FINANCIAL SECTOR REFORMS

Deepening and widening the Pakistan's financial sector

BACKGROUND – CONSTRAINED FINANCIAL MARKETS

- Pakistan's Debt markets are both, shallow - with public markets less than 5% of the primary Banking market; and small, with Deposits 30% of GDP.
- Over the last few years, Debt markets have contracted in real terms – high inflation and low growth, a stagflationary trend. Also reflected by overall falling Investment/GDP: FY'11, SME investment volume exceeded LSM's.
- Lack of market depth limits broad access to credit, and perpetuates high interest spreads in the Banking sector.
- Lack of capacity in market to buy TBs/PIBs forces GoP to rely on Banking market: resultant absurdity is that GoP has higher cost for raising term money than Banks.

CURRENCY IN CIRCULATION

Exhibit 1: Currency in circulation as a percentage of total deposits

Country	Pakistan	India	Bangladesh	Turkey	Korea
FY-99	29%	25%	16%	5%	5%
FY-05	29%	20%	15%	8%	4%
FY-11	31%	18%	15%	8%	4%

DEPOSIT DEPTH

Exhibit 2: Deposits as a percentage of GDP

Country	Pakistan	India	Bangladesh	Turkey	Korea
FY-99	34%	38%	25%	111%	206%
FY-05	35%	50%	37%	125%	271%
FY-11	30%	63%	51%	194%	285%

Implied deposit to GDP ratios

Exhibit 3: If Pakistan's currency in circulation to deposit ratio had bee the same as…

	1999	2005	2011
India's	39%	50%	51%
Bangladesh's	63%	69%	61%
Korea's	201%	278%	212%
Turkey's	182%	127%	112%
Pakistan's actual deposit to GDP ratio	34%	35%	30%

DOMESTIC SAVINGS

Exhibit 4: Gross Domestic Savings as a percentage of GDP

Country	Pakistan	India	Bangladesh
FY-99	14%	24%	19%
FY-05	15%	32%	19%
FY-11	11%	26%	14%

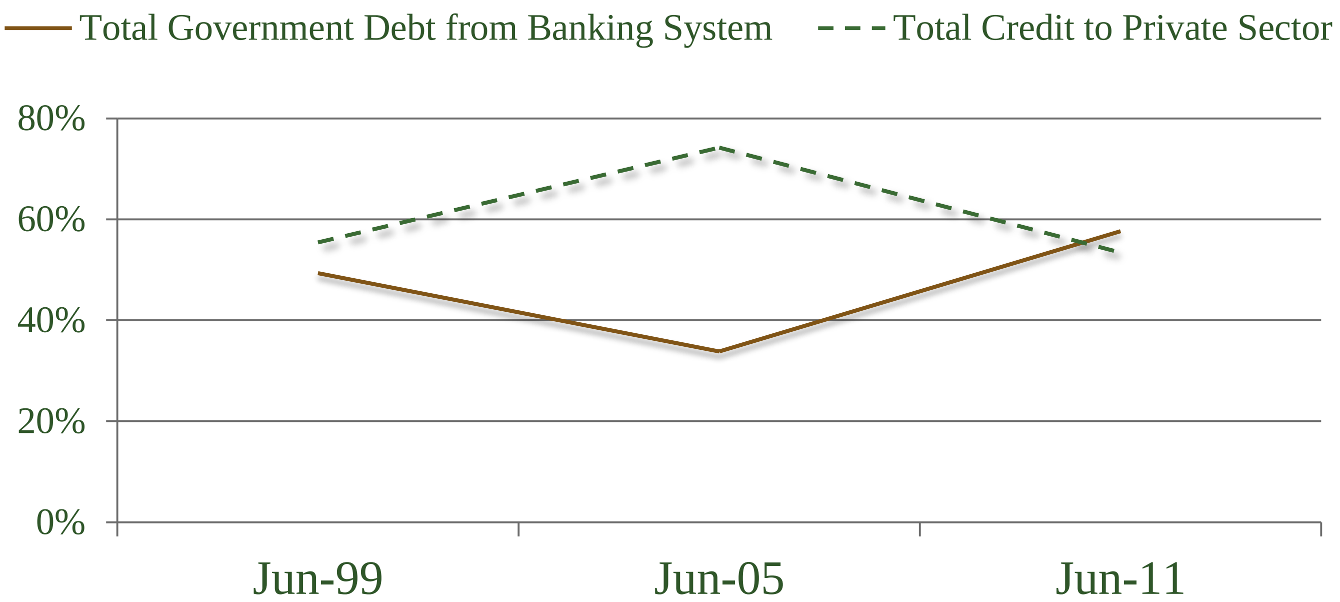
GROSS FIXED CAPITAL FORMATION

Exhibit 5: Gross fixed capital formation as a percentage of GDP

Country	Pakistan	India	Bangladesh
FY-99	14%	23%	22%
FY-05	17%	30%	25%
FY-11	15%	29%	25%

Composition of NDA

Figure 1: Trend in composition of NDA



Source: State Bank of Pakistan

AGRICULTURE AND SME LENDING BY BANKS

Exhibit 6: Lending to the Agriculture and SME sectors by banks (in PKR bn)

Total Advances	721	1,759	3,505
Outstanding loans to:			
Agriculture Sector	87	131	193
SME Sector	-	314	293
As percentage of Total Advances:			
Agriculture Sector	12.1%	7.5%	5.5%
SME Sector	-	17.8%	8.3%

EQUITY RAISED ON KSE

Exhibit 7: Amounts raised in equity issues – including rights share issues

	2004	2005	2006	2007	2008	2009	2010	2011
Total equity issued	90,322	48,809	32,702	138,866	58,264	39,040	94,436	124,069
New issues	66,837	29,990	14,790	57,240	15,312	8,756	33,438	16,011
Rights shares issued	14,660	10,906	13,051	42,504	27,958	27,775	54,903	94,214
All other equity issued	8,825	7,913	4,861	39,123	14,995	2,508	6,095	13,844

DEVELOPMENT OF DEBT CAPITAL MARKETS.

- The failure of Public Debt instruments i.e., MMIs(CP,BAs), Corporate Bonds etc., to develop, is not lack of legal framework or want of professional expertise:
- Issue of undeveloped public (non-Bank) Debt Markets has to with both public and private, Management and Governance, practices;
- ….it is owed primarily to under-management of the GoP Debt activity, which has suppressed emergence of a risk free, time function yield-curve; and to the dominant market hold of Big Banks that does not encourage the Bank 'disintermediation' process to gather momentum

CONT'D….1. DISINTERMEDIATION OF BANKS

- Process through which Banks lose high-rated Corporate Loans to public Markets – and lose corresponding Deposits.
- In summary:

+ High –rated Corporate borrowers forego benefit of strong rating when they take Bank loan: they may have similar cost of funds and they always pay Bank 'spread". So, the issue Bonds to the public;

+ In reverse- depositors could earn more placing funds directly with high rated Corporate – because the <u>Bank spread is split between Corporate borrower, Depositor, and intermediary Investment bank….</u>

+ Intermediary develops Asset management function and creates Mutual Funds to encourage demand for liquid public debt.

CONT'D....DOBs

- Disintermediation process universal, as Markets mature. Effect is to greatly broaden access to credit, as banks replace lost assets with Consumer/Mortgage/ SME loans. – and to raise rates paid to Bank depositors.
- Predicated on:

  + Established, liquid market for Govt securities at all points, in maturities issued – this "yield-curve" sets the "Risk-free' benchmark for pricing risk of all other Debt;

  + Strong and independent Investment Banks and brokerages that can develop intermediary function;

  + Establishment of active, liquid Funds market.

Pakistan lacks all three – but all can be achieved in short-term, if Govt and Regulatory authorities perform their required role.

Cont'd. 2. Development of govt Debt function

- GoP debt function carried out by Debt Coordination Office, in MinFin….. Oversight on activity of MinFin (TBs,PIBs); NSS; and External Finance (all foreign and multilateral debt).
- Weaknesses of present Debt strategy:

+ DCO managed more as Administrative, rather than Commercial, function;

+ Domestic debt too short term, av. Maturity 1.6 years excl. NSS, 2.6 incl.NSS. Average maturity in larger EMs 8 years, India 12 years;

+ Dominantly held by Banks (75%); rapid growth(20%pa) in short-term debt means rising 'rollover' risk, and increased vulnerability to Banks' pricing demands;

+ Illiquid and poorly structured from 'yield-curve' perspective; 17 different issues(incl.NSS) with several overlapping maturities.

DOMESTIC DEBT COST AND RATE OF ACCUMULATION AT LEVELS DIFFICULT TO SUSTAIN: ALREADY ABSORBING ABOUT 60% OF FBR REVENUES.

CONT'D 2.

ACTION NECESSARY:

- Establish Debt Management office, in MinFin. MinFin sets Debt level, but management in hands off DMO; quarterly report to Parliament.
- Staff with Market professionals, working alongside Bureaucrats.
- Mandate: achieve lowest cost of long term funds, by optimal distribution between currencies/tenors/types of debt;
- Also assist cash strapped but real asset rich PSEs, like the Railways, to 'unlock' real asset value through , e.g., Investment and Commercial REITs, and avoid Budget dependence.
- Roll NSS schemes into TBs/PIBs to reduce number of issues, increase liquidity;
- Escalate Distribution capacity:

  + Global: Offshore roadshows, get Global Fixed Income fund rating; Sukuuk/NRP investors;

  + SECP/SBP to fast track development of domestic fixed Income funds.

ETC….

3. PROMOTION OF BANKING AT THE BASE

TO REDUCE CURRENCY IN CIRCULATION:

- Micro-finance;
- Branchless Banking;
- Removing negative fiscal levies;
- Higher interest rates through competition from Fx.Income funds, other 'disintermediation' outcomes;
- More competition for deposits between Banks for deposits once public debt market

STRENGTHENING INVESTMENT BANKS FOR EFFECTIVE MARKET ROLE:

- We have Universal Banking in Pakistan, i.e. commercial banks authorised to undertake all types of Investment Banking (IB) activity.
- Their IB activity is strictly limited.
- Investment Banks proper are very small in relation to the bigger commercial Banks, and have not attempted IB activity on any discernible scale.
- It would be advisable for SBP and SECP to map about action steps that can support the growth of IB activity: IBs should ideally be under the same regulator as commercial banks, so a level 'playing field' can be created, and proper IB allowed to develop
- 'Proper IB would be structuring and distribution of Debt, and M&A, to begin with; Venture capital and LBOs could follow.

CONCLUDING OBSERVATIONS

Fiscal and Financial constraints are tying down capacity for investment and growth.

MinFin and regulatory authorities have to support the rapid development of deeper debt markets, through reform of Govt Debt management; and through promotion of public Debt issuance.

THANK YOU……