PROPOSED REFORMS TO PAKISTAN'S DEBT CAPITAL MARKET

PRESENTED TO

THE SECURITIES & EXCHANGE COMMISSION OF PAKISTAN ("SECP")

BY

THE DEBT CAPITAL MARKET COMMITTEE ("DCMC")

APRIL 2007

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LIST OF ACRONYMS/ABBREVIATIONS

FA	Financial Assets
CDC	Central Depository Company
CDNS	Central Directorate of National Savings
CFS	Continuous Funding System
DCMC	Debt Capital Markets Committee
DPCO	Debt Policy Coordination Office
DSC	Defence Saving Certificates
DVP	Delivery Versus Payment
EAD	Economic Affairs Division
EDMD	Exchange & Debt Management Department
EOBI	Employees Old Age Benefits Institution
FMA	Financial Markets Association
GoP	Government of Pakistan
HTM	Held to Maturity
MoF	Ministry of Finance
MTDF	Medium Term Development Finance
NBFI	Non Bank Financial Institution
NCC	National Clearing Company
NSS	National Savings Scheme
NTN	National Tax Number
OMO	Open Market Operation
OTC	Over-the-counter
PD	Primary Dealer
PIB	Pakistan Investment Bond
PLC	Public Limited Company
REIT	Real Estate Investment Trust
Repo	Repurchase Agreement
RIC	Regular Income Certificate
RTGS	Real Time Gross Settlement
SBP	State Bank of Pakistan
SECP	Securities & Exchange Commission of Pakistan
SGLA	Subsidiary General Ledger Account
SLIC	State Life Insurance Company
SSA	Special Savings Account
SSC	Special Savings Certificate
T-bill	Treasury bill
TFC	Term Finance Certificate

EXECUTIVE SUMMARY

Background

Pakistan's equity market has seen significant growth and development in recent years in terms of depth, breadth, and infrastructure.[1] In comparison, Pakistan's debt market remains significantly underdeveloped as we highlight in this report. While equity markets typically tend to develop earlier than debt markets in most developing countries, Pakistan's economy and financial sector is at a stage where it can support and benefit from a vibrant and efficient debt market.

Compared with the global emerging markets, Pakistan has among the lower international ratios of Financial Assets (FAs) as a percentage of GDP.[2]

- Pakistan's FAs add up to approximately 100% of GDP. [3]
- The global ratio of FAs to GDP averaged 315% in 2005, up from 110% in 1980.[4]
  - Ratios exceeded this level in some emerging markets, e.g. Singapore and Malaysia.
  - China, Chile, South Korea and Thailand have a ratio well in excess of 200%.
  - The Philippines and India stand at around 160%.
- The fastest growing global FA segment has been private debt (money market instruments and corporate bonds).
  - Private debt has increased from 14% of total FAs in 1980, to 27% in 2005.
  - On the other hand, banking assets have reduced from 45% in 1980 to 27% in 2005.
  - Private debt, or Term Finance Certificates (TFCs) in Pakistan, remain under 1% of GDP.[5]

Pakistan is therefore relatively under-leveraged as an economy. On the one hand, this situation reflects prudent fiscal and monetary management; on the other, it points to underexploited capacity available to support economic growth. Despite the very positive effects on market liquidity of GOP's progressive reduction in public debt ratios, lack of secondary debt markets in Pakistan impose constraints on sources of investment finance, particularly in absence of longer term, fixed rate debt.

A major factor impeding the development of a fixed interest rate market is the absence of a liquid, benchmark Government Debt yield. Without fixed rates, a market for long term debt, and for securitization, cannot be viable. Pakistan Investment Bonds (PIBs) are fixed rate government instruments, but are limited in volume (less than 10% of banking assets), held to maturity by investors, and are not available for trading. They are therefore both illiquid, and insufficient, for the purpose of providing a liquid benchmark.

There is an increased need for a fixed rate interest rate market based on the following factors:

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1 The total number of listed companies increased to 663 in 2006 as against 487 in 1990, while the current market cap is of over Rs. 2.8 trillion versus Rs. 61 billion in 1990. Introduction of automated trading and settlement systems on the pattern of the world's modern stock exchanges has been initiated, with Central Depository Company (CDC) playing the role of a depository of scripless securities and the National Clearing Company of Pakistan Limited (NCCPL) responsible for prompt settlement process of the traded securities.

2 FAs are defined as the monetary value of bank deposits, government domestic debt, private debt, and equity markets.

3 SBP Statistical Bulletin. June 2006. Bank deposits and equity markets represent 36% each, and government debt represents 27%. Private debt amounts to under 1%.

4 "Putting China's Capital to Work." McKinsey Global Institute. May 2006.

5 TFCs are closely held, and do not trade. They are floating rate based and exposed to rate fluctuations.

- At present, commercial banks in Pakistan will be hard pressed to make significant contribution either to the levels of infrastructure finance envisaged in the Medium Term Development Framework (MTDF), or to the progressively increasing requirement of mortgage finance.
- Both infrastructure and mortgages need fixed rates to evolve as full blown markets.
- The corporate sector will also require fixed interest rate loans to support plant and machinery investment.
- The alternatives of borrowing on a floating basis, or to borrow at fixed rates in foreign currency both pose risks.
    - The current experience of the textile industry shows that floating rate borrowings for long term investment can jeopardize profit margins in rising rate scenarios.
    - Unhedged foreign currency borrowing presents similar, and possibly higher, risk.
- Apart from the lack of capacity to offer fixed rate financing, there may be increasing pressure also on the liquidity of the banking system.
    - Banks are already operating at Asset/Deposit ratios that are close to the 75% upper limit placed by the SBP.
    - Future room created by growth in the monetary base would most likely be pre-empted by rapidly growing and highly profitable consumer debt, with corporate and SME requirements capturing much of the remaining balance.
    - Therefore, in order to provide headroom for liquidity growth, domestic bond and securitization markets will clearly be necessary.

Purpose of the Committee

Based on the above, it is evident that there is now critical need for an efficient, liquid, deep, and broad local debt market which can fuel growth of the public and private sector, provide liquidity and macroeconomic stability, enhance competition between various sources of financing, and help evolve a financial sector that offers a full range of innovative financial products and services.

In June 2006, the Securities and Exchange Commission of Pakistan ("SECP") formed the Debt Capital Market Committee ("DCMC") comprising of leading experts from the various industry stakeholders (issuers, investors, market participants, regulators, etc.) under the chairmanship of SECP chairman, Mr. Razi-ur-Rahman Khan. The DCMC is delegated the task of identifying the main critical issues hindering growth of the debt capital market in the country and making suitable recommendations to help develop and promote the market.

The committee is comprised of:

1. Mr. Razi ur Rahman - Chairman SECP, Chairman of the Committee
2. Mr. Shehzad Naqvi - CEO Crescent Commercial Bank, Vice Chairman of the Committee
3. Mr. Jamal Baquar - SEVP Crescent Commercial Bank, Secretary of the Committee
4. Ms. Jahanara Sajjad Ahmad - Joint Director SECP
5. Ms. Naz Khan - CEO KASB Funds Limited
6. Mr. Salim Raza - CEO Pakistan Business Council
7. Mr. Asad Umar – CEO and President Engro Chemicals
8. Mr. Khozem Haidermota – Partner Haidermota & Company
9. Mr. Intikhab Ahmed - Vice President Citibank
10. Mr. Shabbar Zaidi - Partner Ferguson & Co.
11. Mr. Maudood Khan - Partner Orr Dignum & Co.
12. Mr. M. Azimuddin

The SECP envisages that the recommendations put forward by this committee, once implemented, will act as a catalyst towards the development of the debt markets in Pakistan. Furthermore, the DCMC seeks to find ways to (i) improve corporate governance, (ii) enhance liquidity and efficiency, and (iii) to encourage transparency in trading of debt securities. Simultaneously, this study is geared towards strengthening the linkages between the SECP, the State Bank of Pakistan ("SBP"), the Ministry of Finance ("MoF") and other stakeholders within the public and private sectors, and to seek their buy-in for the proposed reforms.

General Observations

The DCMC believes that debt market reforms should be part of a broader strategic vision that comprehensively and systematically develops the entire spectrum of capital markets activity in the country. Some of these are as follows:

- All financial markets including equity, debt, forex, commodities, short-term funds (money markets), and derivatives markets need to be developed and enhanced
- Additionally, venture capital and private equity industries need to be promoted to increase depth and breadth of capital
- The institutional investor base comprising of asset management companies, pension funds, and insurance companies needs to be significantly expanded

- Finally, other markets such as asset securitization, structured products, derivatives, and mortgages should also be developed in parallel
- A parallel objective of the suggested reforms is to facilitate the growth of an "Islamic" Capital Market alongside the conventional market. Driven by local and regional demand, this represents a significant opportunity for Pakistan to become a dominant regional "centre of influence" in this growing sector. This would entail introduction of transparent and efficient "Shariah-compliant" structures, mobilization of Islamic funds, and better tax incentives for issuers and investors.

Detailed recommendations on reforms to Pakistan's Debt Capital Market are given in the proceeding sections. However, the broader strategic vision should:

- Focus on turning Pakistan's capital markets into the "preferred" fund-raising centre for all Pakistani companies such that they provide efficiency of execution, competitive pricing, liquidity, and transparency
- Local financial markets should be internationally competitive in terms of innovation, efficiency, productivity, and product offering which cater for a diversified issuer and investor base
- The reform efforts should also encourage competitiveness and efficiency for local and foreign market participants by offering better trading, payment, delivery, clearing, and settlement platforms, efficient exchanges, competitive fee structures and innovative services and products
- Finally, the governing authorities should provide a strong and supportive regulatory framework and encourage a move towards market-based system of regulation with stronger enforcement

Summary Issues & Recommendations

The need for improved debt management and debt issuance by the Government along with the elimination of higher cost 'subsidy' provided on existing debt instruments such as the National Savings Scheme (NSS), is inimical to the development of the bond market. The absence of a flourishing bond market imposes cost and uncertainty upon businesses, and therefore upon the whole economy. Lack of an efficient debt market will also forestall the growth of a national investment and savings market.

In addition to the need for the government to improve its debt management policy and debt issuance calendar there are regulatory and procedural changes required which can help facilitate bond issuance and enhance liquidity. Following is a summary of the key issues and recommendations brought forward by the DCMC, which are discussed in greater detail in the main body of this report.

Key Issues	Recommendations
Debt/Cash Management Strategy	
• The government's monetary policy and its debt management/market development functions often overlap. • Although the government has established DPCO, which is a first step towards debt reduction and management, Pakistan still needs to demonstrate a well articulated and comprehensive debt management policy and strategy.	• It is critical for debt market development, as well as for the efficient management of monetary policy, that the government's monetary policy and debt management objectives and consequent actions be conceptually and operationally separated. • The overall debt management objectives of the GoP need to be further developed so that it is viewed as a credible and frequent borrower. • A transparent, flexible, sustainable and effective medium-term issuance and debt management strategy needs to be devised.
National Savings Scheme (NSS)	
• The NSS, in its current structure, is the most significant challenge in the reform of Pakistan's debt capital markets. • This is primarily due to the subsidized nature of its saving products, which makes comparable market instruments seem unattractive and non-competitive.	• The NSS instruments need to be integrated into the mainstream capital markets. • One option is to convert the NSS instruments into market-based instruments such as PIBs and T-bills, and pass them on to retail clients directly through the NSS network.
Government Securities	
• The absence of an efficient benchmark sovereign yield curve makes it difficult to price debt issues correctly.	• An efficient government yield curve needs to be developed. The primary requirements for this are enhanced,

- Furthermore, Pakistan's money markets fail to anchor a yield curve due to their highly volatile short-end rates.
    - SBP's main policy rate is the cut-off yield for 6-months T-Bill auctions.
    - The artificial suppression of the long-end of the yield curve has resulted in a flat yield curve that reduces the appetite for long-term instruments.

regular, and predictable supply of government bonds, improvement in the infrastructure, broader distribution of government bonds, and development of an effective institutional investor base.

- The SBP should also consider shifting its monetary policy target from six month T-bill rate to a maturity of under one month, allowing the market to determine longer-term yields where the government conducts borrowing operations.
- The government must demonstrate that it is a price-taker at the long-end of the yield curve. A more genuine yield curve will assist in pricing and enhance trading.
- For price formation to take place at the short-end of the yield curve, the State Bank should stay close to preset quantity targets for T-bill auctions.

Issuance, Distribution & Holding of Government Securities

- Presently, the government conducts a price-driven auction instead of a quantity-driven auction, i.e. the government decides the cut-off yield for T-Bill and PIB auctions as opposed to letting the market determine the price.
- Based on market demand Primary Dealers (PDs) estimate the cut-off yield that the GoP is likely to target once it has communicated an indicative volume to the market. Since the government has the right to up-size or down-size, depending on the cut-off yield obtained in the bidding process, this makes matching demand very difficult for PDs.
- The Held to Maturity (HTM) category introduced in 2002 by the SBP allows banks to hold bonds at book value and not at mark-to-market value. In a rising interest rate environment, banks are incentivized to hold bonds to maturity and not trade them to avoid losses.

- The government's uptake must remain close to preset volumes, and auctions must be quantity-driven.
- The government should consider broadening the number of PDs or tiering them to enhance wider distribution.
- The HTM category should be revised or phased out.

Corporate Securities

- In the corporate bond market, the dearth of supply of TFCs is hampering secondary market development as investors do not have sufficient options to choose from.

- Corporates should to be encouraged, and incentivized to access the corporate debt capital market to fulfill their financing needs.

Corporates are more incentivized to fund their capital requirements through bank borrowing instead of capital markets.

- Inefficient pricing of TFC instrument itself can be a problem in the primary issuance process.
- In addition, other factors such as cumbersome primary issuance guidelines, processes, and costs further constrain a corporate in accessing the debt markets.

- The pricing of TFCs needs to be reviewed with the objective of moving toward an efficient pricing structure.
- Shelf registration procedures should be introduced along the lines of the US Securities & Exchange Commission rules. Shelf Registration for corporate bonds is currently allowed by the SECP; however, due to resource constraints, the SECP requires a relatively long time for the approval process. If the onus of issuing certificates is placed on the lawyers and investment bankers, the process would be faster, albeit at higher issuance costs.

Role of Banks as Intermediaries/Investors

- A major factor influencing the scarcity of corporate bond issuance is the role of commercial banks in the financial sector who also dominate the investor base for TFCs.
    - This creates a conflict of interest between the commercial banks' dual role of being the adviser as well as a principal investor in bond markets.
    - As a result the local TFC market remains a captive market where the principal investors (banks) have limited incentive to trade and enhance market development.

- If mutual funds are encouraged to approach corporates directly for issuance of corporate bonds in which they commit to invest, the captive market dominated by banks will give way to a broader investor base that would in turn contribute to a deeper and more liquid bond market.

Investor Base

- The current institutional investor base is insufficient to support an active and liquid debt market.
- Furthermore, an unchanged regulatory framework for pensions and a developing regulatory framework for insurance fail to lay a rigorous foundation for the development of this important investor base:
    - Insurance regulation needs to be undertaken in a more rigorous and comprehensive manner. There needs to be greater focus on evaluating solvency of insurance companies and consolidation must be encouraged.
    - Pension funds are governed by Acts

- The development of a diverse and broad investor base is essential for an active capital market consisting of domestic and foreign investors, insurance companies, mutual and pension funds, institutional investors and individuals.
- The government needs to improve regulation and incentives for the development of the insurance and pension sectors to enhance demand for and investment in government bonds:
    - There needs to be clarity regarding the regulation of the insurance industry. The exact sharing of responsibilities between the Ministry of Commerce and the SECP needs to be clarified, and ideally a single and

promulgated in 1968, and 1976, and rules established in 1971 and 1976. This regulatory framework may be inadequate for current needs.

empowered regulator needs to be established.

- The regulatory framework for pensions needs to be reviewed. The applicability of pension rules needs to be clarified. Rules have been put out by the SECP for provident funds, but it is not clear whether these rules are applicable to pensions.

Rating Agencies

- Lack of affiliations and/or presence of regionally and globally acclaimed credit rating agencies has resulted in inadequate competition within the local credit rating industry.

- The feasibility of getting foreign credible rating agencies to operate in Pakistan needs to be assessed.

Taxation

- There is no concept of allowability of any deduction of expense in respect of income (profit on debt). This effectively discourages borrowing and investing in securities. Thus, for individuals the underlying concept is a channel for 'savings' only.
- Unlike resident companies non-residents are subject to withholding at the rate of 30 percent on capital gains whereas final tax liability is same as for the resident companies.

- It is recommended that in order to streamline the system, for the time being, all income be it profit on debt, capital gains or discounts on debt instruments be taxed at the rate of 10 percent for all individuals including non-residents.
- In order to improve the debt capital market it is recommended that all withholding on debt instruments be removed for companies including non-resident companies, provided such non-resident companies are borne on the National Tax Register.

Legal

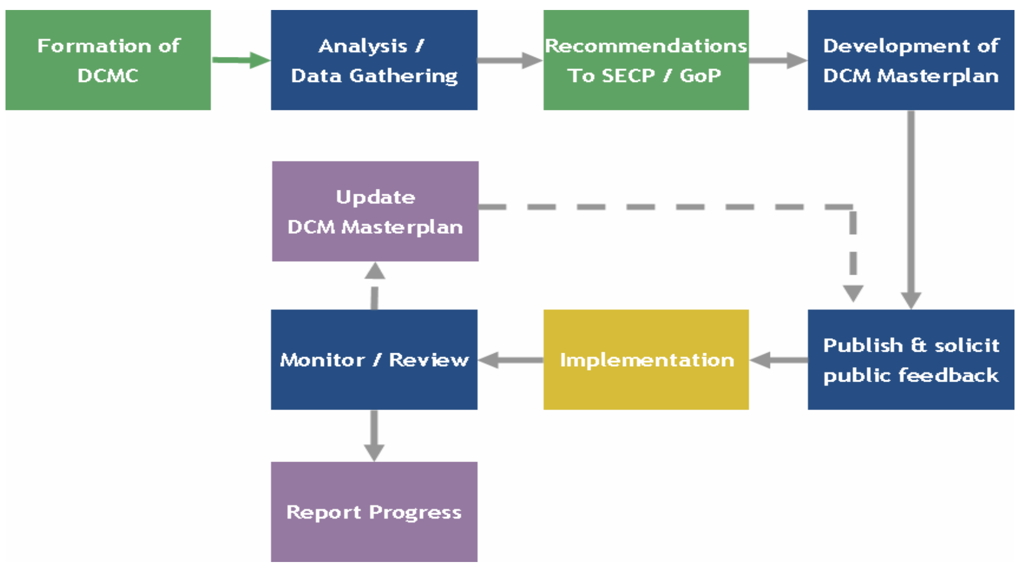
- In the context of securitisation, any instrument assigning receivables by the originator to the special purpose vehicle attracts substantial ad valorem stamp duty.
- It is unclear whether the Banking Courts will have jurisdiction to entertain any recovery proceedings filed by the SPV against the originator.
- The Real Estate Investment Trust Rules, 2006 (**"REIT Rules"**) are still in draft form and certain provisions therein is likely to hamper the development of REITs.
- Sell down of loans can fall within the ambit of a conveyance of property under the Stamp Act attracting ad valorem stamp duty.

- Issuance of statutory notification by the Provincial Government limiting the registration fee and stamp duty to a consolidated amount of Rs.100,000/-.
- Issuance of statutory notification by the Federal Government specifying that a special purpose vehicle shall be included within the definition of "financial institution".
- REIT Rules should be promulgated without delay and consideration should be given to various issues under the REIT Rules as identified in **Appendix "5"**.
- Issuance of statutory notification by the Provincial Government limiting the registration fee and stamp duty to a consolidated amount of Rs.100,000/-.

Workable Framework for Suggested Reforms

A well thought-out and systematic approach is required to first assess the needs of the local debt capital market and then to develop a workable framework. The initial phase of the framework required extensive data gathering and analysis by the members of the DCMC. The outcome of the analysis conducted by the DCMC is now being presented to the SECP and the Government of Pakistan (GoP) via the Ministry of Finance (MoF) as specific recommendations. It is envisaged that, provided consensus is achieved between all parties with a vested interest in the development of Pakistan's Debt Markets (i.e. GoP, MoF, State Bank of Pakistan, SECP, market participants), the development of a Debt Capital Markets Masterplan can be undertaken which can be proposed for public solicitation.

An "Implementation Task Force" can then be formed comprising of select members from all parties with a vested interest to ensure the successful implementation of the debt Capital Market Masterplan. Monitoring and review of the DCM Masterplan will need to be undertaken on a frequent basis.



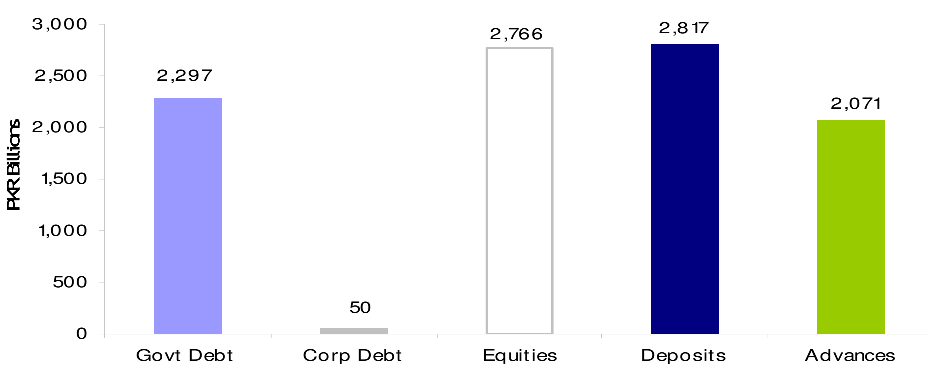
PRIMARY ISSUES & RECOMMENDATIONS

Local Debt Market

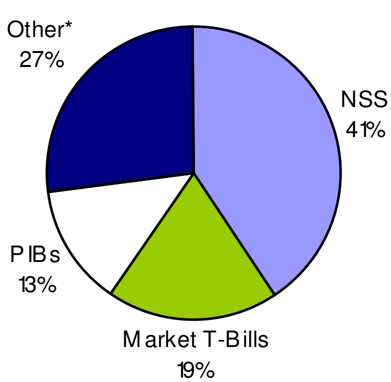
A developed, active and efficient government bond market is vital for the growth of broader debt capital markets of a country. Government bonds represent risk-free assets and hence serve as the reference instrument for securities pricing. Therefore, government bonds need to be efficiently priced across the maturity spectrum whereby they provide a complete and effective yield-curve. This is the precursor to any bond market development.

Pakistan's government debt market, though sizeable, lacks efficiency, depth and liquidity. The total domestic government debt outstanding as of June 2006 is approximately PKR 2.3 trillion (USD 38.3 billion), of which the National Saving Schemes (NSS) account for PKR 934 billion (USD 15.6 billion).[6]

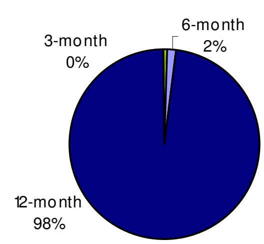
Breakdown of Pakistan's Financial Stock and Debt Securities



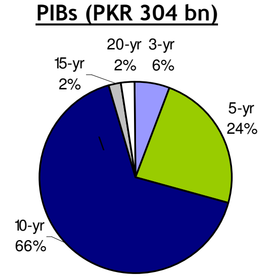
Govt Debt (PKR 2,297 bn)



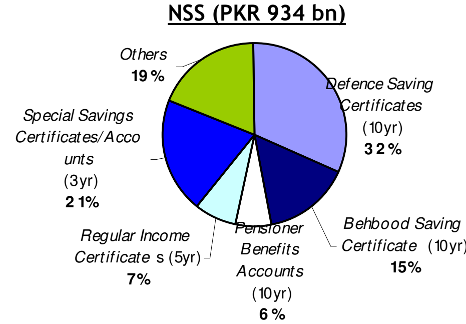
T- Bills (PKR 433 bn)



PIBs (PKR 304 bn)



NSS (PKR 934 bn)



[6] SBP Statistical Bulletin. June 2006.

The size of the corporate debt market in a country can signify the extent of debt market development. In addition to being indicative of the general debt market development of a country, corporate debt markets are vital to the robustness of the financial system of an economy as they strengthen and diversify the funding channels for economic growth. Accordingly, the meager size of Pakistan's corporate debt issues reflects the underdevelopment of the country's debt capital markets.

Historically, Pakistan and many of the world's emerging markets have heavily relied on bank loans as a stable form of financing. This puts undue pressure on a country's banking system, making the economy vulnerable to adverse effects of a banking crisis[7]. As of June 2006, Pakistan's total outstanding listed corporate debt, commonly referred to as listed Term Finance Certificates (TFCs)[8], amounted to approximately PKR 50 billion[9] (USD 833 million), which is paltry compared to the country's GDP of PKR 7.2 trillion (USD 120 billion), the equity market capitalization of PKR 2.8 trillion (USD 46.7 billion), and the outstanding domestic government debt of PKR 2.3 trillion (USD 38.3 billion)[10].

Efficient corporate bond markets spread the credit risk across various investors who participate in the primary issuance process and subsequent secondary market activity. Moreover, high reliance on bank credit can result in maturity mismatches when short-term loans are used to finance long-term investment projects. Finally, banks might not be able to meet the capital expenditure requirements of corporates in their entirety. Therefore, it is essential to have an efficient debt capital market to facilitate bank disintermediation, aid companies in better managing their asset and liability profiles, and to provide additional avenues of financing.

From an issuer perspective, a deepening of issuer class would allow lower rated borrowers better access to financial resources and lead to a well-diversified financial system. From an investor perspective, a deepening of issuer class would widen investment choices for investors by providing risk-return characteristics that are distinct from investment grade debt, and allow them to construct diversified portfolios. Additionally, a broadening of investment choices would also allow some institutional investors to better manage their asset and liability structures. For example, life insurance companies and pension funds, both of which have long-term liabilities, would need access to long-term bonds in order to balance their exposure, else they would be forced to charge a higher premium to compensate for the maturity mismatch.

The development of a corporate debt market would also allow for the deepening of parallel markets such as the derivatives market and the asset-backed securitization market. Incidentally, the relationship also holds the other way, whereby an efficient derivatives or securitization market would further propel debt market activity. Nevertheless, the two markets need to be developed simultaneously so they can leverage the symbiotic relationship. Derivatives products would help corporates hedge against future interest rate moves, and allow for the opportunistic issuance and rebalancing of debt requirement. A parallel area that begs attention and has been briefly mentioned above is the non-development of a market with sub-investment grade paper and high-yield securities.

7 The sudden capital outflow from numerous East Asian countries in the late 1990's was widely believed to be caused by over-dependence on the banking system and lack of alternative forms of financing. As a result, policy makers in East Asia have started to pay attention to developing efficient bond markets and countries such as Singapore, Korea and Malaysia (among others) have indeed made progress on this front.

8 There are two types of corporate debt issues in Pakistan: Term Finance Certificates (TFCs), which can be listed or privately placed, and Commercial Papers. Listed TFCs currently have a 5 to 8 year tenor (previously 3 to 5 year tenor), with the amount ranging from PKR 1,000 million to PKR 3,000 million.

9 Source: KASB Funds Database

10 Source: State Bank of Pakistan Statistical Bulletin

GoP's Debt/Cash Management and SBP's Monetary Policy

An effective debt and cash management system is vital in helping the Government of Pakistan (GoP), via its Ministry of Finance (MoF), establish itself as a credible and predictable issuer of government bonds. This in turn will pave the way for greater participation and liquidity in the primary and secondary government bond markets. The enhanced activity, together with a regular and predictable supply of bonds would aid the formation of a sovereign yield curve. Subsequently, the corporate bond market would also benefit as issuers will have a credible benchmark yield curve to help price corporate bonds efficiently.

Currently, there are three main central government debt managers in Pakistan, with relatively weak coordination and information sharing among them:

1. The State Bank of Pakistan (SBP) – Responsible for issuance of T-Bills and PIBs
2. Central Directorate of National Savings (CDNS) – Responsible for the NSS
3. Economic Affairs Division (EAD) – Responsible for foreign currency borrowing

Realizing the weakness in the current structure, Pakistani authorities established the *Debt Policy Coordination Office (DPCO)* in January 2003, which has been assigned the task of preparing and monitoring a debt reduction path and maintaining centralized and updated electronic record of the government debt and guarantees. Its functions were determined by the Fiscal Responsibility and Debt Limitation Act, 2005.[11]

Issues

The government securities market is operated in a manner where monetary policy and debt management/market development often overlap. The Exchange & Debt Management Department (EDMD)[12] of the SBP is responsible for both areas, namely, (i) the execution of monetary policy through money market operations, and (ii) debt management through the auctions of T-bills and PIBs on behalf of the MoF.

Prior to an auction, representatives from DPCO, the Budget Wing[13] of the MoF, and the EDMD of the SBP meet to discuss the amount and maturity of the upcoming issue, and the ensuing calendar for auctions. The Budget Wing is in charge of the treasury's account with the SBP and is responsible for making cash flow projections. The Budget Wing only forecasts approximate financing needs on a quarterly basis, and there are no formal cash flow forecasts being performed by the wing.

Due to lack of cash flow forecasts, the Budget Wing needs to keep a surplus amount in the treasury's account with the SBP. In case of deficits, the SBP issues T-bills (priced at the average of the last auction price) and credits the account with the purchase amount. Presently, there is no limit on the amount the government can borrow from the SBP[14].

SBP's main policy rate is the cut-off yield for 6-months T-Bill auctions, while cut-off yields for 3-months and 12-months T-Bill auctions play a supporting role. A majority of government funding is currently at these maturities. The choice of the six-month T-bill rate as the target

[11] Refer to the Appendix for the role and responsibilities of DPCO
[12] There has been re-organization of departments at the SBP and as of date, the specific of functionality of each department has not been finalized.
[13] One of the wings in the Finance Division of the Ministry of Finance (MoF)
[14] Source: "Central Government Debt Management & Domestic Debt Markets Development". Joint World Bank – IMF Program Assessment Report. December 2004.

of SBP's OMOs intensifies the short-end rate volatility caused by unpredictable liquidity needs.[15]

In addition, Pakistan's money markets fail to anchor a yield curve due to their highly volatile short-end rates. This has been impeding the development of secondary market for government securities as the high volatility makes it risky for dealers to hold bonds even for a very short period for outright trading.

Recommendations

Although the government has established DPCO, which is a first step towards debt reduction and management, Pakistan needs to demonstrate a more comprehensive debt and cash management strategy. It is critical for market development, as well as the efficient management of monetary policy, that the government's monetary policy and debt management objectives and consequent operations be conceptually and operationally separated. This process needs to be phased in, with better coordination between monetary policy and debt management/market development.

The overall debt management objectives of the GoP need to be developed. Market development could be a part of these objectives. A transparent, flexible, sustainable and effective medium-term issuance and debt management strategy needs to be devised. The government must develop a robust and well-staffed debt office. This office may be organized to consist of a front office, middle office and back office. The front office may deal with the market and concern itself with debt issuance, the middle office may undertake risk management, and the back office may focus on systems and the logistics of the operation.

The debt manager needs to develop an analytical framework that allows for qualification of costs and risks and evaluation of tradeoffs over time. The government needs to enhance its credibility by providing dependable information on government finances, the debt portfolio, redemption profile, and borrowing strategy. The role of DPCO in debt management needs to be expanded:

- For DPCO to meet its mandate of developing a comprehensive debt management strategy, it needs to be aware of the activities of the other three debt offices. In order to achieve this goal, it would make sense for DPCO to develop the yearly government borrowing plan for the entire debt instead of the SBP, CDNS and EAD preparing three separate borrowing plans.
- Transfer Budget Wing's role in debt management to DPCO once it is properly staffed to ensure better coordination. This would include transferring the responsibility of determining interest rates on the NSS instruments/ PIBs & T-Bills from the budget wing to the DPCO so that they are in line with market rates.
- Cash flow forecast should be improved and made more reliable. Effective debt management must rest on the foundations of effective cash management. This is a challenge as it involves effective cash management and MIS at all government departments that constitute overall government cash management.
- More focus and resources need to be allocated to the project of producing the government's current and forecast cashflows than presently assigned. Personnel from

[15] Source: "Central Government Debt Management & Domestic Debt Markets Development". Joint World Bank – IMF Program Assessment Report. December 2004.

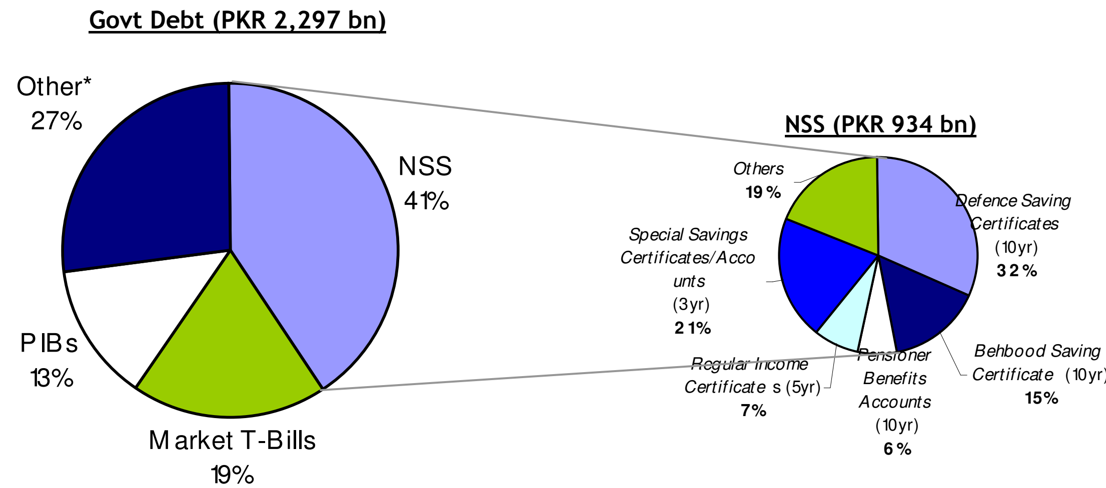
organizations in the private sector, such as banks, may be used to train government managers to undertake cash management. The Budget Wing in co-ordination with the DPCO, CDNS, and SBP is best suited to prepare a plan for how these cash forecasts should be improved.

In addition, for price formation to take place at the short-end of the yield curve, the State Bank should stay close to preset quantity targets for T-bill auctions. The SBP should also consider shifting its monetary policy target from six month T-bill rate to a maturity of under one month, allowing market to determine longer-term yields where the government conducts borrowing operations.

The National Savings Schemes (NSS)

The Central Directorate of National Savings (CDNS) is an attached department of the Finance Division and performs deposit bank functions by selling government sponsored NSS products through a network of 367 savings centers spread all over the country.

NSS accounts for 41% of Government Debt (Rs.934 bn as of June 30, 2006)



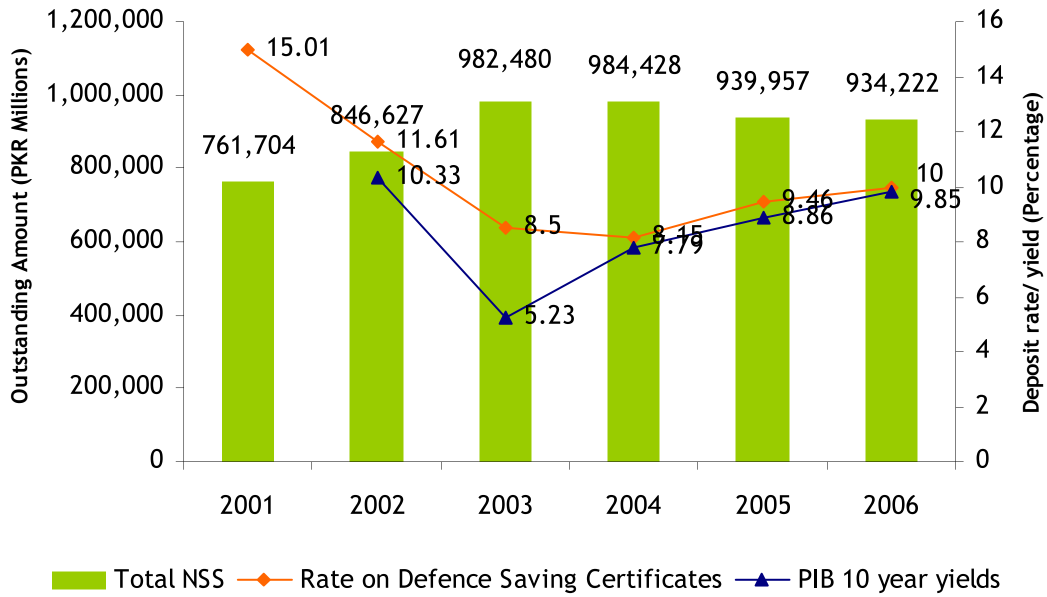
The total amount of outstanding debt in NSS instruments increased at a decelerating rate from 2000 to 2004, and then declined in absolute terms in the year 2005 before rising again in 2006. The erratic trend in NSS balances is attributed to erratic government policy. The government initiated efforts to synchronize NSS rates with Pakistan Investment Bonds (PIBs) resulting in declining rates of return on NSS instruments beginning first half of FY 2002. Additionally, CDNS restricted institutional investment in NSS in March of 2000 which further restricted inflows, and has also led to net repayments to these institutions causing a decline in total NSS balances. However, in October 2006 the CDNS went back on its policy, re-allowing institutional investment in NSS which will contribute to a rise in NSS balance for 2006.

The sudden fall in flows of NSS had created a short-term financing requirement for the government. Although the gradual shift of comparatively expensive borrowing from NSS to PIBs would have reduced the cost of borrowing and also would have provided more control over the government's financing sources, the government seems to be more focused on its needs in the short-term.

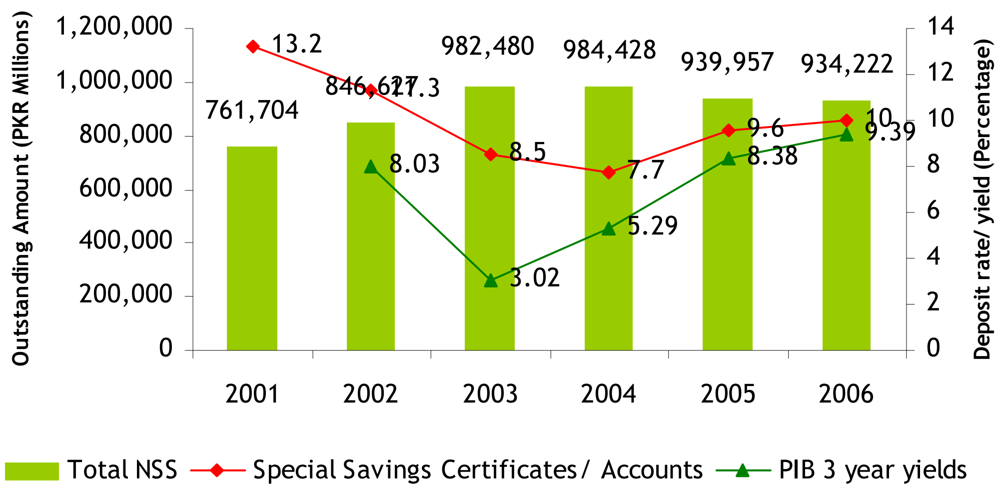
Some popular savings schemes are as follows:

- Defence Savings Certificates (10-year term)
- Bahbood Savings Certificates (10-year term)
- Pensioners' Benefit Accounts (10-year term)
- Regular Income Certificates (5-year term)
- Special Savings Certificates (3-year term)
- Special Savings Accounts (3-year term)

Historical Outstanding NSS balances vs. DSC and 10Yr -PIB Rates[16]



Historical Outstanding NSS balances vs. SSC/A and 3-Yr -PIB Rates[17]



[16] SBP website
[17] SBP website

Issues

The NSS, with its current structure, is the most significant challenge in the reform of Pakistan's debt capital markets, primarily due to the subsidized nature of its saving products. The NSS system has distinct advantages and disadvantages.

- On the positive side, it provides a reliable source of long-term funding to the government and a widespread distribution network that provides access to the retail investor base.
- On the negative side, it has historically been a costly source of funding for the government due to the inefficient pricing structure and the free embedded put option.

Despite efforts to bring NSS rates of returns in line with PIBs, NSS products continue to remain a better investment option due to the higher interest rates, government guarantee, and most importantly, the in-built put option that allows investors to redeem the investment at any point in time without any redemption charges. Subsequently, comparable market-based instruments, in contrast, seem unattractive and non-competitive to the retail investor base. Furthermore, the government has limited control over the amount of money that can be raised due to the 'on tap' nature of NSS instruments.

Recommendations

NSS instruments need to be integrated into the mainstream capital markets. One option is to convert the NSS instruments into existing market-based instruments i.e. PIBs and T-bills, and pass them on to retail clients directly through the NSS network. The second option is to withdraw the policy of allowing redemption at zero penalties in order to make NSS instruments competitive with market instruments.

The NSS retail distribution network can be leveraged and its retail investor base made more resilient by allowing private sector mutual funds access to the platform for distribution of their investment products. Mutual funds will be attractive to the retail investor base as they can be tailored to varying needs and investment/saving profiles.

The government needs to turn to PIBs instead of NSS to fulfill its long-term investment needs, as PIBs would provide the ministry more control over its financing needs unlike the NSS, whose 'on tap' nature puts it outside the realm of government control.

Supply of Government and Corporate Debt Securities

The federal government, through the SBP, currently issues debt in two forms: Treasury Bills (shorter tenor with maturities 3, 6, and 12 months) and Pakistan Investment Bonds (longer tenor with maturities of 3, 5, 10, 15, and 20 years). T-Bill auctions are conducted by the SBP on a fortnightly basis, but PIB auctions are held on an adhoc basis with an advance notice of at least two weeks. PIBs have been issued with an erratic frequency, for example there were no issues from April 2004 to May 2006. The SBP has implemented a Primary Dealer (PD) system, instead of an open auction, for the distribution of government securities to the secondary market. At present, 14 PDs are authorized to participate in auctions conducted by the SBP.

In addition, the federal government borrows funds, via the Central Directorate of National Savings (CDNS), directly from Pakistan's retail sector through the National Savings Schemes (NSS). The CDNS operates through 12 regional directorates and 367 savings centers[18] servicing approximately 6 million accounts. The NSS accounts for approximately PKR 934 billion of the total domestic government debt, which itself amounts to PKR 2.3 trillion.[19]

On the Corporate Debt front, there are two types of issues in Pakistan: Term Finance Certificates (TFCs), which can be listed or privately placed, and Commercial Paper. Privately placed TFCs can have short and long tenors. The investor base for privately placed TFCs includes commercial banks, DFIs and mutual funds. The issuance time is 30-45 days. These issues do not need approval from the SECP as prospectuses are not issued. Listed TFCs currently have a 5 to 8 year tenor (previously 3 to 5 year tenor), with the amount ranging from PKR 1,000 million to PKR 3,000 million. The investor base includes commercial banks, DFIs, employee benefit fund, insurance companies, and mutual funds. The issuance time is longer than that for privately placed issues, in the range of 3-4 months. Listed TFCs require approval of the SECP and relevant stock exchanges and also require a rating.

Issues

As discussed earlier, the absence of a pre-announced PIB issuance schedule which specifies PIB issuance is a major impediment to developing an efficient and active government bond market. In August 2004, the government announced for the first time the issuance calendar of PIBs for the remaining three quarters of the fiscal year 2004-2005, and its intention to announce a calendar for each following fiscal year. However, the two subsequently scheduled PIB auctions were rejected because the market's bid prices were lower (i.e. the yields were higher) than what the government had expected. The PDs responsible for the distribution of PIBs and T-Bills do not have sufficient lead time and information to prepare their bids at the auctions.

Presently, the government conducts a price-driven auction instead of a quantity-driven auction, i.e. the government decides the cut-off yield for T-Bill and PIB auctions as opposed to letting the market determine the price. Based on market demand the PDs have to estimate the cut-off yield that the government is likely to target once the government has communicated an indicative volume to the market. Since the government has the right to up-size or down-size, depending on the cut-off yield obtained in the bidding process, this makes matching demand very difficult for PDs.

[18] CDNS website
[19] NSS is discussed in greater detail in the next section

As mentioned in greater detail in the next section, the **NSS** is the most significant challenge in the reform of Pakistan's debt capital markets, primarily due to the subsidized nature of its saving products, which makes comparable market instruments seem unattractive and non-competitive.

On the corporate side, most corporates fund their capital requirements through bank borrowing instead of capital markets. A major factor influencing the scarcity of TFC issuance is the role of commercial banks in the financial sector. There is a conflict of interest with commercial banks' dual role of being the principal investor in debt securities as well as the main issuers of debt securities. As a result the TFC market remains a captive market where the principal investors (banks) have no incentive to trade and enhance market development.

Furthermore, inefficient pricing of TFC instruments itself can be a problem in the primary issuance process. Due to the differentiated structure of TFCs, they are difficult to price. Two issues that are rated differently might be similarly priced which reflects loopholes in the pricing process. This affects liquidity as it constrains market participants from confidently providing bid/ask quotes. This hampers the development of efficient debt markets. Other factors include:

- There is lack of existence of plain vanilla corporate bonds, even though plain vanilla government bonds exist
- Lack of affiliations and/or presence of regionally and globally acclaimed credit rating agencies has resulted in inadequate competition within the local credit rating industry
- Lack of existence of quasi debt classes such as Convertible Debt issues and Preferred Debt issues. Corporations may find Convertible Debt attractive, as they can raise relatively low cost debt without having to share control, at least for the period stipulated before conversion
- In addition, other factors such as cumbersome primary issuance guidelines, processes, and costs further constrain a corporate in accessing the debt markets. Currently, the processing time for listed corporate debt issues is 3-4 months. The process also includes obtaining approval from the Securities and Exchange Commission (SECP), which regulates Pakistan's securities markets.[20]
- The costs of issuance, albeit not exorbitant, can be a hurdle.[21]

Recommendations

The government needs to ensure a more regular supply of government bonds to the market before government bond distribution and secondary market trading can develop. With the present level of supply, and given that the statutory SBP requirements can be fulfilled by holding government bonds to maturity, there is little incentive for secondary market trading. The government needs to move away from the principle of carrying on all its activities in the government bond market guided by the objective of cost-minimization. The government

[20] Another mandatory requirement for listed TFCs is obtaining a rating from one of the two approved rating agencies: the Pakistan Credit Rating Agency (PACRA) or JCR-VIS Credit Rating, which adds to the processing time. However, the average processing time for obtaining a rating is 4-6 weeks, which is in line if not less than the industry standards as seen in other countries. For example Moody's rating process in Australia take approximately 8-12 weeks.

[21] Refer to annexure for a breakdown of costs

must be convinced and must operate in different interest rate environments, following their indicated annual auction calendar.

The government should not take a commercial view on the domestic debt market. It can do so in the international market, however on the domestic front, the higher cost that the government pays periodically when it maintains a consistent supply of government securities in the market needs to be considered as an investment needed to develop the government bond market. This in turn provides the benchmark yield curve that will form the foundation of the corporate bond market. Furthermore, the government's uptake must remain close to preset volumes, and it must be quantity-driven.

The pricing process of TFC issues needs to be reviewed with the objective of ironing out glitches and moving toward an efficient pricing structure. Plain vanilla corporate bonds may be introduced in the market. While the basis for the introduction of TFCs in their present form was for their Islamic structure, since then the government has issued plain vanilla government bonds. Similarly, plain vanilla corporate bonds could be introduced, but the market fragmentation aspects of such a measure (if both TFCs and corporate bonds are issued side by side) would need to be assessed. Other recommendations include:

- Assessing the feasibility of getting a foreign recognized rating agency to operate in Pakistan
- Consider the introduction of quasi debt classes and review procedural and regulatory requirements for such a move
- Shelf registration procedures should be introduced along the lines of the US Securities and Exchange Commission (SEC) rules, which were updated in December 2005, to allow for registration for three year periods, in the course of which it could issue securities using a very short form prospectus. This would help corporates in quickly obtaining funds through debt issuance when conditions are favorable. Shelf Registration for corporate bonds is currently allowed by SECP; however, due to resource constraints, the SECP requires a relatively long time for the approval process. If the onus of issuing certificates is placed on the lawyers and investment bankers, the process would be faster. However, this would increase the cost of issuance. Placing the onus on the lawyers and bankers should be given serious consideration and its gain/loss analysis reviewed.

Finally, if mutual funds are encouraged to approach corporates directly for issuance of corporate bonds in which they commit to invest, the captive market dominated by banks will give way to a broader investor base that would in turn contribute to a deeper and more liquid bond market.

Secondary Market

The main participants in the secondary markets for government securities include banks, corporates and multi-nationals, provident and pension funds, and mutual funds. Major types of transactions in the secondary markets include calls (clean lending), outright buy and sell of T-bills and bonds, and Repo and Reverse Repo against T-bills and bonds. Debt instruments are mainly traded in the secondary market between different financial institutions that trade through Financial Markets Association (FMA) registered money market brokers. Both clearing and settlement is done through the SBP.
In the corporate debt market, all secondary market activity is over the counter (OTC), typically by brokerage houses with no trading over the stock exchanges.[22] Secondary-market liquidity in the TFC market remains a major concern. Subsequently, market yields are less reflective of the actual credit assessment of specific companies and are driven more by turnover technicalities of the bond issues.

Issues

As discussed, the secondary market for government securities remains thin and illiquid in Pakistan. It remains dominated by repo trades rather than outright trades. In general, outright trades account for 8% as compared to repos which account for 92% of daily trade volume. Of all repos, interbank/PD repos represented 89% of the trades.[23] Furthermore, the system of 14 PDs fails to distribute the government securities broadly. These securities are primarily held by large commercial banks to meet the SBP statutory reserve requirements.

- The Held to Maturity (HTM) category introduced in 2002 by the SBP allows banks to hold bonds at book value and not at mark-to-market value. In a rising interest rate environment, banks are incentivized to hold bonds to maturity and not trade them in order to avoid booking losses.
- Although PDs are required to quote two-way prices representing market sentiment, this is not always the case. The secondary market is 90% indication-driven limiting the market's true potential. Although PDs are required to maintain a 50 basis point bid/ask spread, they are typically in the region of 200 basis points in as much as they are available.[24]
- Although market making activity in the corporate bond markets has improved in the recent past, it remains inadequate. The brokerage houses that participate in bond trading have limited balance sheet strength and therefore need to partake in pass through bids.
- Most corporate issuers rely on bank loans to meet their capital expenditure requirements. The dearth of supply of TFCs is also hampering secondary market development as investors do not have sufficient options to choose from.
- The inefficient pricing structure of the NSS and cumbersome issuance guidelines are also factors contributing to constrained supply of corporate bonds.
- At present, Pakistan lacks an efficient and deep derivatives market that would provide investors the option to hedge their risks. Although lack of a derivatives market does not

[22] KSE has issued regulations for an OTC market, however, regulations are geared toward share issuance of emerging and small companies.
[23] Source: "Central Government Debt Management & Domestic Debt Markets Development". Joint World Bank – IMF Program Assessment Report. December 2004.
[24] Source: "Central Government Debt Management & Domestic Debt Markets Development". Joint World Bank – IMF Program Assessment Report. December 2004.

hamper secondary activity, it does keep risk averse investors from entering the market as they do not have the option to hedge away unwanted risk.

- Another factor that is an impediment going forward as debt markets gain traction is the lack of an effective electronic trading, clearing, and settlement system, which slows down transfer and dissemination of information. This in turn restricts the development of two-way quotes.
- At present, trading instructions and checks must be physically delivered to the SBP each day to carry out a trade in a government security. This then requires a parallel or sequential transaction between an investor and the PD. This can expose both parties to significant operational risk.
- Additionally, the inefficient and slow system also restricts the development of two-way quotes that are inherent to an efficient market. *(Weak infrastructure issues are discussed in more detail later in the paper).*

Finally, the current institutional investor base is insufficient to support an active and liquid debt market. The growing mutual fund industry mostly concentrates investment in equities as the equity markets have historically been the focus of attention. Less than 10% of the Rs 165 billion (approximate) mutual funds assets are directed towards income funds. Moreover these income funds invest substantially in the CFS market. State Life Insurance Company (SLIC) is a major investor in the fixed income market, however, Employees Old Age Benefits Institution (EOBI) liquidated their portfolio of PIBs approximately three years ago and are primarily investing in the NSS now *(Issues on developing demand are discussed in more detail in the next section).*

Recommendations

The government needs to provide a consistent and dependable supply of bonds to promote the government bond market. The instruments need to be priced through the market so that they can be traded at market levels and reflect fair, transparent pricing. If the government holds one PIB auction in 2 years, it cannot expect PDs to develop a liquid secondary market; without adequate supply of PIBs this is an unrealistic expectation and unreasonable evaluation. This process should be revised in line with issuance levels. Of course, ideally, issuance levels need to be increased sufficiently to catalyze the development of a vibrant market.

The distribution system of PDs for government bonds is largely under-utilized, given the highly illiquid secondary market in government securities. However, the criterion for evaluating PDs assumes a liquid and deep market. Therefore, before addressing issues related to the PD system, some of the aforementioned issues such as inconsistent primary issuance and need for a benchmark yield curve would need to be sorted out.

The HTM category should be revised or phased out.

Corporations need to be encouraged, and perhaps given incentives to access the corporate debt capital market to fulfill their financing needs.

For secondary market liquidity and efficient risk management, derivative products like interest rate swaps, futures, and coupon stripping need to be introduced. Introduction of derivatives would help in breaking the impasse created by excessive debt holdings. This would enable institutions to hedge their interest rate risk leading to increased activity.

Technological enhancement to the electronic trading system is imperative for efficient bond and derivative trading, clearing and settlement *(Recommendations on Clearing and Settlement are discussed in more detail later in the paper).*

Development of investor base is essential for an active secondary market consisting of domestic and foreign investors, insurance companies, mutual and pension funds, institutional investors and individuals. With the help of wide array of investors with varying risk preferences, time horizons, and trading motives would ensure active trading, liquidity and allow the government with increased options of funding *(Recommendations on developing demand are discussed in more detail in the next section).*

Demand for Government and Corporate Debt Securities

The absence of sufficiently developed long-term investors is a significant hurdle in the development of any debt capital market. [25] Commercial banks and DFIs are not long-term investors as their liabilities are not long-term. Although employee benefit funds and insurance companies are the natural demanders of long-term assets to hedge their long-term liabilities, in Pakistan they are too small and undeveloped as an investor base to drive demand for debt securities sufficiently. Developing the pension sector is a major initiative primarily motivated by providing a dependable and adequate social safety net for citizens, and the insurance sector is a vehicle for bearing and distributing risk. Creating an enabling environment for these sectors to develop and flourish will be one of the most powerful and effective action that the government and industry participants can take to develop Pakistan's debt capital market.

There has been some very recent development in the pension industry. In January 2007, the Securities and Exchange Commission of Pakistan (SECP) formally launched the Voluntary Pension System (VPS) by issuing registration certificates to four asset management companies to operate as pension fund managers. The SECP developed the legal framework for private pensions in the country through notification of the VPS Rules, 2005. Under the VPS, all Pakistani nationals over the age of 18 years (salaried or self-employed) who have a valid National Tax Number (NTN) are eligible to participate in the forthcoming pension schemes which will be portable. The introduction of the Voluntary Pension System would increase the savings rate and play a positive role in the growth of the financial markets in the country by enhancing a much needed institutional investor base. These long-term funds will enhance the stability and reduce the volatility of both the capital and the money markets.

Issues

In addition to the lack of a dependable supply of debt instruments and the lack of liquidity in government and corporate bonds there are a number of other factors affecting demand for debt securities:

- With pension assets at 1.6% of GDP and life insurance assets at 2.1% of GDP in 2004[26], the small size of the contractual savings sector in Pakistan results in a limited demand for government bonds
- An unchanged regulatory framework for pensions and a regulatory framework for insurance that is in the process of being established fail to lay a rigorous foundation for the development of these sectors
    - Insurance regulation is not being undertaken in as rigorous and comprehensive manner as needed. There is insufficient focus on evaluating solvency of insurance companies
    - Pensions are governed by Acts promulgated in 1968, and 1976, and rules established in 1971 and 1976. This regulatory framework may be inadequate for current needs
- The artificial suppression of the long-end of the yield curve has resulted in a flat yield curve that reduces the appetite for long-term instruments.

[25] Incidentally, demand for corporate bonds is also waning due to the present conditions of rising interest rates. Rising rates would be detrimental to the performance of fixed income instruments whose value moves in the opposite direction of interest rates.

[26] In 2005, pensions and life insurance assets were 59.2% and 17.8% of GDP in Malaysia and 21.4% and 17.7% of GDP in Korea respectively (East Asian Markets study, World Bank 2006)

Recommendations

Government policies and initiatives can enhance the appetite of institutional investors for bonds on three fronts:

- The government needs to become a price-taker at the long-end of the yield curve. A more genuine yield curve will assist in pricing and enhance trading
- The size of the institutional investor base should be expanded
- Adjust regulation and incentives so that greater asset/liability matching capacity, corporate governance, and authorization to invest in government securities, encourage these natural demanders of bonds to invest in bonds. Incentives to attract international technical expertise in this sector need to be developed. The level of investment restrictions on institutional investors need to be reviewed in light of present market developments and availability of instruments.

The government needs to improve regulation and incentives for the development of the insurance and pension sectors to enhance demand for government bonds. There needs to be clarity regarding the regulation of the insurance industry. The exact sharing of responsibilities between the Ministry of Commerce and the SECP needs to be clarified, and ideally a single and empowered regulator needs to be established. The growth of the industry is being affected due to regulatory uncertainty and lack of direction.

The regulatory framework for pensions needs to be reviewed. The applicability of pension rules needs to be clarified. Rules have been put out by the SECP for provident funds, but it is not clear whether these rules are applicable to pensions. The market is assuming that they are, and acting accordingly, but this grey area may stunt development.

Settlement & Clearing[27]

There is no pure electronic means of confirming deals, trading and the subsequent payment of successful deals. In order to run the course of action smoothly, electronic media should be present throughout the process in order to attain maximum efficiency and to avoid delayed payments. Currently, in an attempt to expedite the payment process, this is done at the expense of a shortened trading day. The settlement documents from the seller and the SBP cheque drawn by the buyer are submitted to the central bank in person by an intermediary. In order to meet the deadline, the trading activity is ceased at around 1:00 pm, which is earlier than the official trading day end-time, and messengers are rushed to the central bank prior to the cut-off point of 01:30 pm.

A two-tiered depository system is employed for government securities, where the SBP utilizes manual book entry for recording purposes. All banks and non-bank financials institutions (NBFIs), inclusive of primary dealers (PDs), have two subsidiary general ledger accounts (SGLAs) with SBP, one for bank owned government securities, and the other for the bank's customer owned securities.

The introduction of the Real-Time Gross Settlement System (RTGS) will augment the need for SBP's intra-day liquidity facility, which in turn will increase the demand for collaterals - a requirement of SBP from the participant. It is anticipated that government securities held by banks and NBFIs will be insufficient. Currently, rehypothecation of securities held in customer SGLAs is disallowed.

Issues

The physical system is a bottleneck and will stifle trading growth. It is characterized by a shortened trading day and a high level of operational risk. The provisions of the Public Debt Act 1944 (PDA) do not support the scripless nature of T-bills and PIBs nor a two-tiered holding system for government securities.

Recommendations

The installation of Real Time Gross Settlement (RTGS) Delivery Versus Payment (DVP) Model One[28] should be completed as well as the enactment of the Payment Systems and Electronic Fund Transfers Bill 2005 as soon as possible. This will enable real time settlement process thereby increasing market efficiency in terms of trading and payment. The current arrangement of SGLA facility for new alternatives including (i) rehypothecation of government securities held for customers, and (ii) the transfer of the custodial function to CDC and / or NCC, as well as their participation in the SGLA facility should be reconsidered.

[27] The description of current issues and recommendations is primarily drawn from: "Central Government Debt Management & Domestic Debt Markets Development". Joint World Bank – IMF Program Assessment Report. December 2004.

[28] Model 1: Gross, simultaneous settlements of securities and funds transfers; Model 2: Gross settlement of securities transfers followed by net settlement of funds transfers; Model 3: Simultaneous net settlement of securities and funds transfers. (Committee on Payment and Settlement Systems (CPSS); Bank of International Settlements (BIS)). While Model 2 and Model 3 may be more efficient, Model 1 minimizes operational risk and has become the standard in security settlement.

Taxation & Accounting[29]

Taxability for individuals

Subsequent to Finance Act, 2006 individuals being residents are subject to tax on profit on debt on NSS and TFC at the rate of 10 percent. Such amount is subject to withholding at source at the time of payment and it represents a final tax liability on presumptive basis. This means that no deduction is allowed against such income. Sukuk Bonds, being foreign currency instruments, are exempt from tax under a specific provision of law. Profit on debt on other instruments (not being NSS or TFC) are subject to tax at normal rate. Nevertheless, withholding remains at 10 per cent.

There is no withholding on other forms of income being capital gains and premiums on debt instruments. Under the law:

- Capital gains are taxable at 75 percent of the normal rate of tax if such instruments are held for more than 12 months
- Listed TFCs are exempt from tax.
- There is no specific treatment for discount and premiums and effectively there is no deduction for premium paid on instrument.
    - Discount on instrument is taxed as normal income.
- It is important to note that being a non-transferable instrument there is no basis of earning any income other than profit on debt on NSS.
- Non-resident individuals are subject to a withholding at the rate of 30 per cent on all income on debt instruments and there final tax is one being normal tax as the case may be.
- Under the law mutual funds are treated as a 'Pass Through Entity' being exempt from tax.
    - Accordingly fixed income funds earning income from aforesaid sources remain exempt from tax if it distributes 90 percent of its profits.
    - Thus, an individual including a non-resident is effectively taxed at the rate of 10 percent if instead of a direct investment in the instrument opts to invest in a fixed income mutual fund.
    - Such amount is available as dividend from the mutual fund.
    - Furthermore capital gain on disposal of a certificate of such funds is also exempt from tax provided the mutual fund is listed.

Issues

The above analysis and the prevalent regime suggest that there is no concept of allowability of any deduction of expense in respect of income (profit on debt). This effectively discourages borrowing and investing in securities. Thus, for individuals the underlying concept is a channel for 'savings' only.

Recommendations

It is recommended that in order to streamline the system, for the time being, all income be it profit on debt, capital gains or discounts on debt instruments be taxed at the rate of 10 percent for all individuals including non-residents.

[29] Details on tax and accounting treatment for various kinds of debt instruments are provided in Appendix 3 at the end of this report.

<u>Taxation for Companies</u>

Issues

In the case of companies, including banking companies, 'profit in debt' on debt instruments identified above, there is a deduction of tax at source at the rate of 10 percent. This deduction at source is not a final liability. Capital gains and other receipts arising on debt instruments are not subject to withholding tax.

All income from debt instruments are subject to tax at the normal rate after allowing for deductible allocable costs. Where such instruments are held as capital asset the income is taxed at 75 percent of the normal rate of tax if such instruments are held for more than 12 months.

Other income such as, discount on instruments is taxable as normal income on accrual concept. Pakistan tax laws determine income on accrual basis therefore income on instrument in all form is determined as and when accrued whether or not received. In this situation 'Cash Mismatch' with regard to taxability arises on account of withholding.

Income from instruments if acquired indirectly i.e. acquired through a fixed income mutual fund is subject to tax at the rate of 5 percent in the form of dividend. Since dividends are subject to tax on presumptive basis therefore interest costs are not allowed. This mechanism represents a distortion in the system as in this manner the taxability of income is changed substantially.

In the case of a company being a non-resident withholding on such instrument is made at the rate of 30 percent. Furthermore, unlike resident companies non-residents are subject to withholding at the rate of 30 percent on capital gains whereas final tax liability is same as for the resident companies.

Recommendations

- It is recommended that withholding in the hands of a company, including banking companies are removed as such companies are required to pay tax on such income on accrual basis as and when earned by way of advance tax.

- In order to improve the debt capital market it is recommended that all withholding on debt instruments be removed for companies including non-resident companies, provided such non-resident companies are borne on the National Tax Register.

Legal Issues

Securitisation

Issues

In the context of securitisation, any instrument assigning receivables (absolute or by way of security) by the originator to the special purpose vehicle attracts substantial ad valorem stamp duty. Also any transfer of receivables secured by mortgage of immovable properties can arguably require compulsory registration under the Registration Act, thus attracting ad valorem registration fees (even if the mortgaged property and receivables are divorced). Currently, in certain situations an equitable assignment is possible without attracting ad valorem stamp duty but the same is of limited use.

It is unclear whether the Banking Courts will have jurisdiction to entertain any recovery proceedings filed by the SPV against the originator. Where banks are originators, SBP regulations impose an extremely rigid “true sale” standard. Some limited recourse by the SPV against the originator is generally acceptable provided the recourse is of a nature that a purchaser may have against the seller. For example if the originator (a bank) has warranted that loans being securitised are performing and it turns out that the loans were non-performing then surely SPV must have a claim against the originator. The current “true sale” standard of SBP would disallow such recourse. (We however point out that the aforesaid “true sale” standard is only applicable where a bank is the originator). SBP’s regulation requires that banks purchasing securities issued by SPV can only do so if such securities are listed.

Recommendations

- Issuance of statutory notification by the Provincial Government limiting the registration fee and stamp duty to a consolidated amount of Rs.100,000/-. (Such cap of Rs.100,000/- currently applies to all mark-up base financing and security documents executed in favour of banks in the Province of Sindh). A suggested draft of the notification that may be issued by the Government of Sindh is attached as **Appendix “4 A”**. The same text may also be used for other Provinces.

- Issuance of statutory notification by the Federal Government specifying that a special purpose vehicle shall be included within the definition of “financial institution”. A suggested draft is attached as **Appendix “4 B”**. Upon issuance of such notification any ambiguity with respect to the jurisdiction of the banking court will be removed.

- IAS 39 *inter alia* contains “true sale” standard in the context of debts/receivables. Such internationally recognised standard should be adopted by appropriately amending BPD circular No. 31 dated November 14, 2002.

- SBP’s requirement of listing should be removed as banks should be free to participate in private placements.

Sell Down of Loans

Issues

Sell down of loans can fall within the ambit of a conveyance of property under the Stamp Act attracting ad valorem stamp duty, both in respect of receivables pursuant to the loans and properties securing such loans. Where the secured property is immovable, registration fee can also be leviable under the Registration Act, 1908.

Recommendations

Issuance of statutory notification by the Provincial Government limiting the registration fee and stamp duty to a consolidated amount of Rs.100,000/-. A suggested draft of the notification that may be issued by the Government of Sindh is attached as **Appendix "4 C"**. The same text may also be used for other Provinces.

Safe Harbour For Institutional Investors

Issues

Where an issuer wishes to issue securities to institutional investors (at least legally) they are restricted from in anyway making any announcement or soliciting the subscription or sale of such shares without complying with cumbersome legal requirements. Sophisticated institutional investors can fend for themselves and may not require the protections provided under the Companies Ordinance in relation to public offering.

Recommendations

An appropriate definition of "sophisticated institutional investor" should be formulated and issuance of securities to such investors and trading amongst them should be freely permitted without complying with legal formalities associated with public offerings. The well known rule 144A in the United States may serve as a model. Implementing this above will require amendments in the Companies Ordinance.

Convertible, Warrants, etc.

Issues

TFCs convertible into shares and TFCs with detachable warrants are currently feasible in terms of the first proviso of Section 86(1) of the Companies Ordinance. While this Section enables the foregoing, there are no procedures/guidelines which need to be satisfied for the purpose of procuring the requisite SECP approval.

Recommendations

Guidelines should be framed by SECP in respect of TFCs convertible into shares and TFCs with detachable warrants. This should expedite procurement of regulatory consents. SECP has formulated such guidelines for other matters (such as issuance of shares at a discount and commercial paper). These guidelines need not be in the form of any statutory notification.

<u>REITs</u>

Issues

The Real Estate Investment Trust Rules, 2006 (**"REIT Rules"**) are still in draft form and certain provisions therein is likely to hamper the development of REITs.

Rent control laws are applicable in all provinces of Pakistan.

- Briefly, no tenant can be evicted without an order from the Controller. There are specified grounds on which the Controller will order eviction e.g.
  a) Tenant has failed to pay rent
  b) Handed over possession to some other person
  c) Use of premises for purpose other than which it was let out
  d) Premises required for reconstruction or erection of new building
  e) The Landlord requires the premises in good faith for his own occupation or for use of his spouse or children.

  Proceeding before Controller, District Judge on appeal and the High Court by way of possible revision and even possible appeal before the Supreme Court can be extremely frustrating and time consuming.

- The wide spread practice in Pakistan in relation to under valuation of immovable properties, principally to evade stamp duty, will seriously hamper development of REITs.

- Additionally, there are issues surrounding verification of title in several localities.

Recommendations

- REIT Rules should be promulgated without delay and consideration should be given to various issues under the REIT Rules as identified in **Appendix "5"**.
  - In the absence of REIT Rules, real estate investment trust can be undertaken through modarabas but there seems to be reluctance on the part of SECP to permit the use of modarabas for this purpose.

- Various tenancy laws provide that the relevant Provincial Government may by notification specify areas where the tenancy laws will not apply. If a notification is issued whereby such tenancy laws are made inapplicable in respect of properties owned by the REIT, then eviction will simply be a matter of enforcing the terms of the rental agreement which would be a much more straight forward way of enforcing rental agreements.

- One possible way to deal with the issue of under valuation is for the Provincial Governments to consider passing a law that would permit the State to compulsorily acquire property against payment of, let's say, 25% in excess of the declared value.

- Difficulty in verification of title in several localities is an extremely complex issue and we do not see any adequate resolution to the same in the short to medium term. To alleviate the problem (to a certain extent) consideration may be given to promoting title insurance business in Pakistan.

OTHER RECOMMENDATIONS

Corporate Governance & Best Practices

Corporate governance is the process and structure used to direct and manage the business and affairs of the company towards enhancing business prosperity and corporate accountability with the ultimate objective of realizing long term shareholder value, whilst taking into account the interests of other stakeholders.

A world-class capital market (debt and equity) must have a transparent, accountable and performance-oriented corporate sector that is premised on sound and consistent governance of corporate activity. More succinctly put, good corporate governance is vital for ensuring that the Pakistani capital market provides a conducive environment for all kinds of investors.

Competition for capital in the Pakistani and global debt markets can be expected to increase in the years ahead and it is essential for Pakistani companies to strive towards reducing the risk premium attached to investments into Pakistani corporates. As the sophistication of investors and speed of information dissemination increases, the quality of corporate governance will play an increasing role in creditors' willingness to provide loans to companies, equity investors' willingness to buy their shares, and the cost of raising capital for issuers.

Companies and countries with strong corporate governance practices will enjoy cheaper and better access to capital, and thus have a competitive advantage over those with weak corporate governance. To ensure that the Pakistan debt capital market is characterized by high standards of corporate governance and shareholder value recognition, the Regulator should develop and build on its efforts in this area through the following measures:

- Ensuring that there is a facilitative regulatory framework that supports the adoption of high standards of corporate governance and the promotion of shareholder value
- Promoting shareholder activism through further improving the avenues for minority shareholders to exercise and enforce their rights with respect to the companies they invest in, and encouraging greater institutional investor participation in corporate governance and the promotion of shareholder value
- Enhancing the awareness of and accountability for the duties and obligations of company directors, financial controllers, management and officers, and strengthening the role of auditors of PLCs
- Ensuring high standards of financial reporting and the continuous disclosure of timely, relevant and accurate corporate information to stakeholders

Facilitative Regulatory Framework

Some reforms to laws and regulatory framework may be required in the following areas:

- Duties, obligations, rights and liabilities of directors, company officers, and controlling shareholders
- Adequacy of disclosures and conflicts of interests with respect to transactions that involve corporate assets
- Enhancing the quality of general meetings
- Shareholders' rights and remedies

- Developing effective governance and enforcement mechanisms within the regulatory framework
- Putting special emphasis on the training and education to raise the level of awareness among directors, company secretaries, members of audit committees and investors as to their respective duties, obligations, responsibilities, rights and liabilities in respect of the governance of companies, and on the application of the Corporate Governance Code

Enhancing Investor Rights

The Regulator should further facilitate efforts towards enhancing investor rights, especially those of minority investors, and broadening avenues for private enforcement of these rights. In Pakistan, as with many other parts of Asia, companies with large shareholders and owner-manager structures are relatively commonplace. While such organisational structures have been and still are important participants in contributing to economic growth, it is essential to ensure the existence of a system that promotes and preserves investor rights and how these rights are enforced in practice. The conduct of companies with regard to their minority investors' rights and the legal framework supporting these rights is a matter of priority in overall efforts towards reinforcing investor confidence in the Pakistani capital market.

Emphasis on Shareholder Value Maximisation

In the longer-term, a clearly-defined focus on shareholder value maximisation will enable Pakistani corporations to compete more effectively for global capital, and promote executive compensation structures that encourage the entry and development of skilled labour in the corporate sector. For some companies, focusing on shareholder value can also augment tools for supervisory operations whereby it becomes an explicit factor in daily decision-making at the operational level.

Given that shareholder value maximisation is the fundamental objective of companies, that is, the enhancement of shareholder wealth, it must be further emphasised as a key driver of corporate decision making in the Pakistani capital market. This means that there should be an emphasis for management to focus on long-term value creation, rather than on short term gains. While much of this responsibility lies in the interaction between companies and their stakeholders, the Regulator can play an active role wherever possible to facilitate the development of an environment that places due importance on the duty of the company directors and management to enhance shareholder value. More specifically, this may entail a requirement for management of PLCs to disclose the extent to which their proposals for securities issuance, restructuring, take-overs and merger exercises add value to shareholders. These disclosures could be in the form of a narrative statement of how they apply the relevant shareholder value maximisation analyses to their particular circumstances, as well as certain relevant metrics for illustration. The specific shareholder value metrics (measures of shareholder value) to be adopted in these disclosures will be left to the PLCs to decide. As such, the management of these PLCs should be allowed to use these principles flexibly, after taking into consideration the varying circumstances of individual companies. However, to ensure clarity and the appropriate treatment in this regard, the Regulator should facilitate the introduction of standards of best practice for the preparers of financial reports in relation to this requirement in consultation with the industry. In addition, the Regulator can also emphasise shareholder value maximisation by:

- Educating company directors and management on the importance of maximising shareholder value, as well as their duties in this regard

- Encouraging investors and investment managers to play an active role in ensuring that the firms they invest in place due priority on value creation, which will provide management with greater incentives to maximise shareholder value
- Promoting the creation of a broader and deeper market for equity and debt capital. Therefore from the regulatory perspective, the shareholder value maximisation concept will be actively promoted to underscore the greater transparency, accountability and performance management needed to elevate corporate practices in Pakistan to more competitive levels

A set of principles, best practices and standards should be developed to encourage institutional investor activism in corporate governance and the promotion of shareholder value recognition. Institutional investors such as investment management companies, pension / provident funds, and insurance companies, have an important role to play in strengthening the standards of corporate governance in Pakistan, and in promoting shareholder value recognition. In view of this, efforts should be made to encourage institutional investor involvement in corporate governance.

However, to ensure the effectiveness of these reforms, there is a need to further encourage institutional investors to exercise their voting rights in companies in which they have invested. Institutional investors also should be encouraged to provide disclosure to their investor clientele as to the steps taken to ensure that these companies have undertaken applicable standards of corporate governance and shareholder value maximisation. As such, the Regulator should collaborate with specific representative associations of institutional investors to publish a set of principles, best practices and standards for use by the respective members in determining their approach to promoting corporate governance. The proposed principles, best practices and standards should reflect the views of the investment community on the appropriate corporate governance ‘yardsticks” applicable to the Pakistan corporate environment.

These efforts are intended to be considered with a view to requiring institutional investors to include in their annual reports and/or prospectuses a narrative statement of how they apply the relevant principles, practices and standards to their particular circumstances and to explain any circumstances justifying departure from them. This is to secure sufficient disclosure so that investors and other interested market participants can assess the institution’s investment practices and correspondingly make more informed decisions based on this disclosure.

Investors in the Pakistan capital markets generally lack sufficient information by independent sources on issues relating to the corporate governance standards adopted by PLCs. It is essential for investors to have access to independent and critical analyses of such matters in order for them to be in a position to assess the companies’ performance and practices, and respond in an informed manner. Therefore, the presence of independent shareholder watchdogs is encouraged. Such groups can establish efficient channels of disseminating information, such as through websites and other media, in order to provide minority shareholders with the necessary information required to undertake a comprehensive assessment of the standards of corporate governance practiced by PLCs.

Improved Financial Reporting & Disclosure

Public listed companies should be required to provide appropriate shareholder value disclosures for securities issuance, restructuring, take-overs and merger exercises. The basic concept of shareholder wealth creation remains a pivotal one to the long-term development of capital markets. In relation to the Pakistani corporate sector, effective shareholder value management may be considered vital given the need to ensure effective corporate restructuring to reinforce investor confidence in the value-added opportunities of investing in Pakistani companies

The Regulator and the stock exchanges should initiate further measures to promote timely, comprehensive and regular dissemination of material and relevant company information to shareholders. A strong disclosure regime is a pivotal feature of effective monitoring of companies and is central to shareholders' ability to exercise their voting and other rights in an informed manner. Shareholders and potential investors require access to regular, reliable and comparable information in sufficient detail for them to assess the stewardship of management, and make informed decisions about the valuation, ownership and voting on company-related issues.

Disclosure can also be a powerful tool for influencing the behaviour of companies and for protecting investors. A strong disclosure regime is a cornerstone of a market-based regulatory framework, and can help to attract capital and maintain confidence in the capital markets. Insufficient or unclear information may increase the cost of capital and result in a poor allocation of resources. Pakistani PLCs must practice a high degree and quality of continuous disclosure in order to ensure that their investors are provided with all material information required for informed decision-making. This principle of ensuring all material information is disclosed in a timely manner is not expected to place unreasonable administrative or cost burdens on enterprises but rather offset the inefficiencies of an imperfect market. Companies are generally not expected to disclose information that may endanger their competitive position, unless the non-disclosure of this information leads to the investors being misled in undertaking their respective investment decisions. Towards this end, the Regulator should actively work towards ensuring that PLC directors are appropriately guided to effectively discharge their responsibilities to the shareholders in meeting their continuous disclosure obligations.

In developing such an environment, the Regulator should use a balanced regulatory approach utilising education, incentives and effective enforcement. Among the initiatives that may be undertaken will be the implementation of a scheme that favours and rewards the practice of high standards of disclosure by providing certain incentives to issuers that maintain these continuous disclosure obligations. Under this scheme, companies that practice high standards of disclosure and corporate governance may be provided easier access to the capital markets through for example, **shorter prospectuses**. The aim of the scheme is to instill greater discipline among PLCs pertaining to disclosure and corporate governance issues.

Efforts to further enhance disclosures in annual reports by public listed companies needs to be examined. Given the increasing complexity of businesses today, there is a growing need for annual reports to include comprehensive yet concise disclosures of information that, among other things, analyse and explain the main factors underlying the results and financial position of a company. Although listed companies in Pakistan already provide a certain level of such disclosure in their annual reports, typically as part of the Chairman's / Director's statement, the amount and quality of these disclosures—particularly those relating to non-financial information—tend to vary significantly from one company to another. Some issues that have surfaced in this regard include questions as to the depth and objectivity of the disclosure, a tendency to emphasise only positive developments, and occasionally confusing or incomplete statements. In order to enhance existing practices, the Regulator should work with the exchanges and the accounting profession to introduce guidelines to enhance the quality of non-financial information disclosed in annual reports by PLCs.

Independence of Auditors

The Regulator should work with relevant industry bodies in enhancing the quality and independence of auditors of public listed companies. Independent auditors have an important public duty. In arriving at their investment decisions, investors typically place a significant amount of reliance on financial statements prepared by PLCs and audited by independent auditors. External auditors must perform their services without being affected by economic or other interests that would call into question their objectivity, and hence, the reliability of their attestation. The issue of auditor independence has received significant attention in recent times, particularly in certain jurisdictions such as the US. This has been prompted mainly by evidence of a growing dependence by public accounting firms on fee income from consulting services as well as the increasing number of business relationships between auditors and clients, which call into question the ability of auditors to be independent when discharging their statutory responsibilities.

A re-examination of the role of auditors as service providers within the Pakistani debt (and equity) capital market is timely at this stage. While an auditor's opinion does not guarantee the accuracy of financial statements, it furnishes users of these statements with critical assurance that the information therein has been subjected to rigorous examination by impartial professional accounting practitioners. This is vital in ensuring that the quality of financial reporting is kept at a high level, particularly given the shift towards more market-based regulation.

Among other things, investors should be provided with sufficient information to enable them to evaluate the independence of a company's auditors. In this regard, proposed changes to the current framework should consider the introduction of additional disclosures by companies on the non-audit services provided by their auditors as well as imposing additional reporting requirements by auditors on issues such as fraud. If necessary, the framework will also identify non-audit services that, if provided to an audit client, would impair an auditor's independence. The rotation of auditors within a specified period of time and the establishment of a peer review programme among accounting firms should also be examined.

Better Channels of Communication

The Regulator should encourage the improvement of channels of communication between companies and their shareholders. Channels for the dissemination of information can be as important as the content of the information itself. While the disclosure of information is often provided by legislation, filing procedures and access to information can often be cumbersome and costly. One approach to mitigating this problem is the setting up of investor relations units by companies to deal specifically with requests and queries by shareholders. This channel of communication between shareholders and their companies will facilitate the transfer of information to investors about corporate issues that they consider relevant to the exercise of their rights as shareholders. As such, the Regulator should encourage the establishment of investor relations units in PLCs to ensure an effective channel of communication is available for shareholders.

It is also recognised that electronic reporting can benefit businesses by reducing the costs of reporting, enabling more prompt reporting, and facilitating the dissemination of information to a wide audience. In this respect, while an increasing number of Pakistani companies have established websites on the Internet, there exists considerable diversity in terms of content, quality and presentation of information. The Regulator should encourage the use of electronic media to provide accurate, reliable, timely, up-to- date and readily accessible information to investors. To facilitate the process, the Regulator can work with the local exchanges to provide guidelines on the disclosure of information by PLCs through electronic media. While the focus of these guidelines will be on financial information, it is recognised that it may not always be easy to divorce the reported financial information from other information produced by the company about itself, or from information produced by other parties about the company.

In formulating the guidelines, the Regulator should strive to achieve a balance to ensure that regulatory concerns are addressed while not imposing an undue burden of compliance on companies. To further complement these efforts, mechanisms to facilitate electronic filings by listed and other regulated companies should be implemented. Regulators in several countries such as France and Canada have introduced similar guidelines on electronic communications and disclosure in recent years. A number of developed markets such as the US (under the SEC's EDGAR programme) allow electronic access to company filings. This has vastly expanded the accessibility and availability of corporate and financial information about listed companies.

APPENDIX 1

Other recently developed and developing debt capital markets

The committee reviewed a number of developed and developing markets whose debt markets are at different stages of development. These include US, UK, Singapore, Korea, Malaysia and India. The objective was to look at countries that have developed their debt markets more recently and in a shorter period of time relative to the U.S. and the U.K. whose markets were established over 200 years ago. By doing so, Pakistan could perhaps learn important lessons that are more relevant to the country's debt market given its early stage in the growth trajectory. Subsequently, Pakistan could emulate practices that have proved successful in enhancing the debt markets in other emerging markets.

Out of the four aforementioned developing markets, Korea has the largest debt market with over $400 billion in outstanding debt capital, followed by India with close to $200 billion in outstanding issues. Malaysia and Singapore come next with close to $100 billion and $60 billion, respectively in outstanding issues. Despite the respective sizes, India's debt market is the least developed and Singapore's market seems the most developed among the pool.

Korea

Korea has a sizeable, resourceful and sophisticated market, with high corporate and asset-backed security (ABS) issuance. Korea has also undergone considerable legal and regulatory innovation since 1999. Korean yield curve is comprised of several government-issued security types in maturities up to 10 years. The government also guarantees other public sector borrowers whose issues form part of the yield curve.

When the Asian crisis hit, Korea was a bank-dominated economy with a managed financial sector. Banks contained huge exposures to conglomerates (Chaebols) and the yield curve was made up of 3 and 5-year government-guaranteed corporate bonds that were issued at the same rates for all corporates. The command economy may have worked well for Korea at an earlier time, but in the 1990s, increasing portfolio investment inflows made the economy more vulnerable. As the financial sector did not price risk, when stress built up within the corporate sector it went undetected. The lack of a functioning market-based financial sector meant that no early-warning was given of the stresses that had built up, resulting in a financial crisis which caused great damage. Korea recognized the risks it had borne as a result of its non-market based and bank dominated financial sector, and immediately went about correcting this by issuing government bonds (through auctions where it preset volumes and took the market price) and recapitalizing banks with the proceeds. It ended the practice of providing government guarantees for corporate bonds. It set up an independent debt office, within the Ministry of Finance and Economy (MOFE) and built up a debt management and funding strategy development capability. It improved liquidity in the secondary market for government bonds by reopening issues. It set up a two layered primary dealer system, with full primary dealers and associate primary dealers, maintaining membership based on continuously monitoring.

A regular supply of bonds has continued, even though not at the initial levels that was needed to recapitalize the banks. Any non-market anomalies (such as the practice of holding bonds in investment trusts at book value equivalent to HTM in Pakistan) have been systematically removed. The main impetus for the success in developing the local bond market was the recognition by the government of the key role played by the bond market in today's globalized financial architecture, and provision of resources and building capacity at various government agencies needed to develop the market.

Indonesia

Compared to Korea, attempts by Indonesia to develop its bond market saw mixed success. Indonesia faced difficulty in setting up an independent and well-equipped debt office. Indonesia's stock of debt instruments included central bank instruments, and attempts to replace these with government bonds in order to unify the market moved slowly. Indonesia's bond market development was driven more by technical assistance projects of various donors, while Korea's program was largely indigenous, with help provided by donors. Although it was agreed that the debt office would take the lead and the central bank would provide the logistical approach, the debt office failed to take the initiative. There were several issues that needed to be decided (which type of auction system should be chosen, whether or not a primary dealer system should be introduced, how central bank instruments should be phased out, what characteristics of instruments should be introduced), and the government was overwhelmed by trying to address all these issues at the same time.

Although the debt office was mandated to carry out debt management, its capacity to do so and actions in this area were limited. Cash management within the government was poor, disincentivized by a requirement to keep cash balances in the central bank earning no interest. Government plans to deal with various risks in its funding strategy were not communicated to the public. Improvements in the regulatory frameworks of institutional investors were slow to be introduced. Price discovery and formation on the market were weak. Government bond market development was slow to progress mainly because the government did not perceive this activity as a core step to improve the state of the economy. There were no champions for this work within the government. The government took half-steps on several issues, and did not gain the momentum to launch a vibrant market.

India

India has a structurally flawed market that is dominated by government issuance, which accounts for 99% of the debt market. Investable assets are scarce, especially for non-bank investors. India has a benchmark yield curve for government debt of up to 20 years however, due to high minimum transaction size and inefficient price discovery mechanism prices are not reflective of true valuations. The market is generally highly regulated and reform is desired.

Malaysia

Malaysia has a highly effective debt market, with corporate issuance accounting for over 80% of funds raised, up from less than 50% in 1997. The country has government issues of 3-, 5-, 7-, 10-, and 15-year bonds with plans to issue longer dated bonds of up to 20 and 25 years. However, due to illiquidity in government issues, federal agencies issues serve to provide a benchmark zero coupon yield curve. Islamic debt is one of the fastest growing segments accounting for almost one-third of the corporate market. The current market is a product of systematic innovations. A 'Masterplan' for reform was adopted in 2001 with the objective of improving use and efficiency of all capital markets by 2010.

Singapore

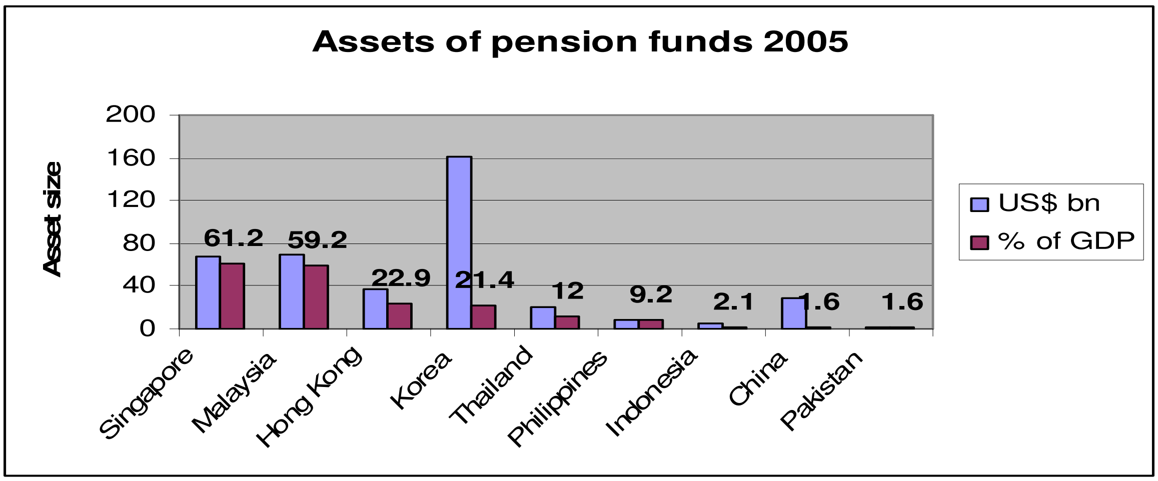
Singapore's debt market has highly effective systems. There is high government bond issuance and strong secondary activity resulting from an enlarged government debt programme. The government's over-funding increased liquidity leading to an effective term benchmark yield curve. The government issues 3-month, 1-, 2-, 5-, 7-, 10-, and 15-year bonds frequently. The country's post-1998 policy changes have led to considerable increase in overall market activity.

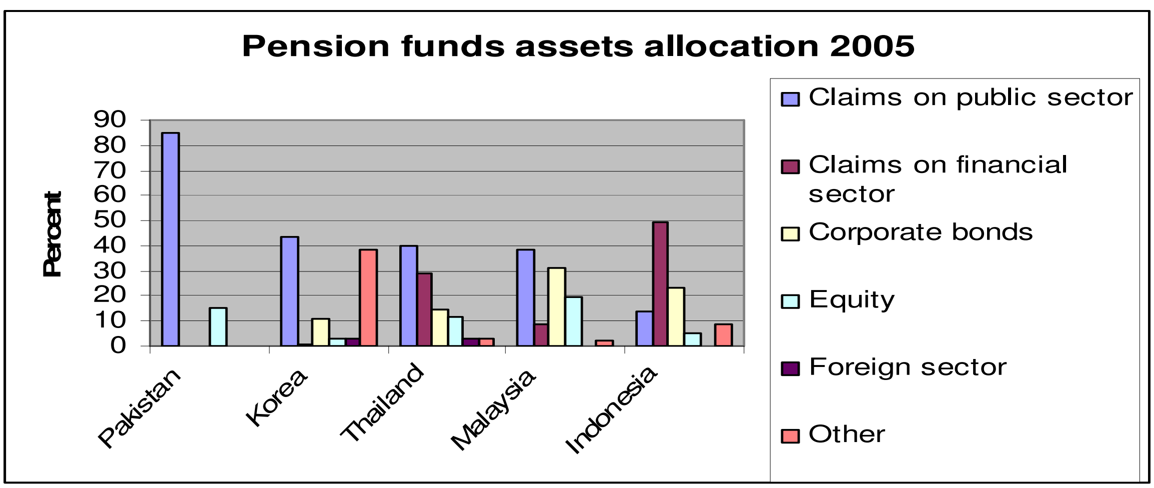
APPENDIX 2

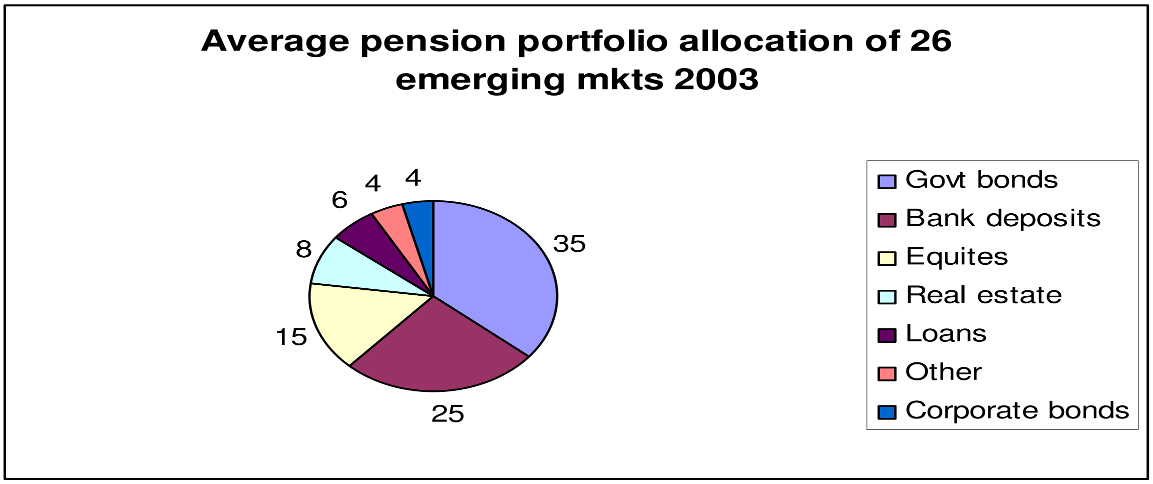
Regional Comparison of Institutional Investors

Pension Sector

Pensions sectors in East Asia are diverse – Korea has a sizeable public and private pensions sector. Malaysia's sector, comprising of provident funds, is a mature system and totals 60% of GDP. In Thailand, the sector is small but complex; Hong Kong has recently reformed its systems and contains both pre-reform and post-reform organizations. Singapore's sector consists largely of a single state-managed plan. The Philippines has a mandatory publicly managed social security system, a separate system for the armed forces, and a defined benefit system covering private sector employees. Overall, only funds in Singapore and Malaysia exceed 50% of GDP, and these funds include non-pension mandates. Defined benefit schemes in Korea, the Philippines and Thailand do create a demand for fixed-income securities, but they are still developing. Asset allocation in the region is skewed towards government securities and bank deposits, with the exception of Hong Kong, where pension assets are largely held in equities. The conservative investment regulations in emerging markets contrast sharply with relatively looser rules in the OECD. Improved asset-liability management, governance framework and risk management can provide the confidence to emerging markets to loosen investment rules.



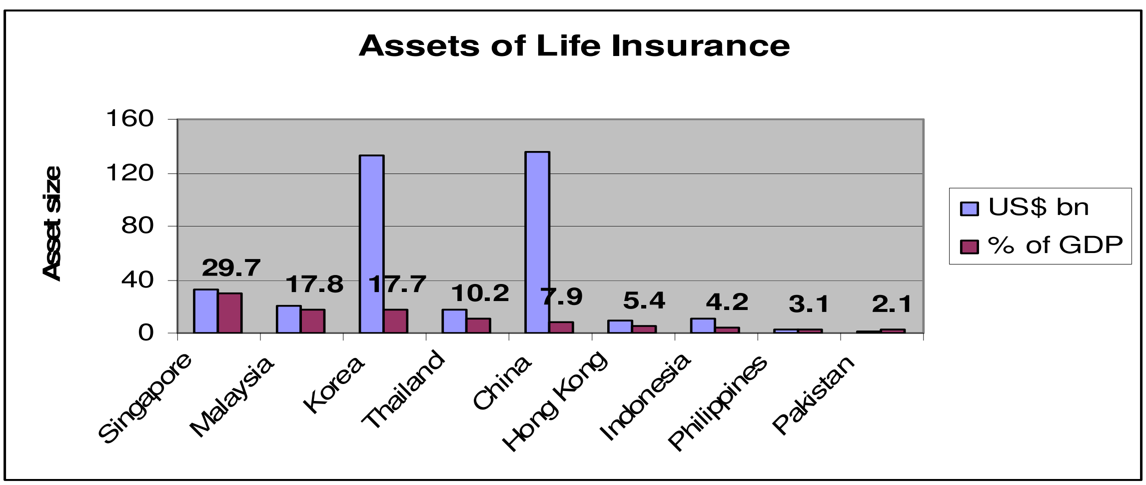




Source: East Asia Finance -The Road to Robust Markets, World Bank, 2006; State Bank of Pakistan Financial Sector Assessment; The Governance of Public Pension Plans, The World Bank 2005.

Insurance Sector

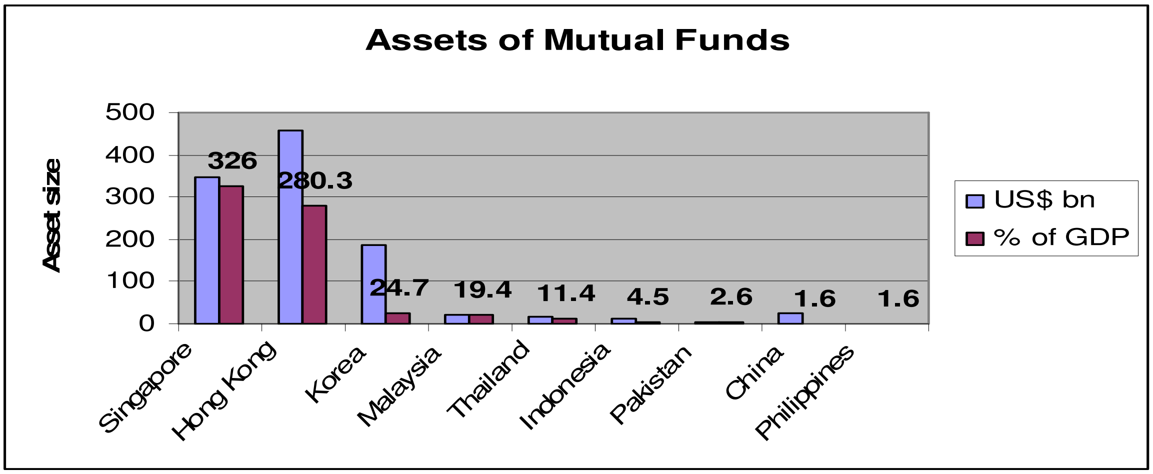
The asset size of the insurance sector in East Asia is relatively small, and investment regulations in general are not very binding, hence development of the sector may mean focusing on growing the asset size. Asset size can be increased by increasing insurance penetration (insurance premium/GDP) and insurance density (insurance premium/population). Chinese insurance regulators are encouraging companies to reduce regional disparities through introduction of banc-assurance, while Indonesia is focusing on micro-insurance. Korea, the Philippines and Thailand are moving towards risk-based capital requirements, while Malaysia plans to introduce a system of dynamic solvency testing.



Source: East Asia Finance -The Road to Robust Markets, World Bank, 2006; State Bank of Pakistan Financial Sector Assessment.

Mutual Fund Sector

Mutual funds can play a critical role in deepening securities markets. Mutual funds have grown at faster than 20% per year in all East Asian countries except Thailand, with Indonesia and China seeing the highest growth. Hong Kong and Singapore have set out to be regional centers with a large portion of funds sourced abroad. Dramatic growth has been accompanied with problems in some countries hence it is essential that future growth takes place in a well-regulated environment. This includes an appropriate and adaptable regulatory framework, maintaining investor confidence, and ensuring that regulations are enforced.



Source: East Asia Finance -The Road to Robust Markets, World Bank, 2006; State Bank of Pakistan Financial Sector Assessment.

APPENDIX 3

Description of Tax and Accounting Treatment of Debt Instruments in Pakistan

Various kinds of debt instruments from the tax viewpoint and their tax treatment, being withholding and final liability, has been identified in Table 1 below. The kinds of instruments are also described below.

1. National Savings Scheme (NSS)
2. Pakistan Investment Bonds (PIBs)
3. Treasury Bills (T-Bills)
4. Term Finance Certificates-Listed (TFCs – listed)
5. Term Finance Certificates-Unlisted (TFCs – unlisted)
6. Sukuk Certificates

Income arising from such instruments can be identified into following groups:

1. Profit on Debt (interest)
2. Capital gains / loss on disposal
3. Discounts and Premiums

Table1: Profit on Debt (Interest)

		WITHHOLDING		*FINAL*	
		Resident	*Non-resident*	*Non Company*	*Company including Banking Company*
1.	NSS	10%	30%	10%	Normal
2.	PIB	10%	30%	Normal	Normal
3.	Treasury Bill	30%	30%	Normal	Normal
4.	TFC – Listed	10%	30%	10%	Normal
5.	TFC – Unlisted	10%	30%	10%	Normal
6.	Sukuk Bonds	Exempt	30%	Exempt	Exempt

Table 2: Capital Gains / Discounts

		WITHHOLDING		FINAL	
		Resident	Non-resident	Non Company	Company including Banking Company
1.	NSS (Non-Transferable)	N/A	30%	N/A	N/A
2.	PIB	N/A	30%	Normal Rate	Normal Rate
3.	Treasury	N/A	30%	Normal Rate	Normal Rate
4.	TFC (Listed)	N/A	30%	Exempt	Exempt
5.	TFC (Non-Listed)	N/A	30%	Normal Rate	Normal Rate
6.	Sukuk Bond	Exempt	30%	Exempt	Exempt

Accounting

Income Tax Ordinance, 2001 recognizes and accepts the accrual basis of accounting for taxation purposes. In strict sense, in the case of a company, in effect, now unlike the past there is no option to account for income in all the form identified above on 'receipt' basis. Under the accounting principles 'discounts' and 'premiums' on debt instruments are recognized on accrual basis taking into effect the timing factor. This treatment is termed as 'amortization' on time basis of value of instrument. Under the new Ordinance such accounting treatment is also valid for taxation purposes. The relevant provisions are:

> *"**32. Method of accounting.-** (1) Subject to this Ordinance, a person's income chargeable to tax shall be computed in accordance with the method of accounting regularly employed by such person.*
>
> *(2) Subject to sub-section (3), a company shall account for income chargeable to tax under the head "Income from Business" on an accrual basis, while other persons may account for such income on a cash or accrual basis.*
>
> *(3) The Central Board of Revenue may prescribe that any class of persons shall account for income chargeable to tax under the head "Income from Business" on a cash or accrual basis.*
>
> *(4) A person may apply, in writing, for a change in the person's method of accounting and the Commissioner may, by order in writing, approve such an application but only if satisfied that the change is necessary to clearly reflect the person's income chargeable to tax under the head "Income from Business".*

(5) If a person's method of accounting has changed, the person shall make adjustments to items of income, deduction, or credit, or to any other items affected by the change so that no item is omitted and no item is taken into account more than once.

33. Cash-basis accounting.- *A person accounting for income chargeable to tax under the head "Income from Business" on a cash basis shall derive income when it is received and shall incur expenditure when it is paid.*

34. Accrual-basis accounting.- *(1) A person accounting for income chargeable to tax under the head "Income from Business" on an accrual basis shall derive income when it is due to the person and shall incur expenditure when it is payable by the person.*

(2) Subject to this Ordinance, an amount shall be due to a person when the person becomes entitled to receive it even if the time for discharge of the entitlement is postponed or the amount is payable by installments.

(3) Subject to this Ordinance, an amount shall be payable by a person when all the events that determine liability have occurred and the amount of the liability can be determined with reasonable accuracy.

(4) Omitted

(5) Where a person has been allowed a deduction for any expenditure incurred in deriving income chargeable to tax under the head "Income from Business" the person has not paid the liability or a part of the liability to which the deduction relation within three years of the end of the tax year in which the deduction was allowed, the unpaid amount of the liability shall be chargeable to tax under the head "Income from Business" in the first tax year following the end of the three years.

(5A) Where a person has been allowed a deduction in respect of a trading liability and such person has derived any benefit in respect of such trading liability, the value of such benefit shall be chargeable to tax under the head "Income from Business" for the tax year in which such benefits is received

(6) Where an unpaid liability is chargeable to tax as a result of the application of sub-section (5) and the person subsequently pays the liability or a part of the liability, the person shall be allowed a deduction for the amount paid in the tax year in which the payment is made."

In case of individuals all income on debt instrument can be accounted for on receipt basis, with option to record on accrual basis.

APPENDIX 4

Appendix 4 A*:** ***Suggested Notification by the Government of Sindh Finance Department regarding Stamp Duty in respect of Securitisation

Notification No. [•] Karachi, [•], 2007

In exercise of powers conferred by sub-section (a) of Section 9 of Stamp Act, 1899 and Section 78 of the Registration Act, 1908, the Government of Sindh is pleased to reduce stamp duty and registration fees chargeable on, or in respect of, the following instruments to a consolidated duty/fee of Rs.100,000/- (Rupees One Hundred Thousand):

Description of Instrument

1. Conveyance of property, as a consequence of a securitization, by an originator to a special purpose vehicle

2. Mortgage Deed, as a consequence of a securitization, securing money advanced or to be advanced by an originator to a special purpose vehicle

Explanation

1. "securitization", "originator" and "special purpose vehicle" shall have the meanings assigned to them in the Companies (Asset Backed Securitization) Rules, 1999 made pursuant to section 506 of the Companies Ordinance, 1984 (XLVII of 1984), as amended or re-promulgated from time to time.

2. "property" means property of every description, present or future and whether or not existing at the time of execution of the relevant instrument, and includes rights, book-debts, receivables and actionable claims.

Appendix 4 B*:** ***Suggested Notification by the Government of Pakistan Ministry of Finance regarding Jurisdiction of the Banking Court

Notification No. [•] Karachi, [•], 2007

In exercise of powers conferred by sub-section (a)(iii) of Section 2 of the Financial Institutions (Recovery of Finances) Ordinance, 2001 (Ordinance No. XLVI of 2001), the Federal Government is pleased to specify that a special purpose vehicle shall be included within the definition of "financial institution" under the said Ordinance.

Explanation

1. "special purpose vehicle" shall have the meaning assigned to the same in the Companies (Asset Backed Securitization) Rules, 1999 made pursuant to section 506 of

the Companies Ordinance, 1984 (XLVII of 1984), as amended or re-promulgated from time to time.

Appendix 4 C*:** ***Suggested Notification by the Government of Sindh Finance Department regarding Stamp Duty in respect of Sell Down of Loans

Notification No. [●] Karachi, [●], 2007

In exercise of powers conferred by sub-section (a) of Section 9 of Stamp Act, 1899 and Section 78 of the Registration Act, 1908, the Government of Sindh is pleased to reduce stamp duty and any registration fees chargeable on, or in respect of, the following instrument to a consolidated duty/fee of Rs.100,000/- (Rupees One Hundred Thousand):

Description of Instrument

1. Conveyance of property, as a consequence of: (a) an absolute assignment or sale of finance; and (b) any properties securing such finance.

Explanation

1. "property" means property of every description, present or future and whether or not existing at the time of execution of the relevant instrument, and includes rights, book-debts, receivables and actionable claims.

2. "finance" shall have the meaning ascribed to the same in the Financial Institutions (Recovery of Finances) Ordinance, 2001 (Ordinance No. XLVI of 2001) and shall also include all loans, advances, guarantees and the like originating outside Pakistan.

APPENDIX 5

Certain Issues under the Draft REIT Rules, 2006

1. There are a few provisions in the REIT Rules that would make prospective trustees quite uncomfortable as they require the trustee to perform functions that should be left to the management company, e.g.:

   (a) The trustee is required to ensure that REIT assets are lawfully vested in it in accordance with the constitutional documents. This means that the trustee independent of the management company, will have to investigate and satisfy itself as to title of the property; and

   (b) The trustee is required to ensure that the contracts to be entered into by the management company are on an arms length basis.

2. The obligations of the trustee in the context of asset management companies as set out in the NBFC Rules, 2003 are more appropriate in the context of REIT Rules. For example, in respect of ownership of the invested property, the trustee under the NBFC Rules is required to take custody and control but not verify title of the same.

3. With regard to eligibility of trustees, they are virtually identical to those contained in the NBFC Rules with one notable omission. Eligible trustee in relation to asset management companies under the NBFC Rules includes Central Depository Company but the REIT Rules do not. More often than not, in the asset management companies, the trustee is the Central Depository Company. It is unclear whether the said omission was deliberate or inadvertent.

4. The management company is obliged under the REIT Rules to provide professional management and act in the sole interest of unit holders. This is quite obvious and several provisions in the REIT Rules are intended to reinforce this concept. There are, however, concerns with regard to a couple of provisions and are detailed as follows:

   (i) The management company needs to ensure that proper legal title to the real estate acquired through the REITs is vested in the trustee and all material contracts including rental agreements are legal, binding and enforceable. This may be a very stringent standard as frequently parties exercise commercial judgment in acquiring property even where the lawyer points to certain defects; and

   (ii) Given the property laws and practices in Pakistan, in a large number of cases clean opinions may not always be possible. This provision has probably been inspired from the laws of an advanced jurisdiction where title insurance is available and there is an organised and reliable way to verify the title. It is suggested that instead of a clean enforceability opinion the minimum obligation should be to satisfy that the documents, prima facie, are in order and there should also be an obligation to place public notices to seek objections to any sale of property. While it is appreciated that non-receipt of objections does not necessarily mean that the title is clean but this nevertheless is a practice adopted in Pakistan to mitigate the risks. It is emphasized that the issue of satisfaction of title should be left to the management company with certain minimum standards prescribed by legislation.

5. For the purpose of obtaining the necessary SECP authorisation to affect a public offering, the REIT management company must also demonstrate a firm agreement to purchase real estate asset. This means that before the fund can raise money from the public it must have entered into a binding agreement to purchase and thereafter consummate the sale following a successful public offer. Imagine the reaction of the seller when he reads a clause in the agreement to purchase that says that while you the seller are bound to sell, my obligation to purchase is contingent upon a successful public offer and SECP authorization. Therefore, the practicality of entering into an agreement to purchase before the public offer needs to be debated.

6. A very critical part of the REIT Rules relate to the requirement of diversification of the REIT fund. REIT Rules states that unless the offering document specifically states that the REIT fund will be undiversified, the real estate acquired through the fund must be diversified on the basis of types of real estate and geographical locations. This concept needs to be connected to the point that before the SECP authorizes floatation of the funds, purchase agreement needs to be in place. It is improbable to have a diversified portfolio at the time of commencement so it must follow that funds can be raised by a rights issue for further projects. REIT Rules have no requirement to clear agreements with SECP to purchase property before a right issue. If so, why does it have this requirement for the first issue? It may be left to the management company to decide the number and kinds of projects it wishes to invest in provided it has fully disclosed its diversification plan in the offering circular along with associated risks.

7. The prohibition relating to investment in vacant land is probably a good one if the aim is to stimulate development and income generating activity. Vacant land can however be acquired if the plan is to develop it. Even here we are faced with another restriction. Vacant land cannot be developed in collaboration with a joint venture partner. Thus, if the fund wants to buy vacant land jointly with another developer and then build on it, the same is not permissible. It is suggested that joint ventures may be made permissible provided management control vests with the management company of the REIT fund.