**POSITIONING DOMESTIC CAPITAL MARKETS**

**FOR EMERGING COMPANIES**

**MACROECONOMIC CONTEXT**

The current macroeconomic context is not very conducive to the growth of capital markets. Stagnant per capita incomes, high inflation, declining investment, large fiscal deficit, severe energy shortages, current account imbalances and drying up of foreign investment do not provide an appetizing menu of options for the savers, investors and issuers. Strong borrowing needs of the government have increased banks’ exposure to government paper. As banks account for 95 percent of the total financial assets private sector credit has there shrunk. The share of net advances has dropped from 57 percent to 44 percent between Dec 2008 and June 2011. The amount of net investment has increased from 19 percent to 34 percent. The response of the banks was quite rational. Credit risk has significantly increased due to deterioration in macroeconomic environment. Surge in delinquencies and loan losses have made the banks more cautious in lending to counterparties other than known names or well established brands. The continuous stream of lucrative risk-free government securities at the same time has led to assured profitability and preservation of capital. Advance-Deposit ratio is down to 57 percent while Investment to Deposit ratio has inclined up to 43 percent – unprecedented in the recent times.

Outside the banking system the NSS investments have been attracting a lot of domestic savings as they offer significantly higher returns and early encashment facility without penalty. The removal of ban on institutional investments in NSS has accelerated the flow of funds to this channel.

This predominance of government both in diverting the banking sector’s deposits and mobilizing non-bank saving by offering high remunerative returns on its own instruments has edged out the space for emerging companies.

The leaves the only viable avenue open for them i.e. domestic equity and debt markets. Stress in the domestic capital markets appears to be easing despite the deteriorating macroeconomic situation. The trading volumes that had sharply reduced have begun to regain their previous levels. As inflationary expectation subsides the pace of activity should pick up more. Foreign investors have enjoyed higher forward earning yields in Pakistan compared to regional markets. Corporate profitability particularly of multinational corporations has been quite strong. There should therefore be surge back of foreign investment in near future. The reforms underway in these markets and the decision to demutualize the three Stock Exchanges should be taken as a point of departure for a shift in the popular sentiment towards these markets. The recent oversubscription of the IPO floated by Aisha Steel augurs well for the private sector companies interested in expanding their capital base for investment in real sector. But this is not going to be easy and all the players in the market have to play a concerted effort to make this happen.

**SOURCES AND DEMAND FOR FUNDS**

On the supply of funds, contractual savings such as Pension Funds, Provident Funds, Insurance, and Takaful are the natural candidates. They have long term time horizon and are not so disturbed by short term volatility. Capital markets with the diversity of issuers, tenor and returns can meet the requirements of these institutions.

We all know that we do not have any social safety nets in this country - Social Security, Medical Insurance, Unemployment benefits, Housing Schemes for the retirees except in a few isolated cases such as the Armed Forces. Most households do therefore have to save for their post retirement lives. Extended families, under the pressures of urban living and changing social norms, are giving rise to nuclear families. Therefore the dependence on sons in the old age as insurance is also becoming less reliable. Many households therefore resort to real estate, gold and precious metals, foreign assets as vehicles for long term post retirement savings as well as hedge against inflation. These forms of savings do not help the country in financing its investment needs. International experience shows that the CSls have become an effective mechanism for channeling savings for the old age and using them to finance an expansion in the supply of productive capital. Thus, we have a hidden source of untapped supply of long term savings that can be channelized by Contractual Savings Institutions (CSls) and converted into financial assets.

Why is this channelization not taking place in Pakistan? Why are insurance penetration ratios so low? Why aren't the Pension Funds, Provident Funds and Endowment Fund big players in mobilizing these savings?

On the demand side, the Development Finance Institutions (DFls) such as PICIC, IDBP, Bankers Equity, ICP, Equity Participation Fund, RDFC and others used to provide long term financing mainly from the lines of Credit of international financial institutions, SBP or the Government. This model of Government owned, non-professional managed DFls highly leveraged using non-commercial credit criteria has miserably failed not only in Pakistan but in a large number of developing countries. Private commercial banks which are now universal banks are in theory supposed to provide long term financing. But they are constrained by the limits of maturity transformation. They raise short term deposits and their capacity to lend for long term tenor is linked with the stable rollover of these deposits. It is not realistic to expect that the commercial banks will act as the leader in supply of long term investible funds. On the other hand, long gestation investment projects in power, natural gas, pipelines, terminals, roads and highways, bridges, ports and berths, airports, pipelines, railways, engineering goods manufacturing, petro-chemicals, refineries, exploration and development, housing, commercial buildings, technology parks, industrial estates, export processing zones require large sums of 10 to 15 year tenor funding. In countries all over the world, the Debt Capital Markets and Equity Capital Markets are the main source of this financing. Where do these markets get supply of funds? Besides, retail investors the bulk of the funds come from institutional investors of all kind and type. CSls are one of the most natural buyers of these assets as they have an appetite that matches the maturity structure of the bonds and capital appreciation of equities.

**ROLE OF REGULATOR**

The basic aim of a regulator is to prevent undue concentration of investment risks in particular types of securities, sectors or companies. Investment regulations should therefore place maximum limits on permissible holdings but avoid imposing minimum requirements or direct investments in particular securities or in favor of particular sectors.

The pension funds should be invested prudently and limits on the amount of pension reserves that can be invested in the securities, property of the sponsoring employer and the stipulation of diversification requirements should be similar to those applicable to the technical reserves of insurance companies.

In Pakistan the shallowness and lack of credibility of the domestic financial markets and lack of familiarity of pension members with those markets dictate that stringent investment rules should be prescribed and followed. Exposure limits of different forms have to be laid out to ensure that excessive risks are not taken with the savings of the pensioners. Of course, this involves trade-offs in form of lower returns because the Pension Funds cannot take advantage of the boom in the equities market by exceeding the binding limits. However, as the pension funds gain experience and mature, the professional investment managers become skilled and proficient and internal controls are established most of the concerns with which the regulators are preoccupied can be addressed. Gradual liberalization and revision in investment rules should be allowed then.

The SECP has to work hard to rebuild the confidence of small retail investors by introducing transparency, full disclosure and separating ownership from management of the debt and equity capital markets. Vigilance and strong oversight by the regulator accompanied by strong enforcement and penal actions against those indulging in malpractices would provide a powerful signal in re-building this trust.

The regulatory agencies have to make the process of listing easy and hassle free while reducing the costs. The incentives for remaining off the radar screen are quite high and we have to remove those impediments that are reinforcing this tendency. Credit rating agencies have lost a lot of their luster in the 2008-09 global financial crises. In Pakistan, the two Credit rating agencies are coming out of age. Their professional competence and norms of behavior have to be strengthened, possible conflicts of interest eliminated so that they are able to give a verdict on the issuer that is credible to an ordinary retail investor. In absence of such an assessment by an independent third party the capital markets in Pakistan will never be able to take off.

What types of emerging companies should be encouraged to tap the markets?

Oil and Gas, Coal and Hydropower based generation plants, Transmission and Distribution Companies, Roads, Bridges and Highways based on tolls and managed by private operators, terminals and pipelines, storages and silos, Food, Dairy and Beverages Companies, Supermarkets and Real estate companies, Railway trains in private sector, Petrochemicals, are some of the areas where the future demand is likely to exceed the existing supply.

**ROLE OF INDUSTRY**

The Brokerage houses and Asset Management Industry have to move out of their cozy offices in metropolitan areas and establish their presence in other cities such as Hyderabad, Sukkur, Rahim yar Khan, Multan, Faisalabad, Sialkot, Peshawar and Quetta. They have to educate the investors – both retail and institutional – and mobilize their savings. Remittances from overseas Pakistanis now account for 6-7 percent of GDP. Even a fraction of these savings for investment in capital markets would make a big difference in liquidity as well as depth of the markets. Similarly, the number of high net worth individuals in agriculture sector is rising. Philanthropy is also showing signs of shifting from informal, personalized giving to more formal Trusts, Foundations, and Endowments etc. This is a source that can be tapped also.

Investments banks and financial Advisory Services have to play a key role in preparing the grounds and persuading the sponsors to issue the bond or stock on the markets. They should be disabused of the notion that only 100 percent ownership assures complete control. The strategic investors with diffused ownership retained control with as little as 26 percent. They don’t have to remain constrained by internal earnings generations and retentions or borrow short term for long gestation periods. They can profitably utilize other people’s funds as long as they remain diligent, overboard in their dealings and maintain high ethical standards. It is a myth that understating the balance sheet, concealing income, evading taxes would always lead to consistent expansion. Companies in India have realized that the personal fortunes of the sponsors have multiplied manifold by going public rather than remain beholder to the old tactics. Globalization offers enormous opportunities but also demand onerous responsibilities and obligations including transparency and disclosure.

Corporate Governance in these companies has therefore to improve substantially Independent Directors have to be inducted on the Boards and the dominance of family members has to be reduced.

The Board must make sure that the company conducts its affairs with integrity and in accordance with high ethical standards, and in full compliance with the rules and regulations in existence. One of the most agonizing parts of the Board’s responsibilities is to see that neither majority shareholders nor management abuse their power and that decision are taken with the company’s best interests in mind. This is easier said than done because the recent financial crisis has revealed the contrary trend. Fit and proper criteria should be applied in selecting the Directors having some fair understanding of the business. Rigorous and independent internal and external audit should be performed and reported to the Board.

The participation of Contractual savings institutions itself contributes to good corporate governance. These institutions monitor the companies they invest in and are careful in selecting those who practice good corporate governance or insist that their potential investees improve corporate governance. The institutions develop performance indicators and take action on significant deviations from the agreed benchmarks.

Let me conclude my remarks by quoting my address of July 29, 2004 in which I had set out a vision for Pakistan's financial services industry. This vision envisaged a continuum on the domestic front with well-functioning capital markets at one end, the banking system in the middle and micro­ finance institutions at the other end. Capital markets will cater to the needs of well established, highly reputed, credit worthy large issues of capital trusted by both the retail and institutional investors and to whom they are willing to provide their savings at competitive prices. The CSls in Pakistan are highly segmented, narrowly focused and making sub-optimal returns on the assets they manage. It is the joint responsibility of the Government, regulators and the industry to mobilize and manage these savings in an optional and professional manner. As we further develop and manage private pension funds, provident funds and endowment funds the overall domestic savings rate in the country will rise. That vision remains valid even today and needs to be translated into a strategy with goals and milestones. The strategy needs to be executed with continuous monitoring and fine tuning.