the year 2000. Bank intermediation dominated the economy compared to the direct lending (corporate debt) even today followed by equity issues by the private sector. Corporate Debt market in the emerging economies is better in providing direct lending to the long term business ventures compared with Pakistan. The stock market capitalization is poor by the western standards and in comparison with the emerging economies of Asia Pacific region. It was (10.78 percent of GDP) not even comparable with that of Indian stock market with a capitalization of (35.5 percent of GDP) during the year 2000 [7]. The stock market in Pakistan had been quite active since 2003. KSE 100 index crossed 4000, 5000 and 5500 barriers in August 2003, March 2004 and April 2004, respectively (Figure 3).

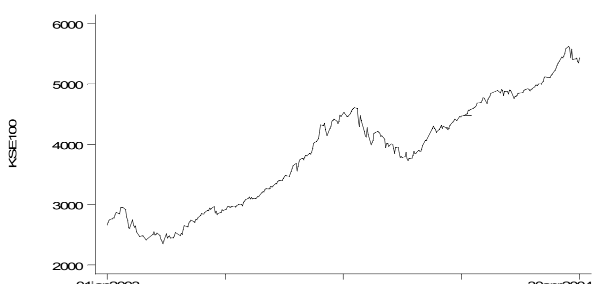

Figure 3. KSE 100 Index

Source: Karachi Stock Exchange

2.1 Financial Market Maturity Model

Financial markets in emerging and developing economies are passing through a transition. The development of financial markets in these countries is subject to a different process of evolution (Figure 4).

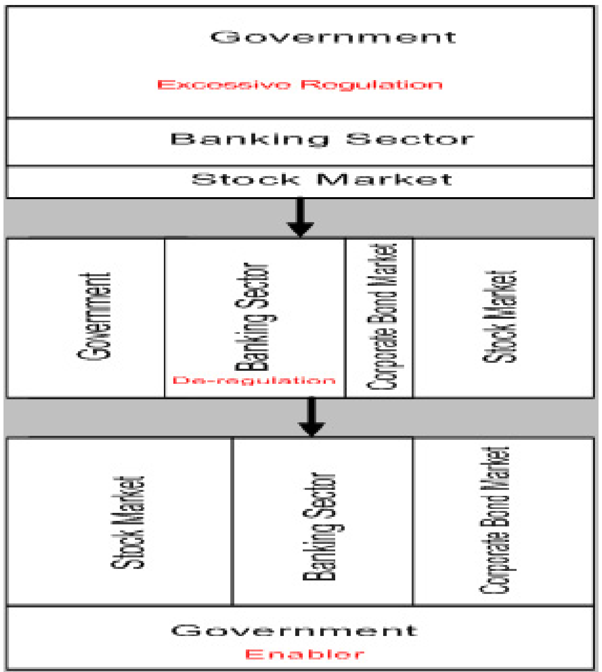

Figure 4. Financial Market Maturity Model

The first stage of the economy is such that there is excessive regulation and banking sector and stock markets are very small. Even the banking sector is owned by the Government, which is jealous of the private sector in its role of allocation of resources in the economy. Successive problems, stagnation of the economy and globalization pressures compel the Government towards the path of de-regulation and liberalization. In this phase, there is a very strong and effective role for the Government in devising policies, providing legal infrastructure and incentives to the private economic agents attracting them toward a greater role. De-regulation efforts, provision of legal infrastructure and creation of institutions responsible for enforcement and transparency of operations leads to an enhanced role of the private sector in the economy. Stock markets, corporate sector and banks tend to flourish under this enabling environment as the corporate debt market generally lags behind the development of government debt market [7]. However, the bond market is generally overshadowed by the banking sector, which enjoyed monopoly on lending in the economy before deregulation and liberalization. At this stage, there is a need to identify the possible causes and remove irritants through policy decisions providing equal and fair opportunity to either sector (banking or bond market) of the economy. The Government at this stage of development has the option to follow the international standards and best practices according to the ground realties or inventing something from scratch altogether to face this malaise (monopoly of banking sector in the lending business). Pakistan and several other developing countries of the region are still at this stage of transformation of the financial market where the lending market is bank dominated. Commercial banks advance long term loans to the private sector taking on short term liabilities. This mismatch of maturities of liabilities (deposits) and assets (loans/advances) can be managed to some extent by prudential regulations but make banks vulnerable to crisis [8].

If all goes well, the economy can transform into an environment, where the Government sector functions as an enabler, regulator and guardian of the investors. This stage of the economy is achieved when the corporate bond market is fully developed and competes with the banking sector thereby inducing efficiency in the financial market. This competition does not necessarily mean a downside for the banking sector, provided it can diversify its activities, capitalize this threat into a window of opportunity and reap the benefits of economies of scope. Such diversification can be in the form of providing value added services to the clients, and playing its role in the development of the corporate bond market by being issuers, holders, dealers, advisers, underwriters, guarantors, trustees, custodians and registrars in this market [9]. Under this condition of maturity of the financial market, each of the sectors of the economy is evenly developed and provides incentives for investors / savers and lenders to involve in the financial market. Their interaction leads to a state, where capital is optimally allocated through demand and supply interactions (market forces). The role of Government at this stage becomes more complicated being an enabler, guardian of investors and provider of legal and regulatory framework for inducing market discipline without discouraging the market. Banking sector at this stage will usually involve in short term lending activity to finance production through provision of credit for meeting working capital requirements of the corporate sector. The Financial Market Maturity Model discussed above is applicable to the developing and emerging economies only. However, in complete contrast, the development of corporate bond markets in the US and other developed countries was preceded by that of the stock and government bond markets [10].

2.2 Costs and Benefits of Debt Market

It is generally believed that there are benefits in terms of microeconomic efficiency and macroeconomic stability associated with the development and proper functioning of a domestic debt market. Further, such a market might provide an alternative source of financing to the corporate sector in the event of stress as evidenced in the banking crises in the United States during 1980s and 1990s. However, the authors are of the view that the argument of alternative source of borrowing during the time of stress might not be valid for Pakistani economy as the same is no way comparable to the developed economies of the west or the United States. Despite of this view, there is a rational for development of the economy from the efficiency perspective whereby the market will provide an opportunity for competition with the banking sector. Such competition will pave the way for efficient allocation of capital resources in the economy. It will possibly reduce the current maturity mismatch of the lending of the banking sector. Given a robust and performing corporate debt market, the role of bank intermediation can not be ruled out for short term lending for the working capital and long term lending through syndication and rollover strategies.

Though there are gains for the economy in the development of a corporate debt market in a country but there are costs, which should not be ignored altogether in deciding the financial structure. Such costs emerge from asymmetry of information in the emerging and developing markets of the world. This aspect leads to the herding behavior among bond investors possessing a potential for spreading financial contagion in the economy in the times of distress. Policy prescriptions are, therefore, required to deal with the problem of asymmetry of information to mitigate the problem of herding behavior of the investors in the bond market. Capitalizing on this argument Jiang, Tang and Law [4] are of the view that the policy efforts should not be directed at supporting a particular financial structure favoring bond markets over the banking sector.

Bank loans and corporate bonds deal differently with the problem of information asymmetries. Banks borrow from depositors taking credit risk and manage it by strong monitoring of the corporate sector to which it lends given its size and capacity to do so. Bond financing involves public at large taking on the credit risk by themselves in sharp contrast to the bank loans. In this mode of financing, the risk is spread over diverse group of people and organizations (individuals, insurance companies and pension funds etc.). It is advantageous as compared to bank funding where the risk is usually concentrated or distributed to a limited extent through syndication of the loans among various banks. The problem of maturity mismatch in case of bank funding is mitigated to limited extent through rollover of the loans, which might not be possible during the times of distress faced by the banking sector. In contrast, there is no such mismatch under bond financing as the investors are aware of the yields and time horizons of their investments. However, the bond investors do not possess the potential or capacity to monitor the corporations in sharp contrast to the banks. This problem can be solved through the statutory requirements of greater disclosure of information, establishment of strong judicial system and enforcement of the rule of law. These factors lead to greater transparency in the corporate operations and protect the investors and reward strong performers with lower funding cost [11], which in turn lead to efficiency and increase the overall economic welfare in the country. The benefits of establishing a solid and strong corporate bond market are consolidated below:

1. Corporate debt market will reduce the maturity mismatch as against the bank borrowing;
2. Development of a bond market leads to further development of financial instruments useful for risk management in an economy, viz: forwards, futures, swaps and options [12];
3. The intermediation costs associated with the issuance of corporate debt are generally lower than the bank borrowing especially when the bond market is robust and strong;
4. Best quality debt offered by performers (based on the past results of the issues) will seek favorable terms from the investors, who prefer to buy the bonds of these corporations providing lower returns in view of less risk. The market mechanism thus possesses a potential of lowering the cost of funding for best quality borrowers;
5. Bond market provides flexibility to borrowers to diversify their sources of funding and opportunity to raise long term capital to meet any long term expenditure needs [13];
6. This market provides a yield curve / term structure of interest rates based on the supply and demand interaction, which can be used as a benchmark for pricing stocks, credit risk useful for banks and other lenders in the economy;
7. Development of debt market will introduce competition for the banking sector in the economy. This competition will compel the banks to discipline and diversify in their operations with a view to improve the profitability apart from efficient allocation of capital resources in the economy;
8. If the banks regularly issue bonds for raising capital, they will also be subject to the market pressure (reflected in the bond prices) in excess of the monitoring of the Central Bank. This will lead to improvement in the performance of the banking sectors;
9. If the banks are allowed to securitize their loans through the corporate debt market, it will reduce the maturity mismatch and vulnerability of the banks towards a crises;
10. Development of domestic bond market will increase the capability of the best performing local firms to raise the debt without resorting to foreign borrowing. This will mitigate the exchange rate risk and volatility of the profits of the local firms apart from possessing a potential to avert harmful effects to the real economy during the times of stress;
11. Optimum allocation of capital resources through the market mechanism, development of market yield curve and competition will lead to increase in the savings by individuals;
12. Corporate bond market possesses the potential of diffusing stresses on the banking sector by diversifying the credit risks across the economy;
13. Corporate bond market can provide products with flexibility to meet the specific needs of the investors and borrowers;

3. TFC MARKET IN PAKISTAN

The Pakistani debt market had been dominated by the public sector and relatively underdeveloped to tap the new sources of financing. At the same time, it offers very limited options to investors who are looking to park their savings to get better rate of returns.

Corporations in Pakistan have been raising capital from a number of sources. Common stocks, corporate bonds and borrowing from the financial institutions have been the most active sources to tap finance for investments.

As suggested earlier, in Pakistan, the Term Finance Certificates (TFCs) take the form of CB. The TFC is a corporate paper normally having tenure of 3-5 years. As against the interest payment made on corporate bonds, the TFC uses the words "expected profit rate" to comply the Sharia principles. These instruments are issued under sub-section (1) of section 120 of the Companies Ordinance, 1984 [14].

Private sector Pakistani companies raised capital mostly through common stocks during 1984-95. Hence, TFCs' market remained calm during this period. However, public sector TFC issues came to light during 1988 to 1994. During this period, WAPDA floated Rs 18.258 bonds in denomination of Rs 10,000, Rs 50,000, Rs 100,000 and Rs 500,000 to the public (Table 2). The total amount of these issues is about 64.5 percent of the total TFC amount raised by Pakistani companies in public issues since 1995. In Pakistan, the capital issued via TFC is only Rs 28.308 billion (until February 2004) as against equity of Rs.313.267 billion and equity market capitalization of Rs 951.446 billion (31st Dec. 2003).

Table 2. History of WAPDA Bond

Issue	Term (Years)	Year	Rate %	Scale Achieved (PKR bn)
First	5	1988	13.5	3.102
Second	5	1989	13.5	5.631
Third	10	1990	12.5	6.844
Fourth	10	1992	15	1.431
Fifth	10	1993	16	1.250
Total				18.258

Source: [15], Original Source Khadim Ali Shah Bukhari & Co. Ltd.

3.1 Issuance of TFC

Securities and Exchange Commission of Pakistan (SECP), which regulates Pakistan's securities, is also responsible for regulating the TFC market. Without SECP's consent no company can issue TFC for public subscription in Pakistan. To get green signal from SECP, the TFC must meet certain conditions (Box 1).

3.2 Private TFC Issues

It was in 1995 that the private sector got active in Pakistani debt market and started selling and buying TFCs.

Box 1. Conditions for Issuance of TFCs in Pakistan

- SECP will permit bond issues for specified uses only;
- TFCs must be secured and the public issue must be fully written;
- TFCs have to be listed on the Stock Exchanges;
- There will be a trustee for each TFC issue;
- The proposed security for the issue must be specified;
- A minimum of 25 percent of proposed issue will be raised from public;
- SECP's consent is not required for private placements;
- The issue must have been given a credit rating by one of the two approved credit-rating agencies (The Pakistan Credit Rating Agency (PVT) Ltd. or DCR-VIS Credit Rating Co.)

Source: [15]; Original Source Khadim Ali Shah Bukhari & Co. Ltd.

This phase of the TFC market lasted until 1998, which witnessed 6 issues (Table 3) raising an estimated Rs 2.559 billion. These issues were at least A $^{+}$ rating, mostly of 5 year tenure and a minimum coupon at least 17.5 percent. Financial institutions remained the predominant investors for these issues whilst institutional funds remained locked in NSS.

However, in May 1999, discount rate dropped to 14 percent, in December 1999, rates on NSS dropped to 14 percent, in January 2000, discount rate again dropped to 14 percent and in March 2000, institutional funds were prohibited from investing in NSS. These developments provided issuers of TFC a level playing field and 9 further issues came in for fund raising to the tune of Rs 2.513 billion by the end of the year 2000. Re-structuring of financial market led to a reduced role of NSS schemes in the debt market in Pakistan. The market crossed Rs.13billion mark by the year 2001; Rs. 22 billion by December 2002 and Rs. 27 billion barrier by the end of 2003 (Table 3).

Table 3. TFC Issues by the Corporate Sector

Year	No. of Issues	Size of Issue (Rs.m)	Cumulative TFC Issues
1995	2	710	710
1996	2	1250	1960
1997	-	-	1960
1998	2	599	2559
1999	4	1650	4209
2000	5	863	5072
2001	12	7978	13050
2002	17	9544	22594
2003	11	4664	27258
2004	2	1050	28308
Total	57	28,308	

Source: [20]; AMZ Securities; SBP Annual Report 2001-2002,

According to a report prepared by IFC, the estimated volumes of corporate debt securities traded on the secondary market are low [15]. Further, Market sources suggest that less than 15 percent of TFCs issued have been traded on the secondary market these days.

Table 4 reflects the relationship of Gross Domestic Product and Investments in National Savings Schemes and cumulative TFC issues in Pakistan. A regression analysis of this data yields the following results:

Table 4. Relationship among TFC Issues, NSS and GDP

Year	NSS	GDP (Rs. bn)	Cumulative TFC Market (Rs. m)
1994-95	40,873.9	1671.977	210
1995-96	49,280.4	1929.891	960
1996-97	69,782.5	2226.580	1960
1997-98	113,646.	2480.884	2234
1998-99	142,316.8	2735.943	3673
1999-00	95,509.	2921.988	4569
2000-01	51120.6	3161.923	9697
2001-02	91,371.3	3428.318	13757
2002-03	73,970.8	3599.7339	26258

Source: Directorate of National Savings; ADB Key Economic Indicators; AMZ Securities; KSE; SBP Annual Reports

Model: $TFC = a + b.GDP + c.NSS$

$\hat{a} = -18812.96$; $\hat{b} = 12.07$; $\hat{c} = -0.0808$

(6620.151) (2.441512); (0.0489756);

This model explains 73.72 percent of the variations in the TFC market. The coefficient of the variable NSS is statistically significant at 15 percent level. The signs of the coefficients are as expected. Increase in the NSS deposits adversely affects the TFC market and vice versa. The increase in GDP results in increase in the savings of the economy, which are available for investment through the alternative modes of intermediation. The model exhibits a strong relationship between the size of GDP and that of the TFC market in Pakistan over the years under consideration. There is, however, a room for further improvement in the model by including Market Capitalization and Disbursement of Loans by banking sector and non-banking financial institutions. With the inclusion of correct variables, the value of Adjusted R-square might improve since the current model contains a large value for the coefficient "c". Inclusion of further variables will, however, induce the problem of multi-collinearity and heteroscedasticity in the model.

```
 Source |    SS          df          MS              Number of obs     = 9
---------+-----------------------------------------------F(  2,     6)= 12.22
Model   458828535    2        229414267           Prob > F = 0.0077
Res.     112642397   6        18773732.9          R-squared = 0.8029
---------+-----------------------------------------------Adj R-squared = 0.7372
 Total |  571470932   8        71433866.5          Root MSE= 4332.9
------------------------------------------------------------------------------
TFC | Coef.          Std. Err.       t       P>|t|      [95% Conf. Interval]
---------+--------------------------------------------------------------------
GDP| 12.06961     2.441512      4.943    0.003     6.095448    18.04378
NSS| -.080833      .0489756      -1.650   0.150     -.200672     .039006
_cons| -18812.96  6620.151      -2.842   0.029    -35011.89   -2614.039
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Hypothesis: H0: $b = c = 0$; Ha: $b \neq c \neq 0$

From F – Table: ${}_{0.01}F_{(2,6)} = 10.9$; As $F > F_{critical}$,

Null hypothesis is rejected at 2 percent significance level. Therefore, at least one of the two coefficients (b or c) is non-zero. But the model seems to be insufficient in view of the p-value associated with the coefficient of NSS.

The model yields interesting results when the data for the last two financial years is dropped from the regression. Investments in NSS schemes become statistically significant at 2.4 percent, the level of significance of the coefficient of GDP improves from 3 percent to 1 percent and the model explains 92.48 percent of the variation in the primary TFC market. This suggests policy changes, which occurred in the March 2000 when the Government prohibited institutional investors from purchasing NSS instruments. This result can further be verified and strengthened through the test of structural change, e.g. Chow Test. At this stage, such a test can not be carried out as sufficient data is not available in respect of the post structural change period.

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. reg TFC GDP NSS

Source | SS              df    MS                      Number of obs =      7
---------+--------------------------------------------F(2, 4) = 37.87
Model| 57580287.8    2    28790143.9           Prob > F  = 0.0025
Res.|    3040580.23   4    760145.056           R-squared  = 0.9498
---------+---------------------------------------------Adj R-squared = 0.9248
Total|  60620868.0     6    10103478.0            Root MSE = 871.86
--------------------------------------------------------------------------------
TFC | Coef.         Std. Err.        t         P>|t|          [95% Conf. Interval]
---------+----------------------------------------------------------------------
GDP|  6.442085   .7411744    8.692   0.001       4.384255   8.499915
NSS| -.0371145    .0105374    -3.522   0.024      -.0663711   -.0078578
_cons| -9445.97     1651.785    -5.719   0.005      -14032.06   -4859.881
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Hypothesis: H0: $b = c = 0$; Ha: $b \neq c \neq 0$

From F – Table: ${}_{0.01}F_{(2,4)} = 21.2$; As $F > F_{critical}$,

Null hypothesis is rejected at 2 percent significance level. Therefore, at least one of the two coefficients (b or c) is non-zero. Our model is found to be suitable for explaining the variation in the size of primary TFC market in Pakistan for the period under consideration (1995-2001).

3.3 Market Players

The Pakistani Corporate Bond (CB) market, like other debt markets, is run by issuers of TFC, buyers of TFC and traders or intermediaries. Issuers of TFC have been mostly private sector firms and WAPDA. TFCs in Pakistan are mainly bought by commercial and investment banks, insurance companies and pension funds.

Both foreign and major local banks have been active as intermediaries. In local banks MCB, has been most active. Others are First International Investment Bank Ltd., Orix Leasing, Jahangir Siddiqui & Co., Khadim Ali Shah Bukhari & Company, and UBS Securities. Citicorp Investment Bank and Bank of America (later sold to Union Bank) have been most active foreign banks.

3.4 The Yield Curve

The single most important factor, which influences the investors' interest, is the changes in interest rates. Theoretically speaking, interest rates move due to changes in supply and demand of credit, monetary and fiscal policy, exchange rates, economic conditions, market psychology and, most importantly, future expectations of inflation.

In mid 1990s, TFC issuers had to pay very high interest rates in the vicinity of 14 to 17 percent compared with 11-13 percent in India for raising capital. This stems from the fact that the TFCs had to compete with National Savings Schemes (NSS) and Federal Investment Bonds (FIBs). Another factor affecting interest rates was the increasing inflation rate (around 5 percent average), which private economists reckon to have been it in double digits.

Figure 5 and 6 reflect the SBP Discount Rate (Average per visit) and yield on Defense Saving Certificates respectively. Despite the fact that returns on DSC remained quite high but the TFC market attracted large amounts of new subscription during the year 2001 and 2002. This increase in the market despite high yields on DSC is a result of the policy shift of the Government whereby the institutional investors were prohibited from investing in NSS schemes. Later, when the DSC returns further lowered during the year 2003, the TFC market saw further issuance of 11 TFCs raising 4.664 billion rupees from the market. The issuance of TFCs also seems positively correlated with the SBP discount rate. Further, the discount rate is also used as a benchmark by the TFC issuers for coupon payments to the investors. Lately, Government had been taking concerted efforts for development of a benchmark through regular auctions of Pakistan Investment Bonds (PIBs). These bonds will also create the so called demonstration effect and facilitate the issuance of TFCs in the market. Figure 7 reflects the weighted average yield of 5 Year PIB with effect from Dec.00 to Dec. 03.

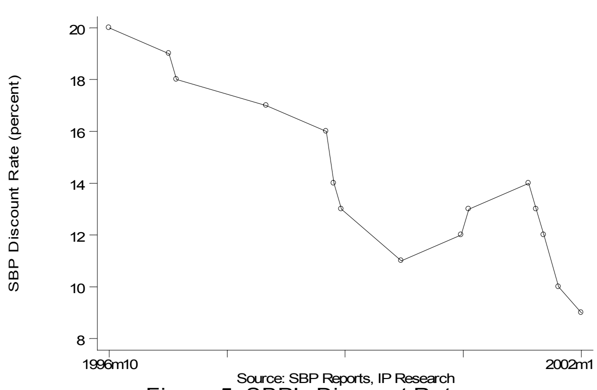


Figure 5. SBP's Discount Rate

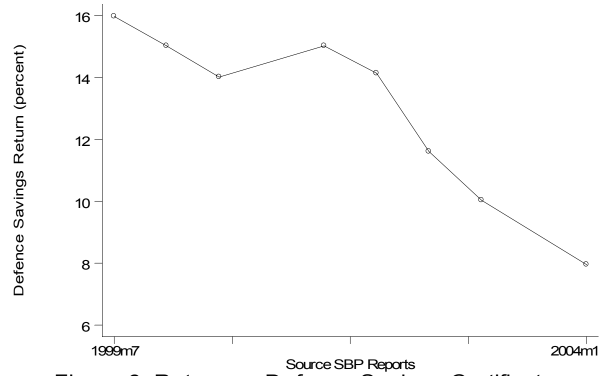


Figure 6. Return on Defence Savings Certificates

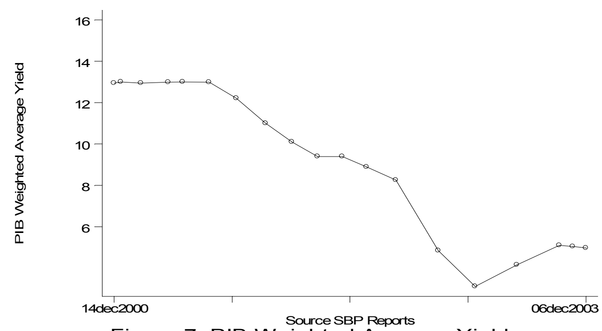


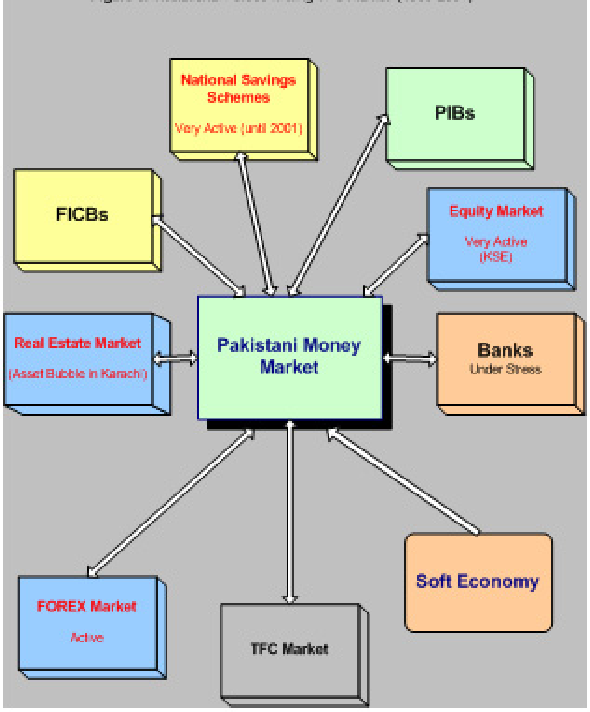
Figure 7. PIB Weighted Average Yield

3.5 Institutional Forces

A model has been developed by the authors of this paper for the Money Market in Pakistan reflecting the interaction of various players, including market forces and the role of public policy (Figure 8). TFC forms a part of the money market where it competes with the equity market, NSS, FIBs, PIBs, Real Estate and FOREX markets for attracting investment from the individuals and institutions.

Major component of the investment in the TFC market comes from the institutional investors. NSS had been a major player in the money market prior to the March 2000. It was realized by the Government that the competition among TFCs and NSS was not fair. Institutions were prohibited from investing in the NSS schemes. This diminished the competition between TFCs and NSS and provided room for expansion in the TFC market. The corporations got a leveled ground for competition through this policy initiative and the market grew towards efficient allocation of capital resources. The role of PIBs is not only that of the competitor but is expected to provide benchmarking [16] for the issuance of the TFCs in future. Banks compete with the TFCs in intermediation between lenders and borrowers but are less important in attracting savings of individuals compared with the NSS. If a solid and strong market for TFCs emerges, the role of banking sector will have to change from monopolist to competitor and further facilitation of the debt market through diversification in future. Equity market is a competitor with regard to the investments of the individuals and institutions and possesses potential for tax exempt capital gains. At present, the equity market together with the Real Estate Market dominates the investment climate in Pakistan. Huge sums have been attracted by these two markets during the last few years. KSE 100 index has crossed 5,500 barrier (Figure 3) prices of plots in Defense Housing Authority (DHA) Karachi have jumped many times compared with the last year. This asset price bubble possesses the potential of invoking a financial crisis in the country. FOREX market in the country involves all kinds of speculative activities including buying of the old and new Iraqi currencies for capital gains. In the current scenario, there is a strong case for public policy intervention by the SBP and SECP to avoid an eminent crisis.

Figure 8. Institutional Forces limiting TFC Market (1995-2004)



4. CHALLENGES

The preceding discussion suggests that the Pakistani TFC market is still not mature to play a key role in the economic development of the country. This stems from the fact that the country has been weak, both politically and economically. These determinants are interwoven, and cannot be unchained. They need to pull together to move the TFC market actively. Key challenges confronted by the TFC market are given below:

1. Cost of issuance of publicly listed TFCs is an inhibiting factor. An estimate of the cost of issuance of Rs.500 million TFCs by a corporation has been computed at Rs.9.0 million [17]. This comes out to 1.8 percent of the value of the issue;
2. Secondary market has been inactive due to the fact that the institutional investors tend to buy the TFCs and hold them until maturity. Individual buyers form a small minority in the TFC market in Pakistan. These characteristics of the market together result in a general lack of liquidity;
3. Market infrastructure is weak and needs to be upgraded through the use of on line automated buying, selling and settlement;
4. There is a general confusion in the market as to whether this instrument is Islamic or otherwise. It looks as if there is only a change of name and TFC is a debt instrument like the ones traded in the markets around the around;
5. Expectations of inflation and frequent devaluation of PKR (Pakistani Rupee) has hindered the foreign investors to buy TFCs;
6. Lack of benchmark in the market created difficulties among the investors with regard to the valuation of the offers by the investors. At present, PIBs are being traded having maturities of 3, 5 and 10 years. Healthy trading of these bonds in the market will create the so called demonstration effect and pave the way for TFC market;
7. Most domestic business concerns in our country are owned by families, who are reluctant to disclose financial and other the information to the public and prefer either bank lending or private placement rather than public offering;
8. There is a need for greater accounting and related disclosures by businesses to mitigate moral hazard arising out of asymmetry of information between the corporations and individual investors. This problem can be solved through independent private credit rating agencies in the country;
9. There is a need for capacity building of the State Bank of Pakistan (SBP) and Securities and Exchange Commission of Pakistan (SECP) so that these agencies can proactively deal with the problems of the TFC market in Pakistan;
10. The infrastructure and legal framework for facilitation of the corporate debt market is not sufficient at present. It needs to be improved and augmented by strong and transparent courts where justice should be seen to have been dispensed;
11. Pakistan has seen policy shifts strongly correlated with the political instability in the country. There is a need to have long term policies relating to taxation including income tax and stamp duties in respect of the TFC transactions;
12. Average issuance time of a TFC by a company in Pakistan has been estimated by Adil and Hirani [17] as 20 weeks. Sizeable time is spent in meeting the requirements of the SECP and Stock Exchanges for public issuance of the TFCs in Pakistan;
13. High returns on NSS Schemes had been a major hurdle in the way for development of the TFC market in Pakistan until March 2000 when the Government prohibited institutional investors from buying NSS instruments;
14. Excessive borrowing by the public sector for financing the budget deficit led to the increase in the

interest rates and crowded out the private investment. High inflation rate, mounting debt, low savings rates in the country and unimpressive capital formation are some of the key macroeconomic issues, which require concerted efforts for fiscal and monetary discipline in the country;

15. TFCs are relatively new instruments in the Capital Market of Pakistan. They are not well understood by an average investor [18]. Thus there is a need to educate the retail investors of the risk and returns of the investment in the debt instruments;
16. There is a need to use technological developments for increasing transparency and liquidity in the debt market;
17. Last decade has witnessed economic volatility in Pakistan reflected in the form inflation and interest rate instability. This has constrained the individuals and institutions to invest in the short term projects only. They are inclined to find alternative investment avenues rather than investing in the long term debt market;

5. PROSPECTS

Tossing aside all the challenges, the TFC market has great potential to grow. TFCs are freely tradable and easily transferable. A closer look at the TFC market suggests that most good quality companies are considering raising corporate debt and are participating directly or indirectly through provident and pension funds in good quality issues. The number of brokers facilitating the purchase and sale of the TFCs is rising and a combination of falling interest rates (around 5 percent) and rising institutional liquidity has given the TFC a firm foundation to stand on. Secondary market turnover is growing, but with a small base, public subscription by retail investors is picking pace.

Attractive rate on investment and tax exemption on listed and credit rated TFCs and other positive developments in government policies have made TFCs viable form of investment. An estimate of the potential of investment in TFC market suggests that the market is likely to increase in size to approximately 250 billion rupees with the next few years [17]. This estimate uses investments in the NSS as a benchmark for projecting the possible size of the TFC market in future.

The need for vitalizing the TFC market cannot be over-emphasized. Though the government has taken some positive steps but there is room for more efforts. Yet there are many clouds on the horizon but the prospects of local TFC market seem promising. To see the clear sky many initiatives have to be taken. Some of them are discussed below:

1. Stamp duty on newly issued securities was reduced from 4.5 percent to 0.5 percent and set at 0.1 percent for subsequent transfers. Tax exemption on TFC income was reinstated withholding tax was withdrawn. It is hoped that these policy measure are likely to continue and generate some activity in the secondary market;
2. Aid from the Asian Development Bank under the Capital Market Development Program (CMDP) was also focused on establishing a national clearing and settlement system and an over-counter-debt market. This will smoothen the working of TFC market and will help share the information between the market participants (issuers, investors, and intermediaries);
3. Hopes are high in the debt market with growing institutional and retail NSS maturities, investors are likely to find the TFC market as an attractive fund raising source. Also experts suggest that in due course a yield curve, benchmarked against the PIB rates will emerge which will help monitor the performance;
4. The yield on PIBs had been decreasing over the last three years thus creating room for issuance of TFCs by the corporate sector (Figure 5). This phenomenon will create incentive for large corporations to generate funds through long term debt financing;
5. There is a room for development of market for longer term Government Bonds (10 and 20 years) to provide a benchmark for the corporate sector to issue bonds of longer maturity. This will pave the way for investment in the long term projects in the country financed through domestic borrowing. Such projects include development of infrastructure, investment in the housing sector and sophisticated production technologies;
6. There exists great potential for the Pakistani large corporations enjoying good credit rating to turn to TFC market for raising capital. It possesses the potential to increase investors' confidence.
7. Privatization of state-owned enterprises will give a great boost to the debt market if new privatized enterprises raise capital through TFCs.
8. Another impetus in this direction will be the restructuring of leasing companies, insurance sector and sale of public sector banks. It is hoped that these steps will improve the asset management in the financial sector and stimulate the secondary market and demand for debt instruments including TFCs;
9. Equity market volatility in Pakistan possesses the potential of diverting institutional investors to the stable returns of TFC market;
10. Lot depends on how the economy moves in the near future. If Pakistan economy moves upward and continues to have sustainable growth rate then demand of goods and services is likely to grow. This in turn will provide stimulus to debt market and the TFC market could expand quite quickly in the immediate future.

6. TYING THE KNOT

Despite current weaknesses and threats to the TFC market, there is a promising future in terms of the potential market size in Pakistan. Development of TFC market promises benefits in both micro and macro economic fronts for the economy. Apart from these benefits, there are costs as well. The cost benefit analysis is, however, inconclusive and it is suggested that there is little room for active intervention by the Government. The Government should facilitate market development and let the investors base their decisions by weighing risk and expected rate of return only. In this regard financial reporting system and benchmark yields can play and effective role for investors in valuing the instruments. SECP will have to play its role in devising disclosure requirement for mitigating the moral hazard associated with the asymmetry of information. Its role as investor's guardian is warranted in this respect.

Base rates such as the T-bill rate and the Discount rate have to be at levels that allow issuers to periodically tap the corporate debt market.

A well-developed TFC market is likely to have a mechanism for efficient reorganization in the case of default and bankruptcy. The mechanism acts like a cushion and gives breathing space to distressed company from its creditors while it works out a plan to compensate creditors partially, in cash or securities, with little delay. More work is needed in this area as far as Pakistan goes.

As banks and other financial institutions play a key role in a mature market, the forces acting in the TFC market are likely to have some spillover effects on the banking system. The banking system then can not afford to engage in non-competitive credit analysis practices. It is said that a local bond market cannot be developed in isolation from the banking market.

It is suggested that issuers and investors must strengthen their units to fully understand TFC market. They should have in-house capability of reckoning companies in terms of their financial standing.

As suggested earlier, the volume in the local secondary market remains low due to absence of short-selling provision. Efforts are needed to make policies which can allow short-trading to take place. Once this happens, authorized scheduled banks, major long-term investors, and stock exchange firms who are major participants in the debt market will become more active.

7. CONCLUSION

This paper has argued that the Pakistani TFC market is yet to take off and facet the challenges that need to be addressed before it can be put into top gear. Indeed the development of TFC market requires hectic efforts which include corporate sector and banking reforms, the strengthening of legal environment, restoring investors' confidence, improvement of infrastructure, re-engineering of the process relating to the approval of draft prospectus, issue costs, competition from other public savings schemes, poor understanding about the TFC market on the part of retail investors and last but not least low volume and limited supply of TFCs.

Despite all challenges, TFC market possesses promising future due to large corporate sector and increasing activity in the privatization of state owned enterprises. However, its direction depends on how the above objectives are met. All these objectives are inter-woven and therefore need to be addressed in an integrated manner. Further, overnight changes in the TFC market cannot be expected, as it is an incremental process and may take up many years before it bears fruits. Challenges, prospects, and development of TFC market should be viewed as complementary and mutually reinforcing.

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