

CAPITAL MARKETS AND BANKS: CASE OF PAKISTAN¹

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I want to congratulate the PBA, SBP, SECP and the Ministry of Finance for organizing this conference and thank them for inviting me to share my thoughts on this subject.

. Any meaningful discussion of Capital markets and banks cannot take place in absence of their appropriate place in the whole financial system. Let me therefore begin by reiterating my vision for Pakistan's financial services industry. This vision envisages 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. Banks would raise deposits mainly from households to provide working capital, trade finance, foreign exchange, guarantees etc to corporates, mortgages, consumer loans to households, lending to SMEs, agriculture etc. Microfinance Institutions would cater to the needs of the micro enterprises by deploying their savings for nano loans and micro insurance. ..

In Pakistan, the banks control almost 80 percent of the financial sector assets .(I would revert to this later on) Within the banking sector, in last seven years or so the demand from the Government to finance its deficits has been diverting the banking sector's deposits and also mobilizing non-bank saving by offering high remunerative returns on its own instruments edging out the space for private sector companies .Therefore logic would demand that the only viable avenue open for these companies

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should have been domestic equity and debt markets. But this has not been the case. Despite a robust and vibrant secondary market in equities only seven IPOs were issued in FY 25 amounting to \$29 million. In the same period India issued 268 IPOs mobilizing \$19.5 billion. Of this, 178 were by SMEs . After discounting by one tenth for the size of the economies we should have raised \$ 1.9 billion. Similarly, Corporate bonds issued by India amounted to \$ 602 billion or 16 percent of GDP while our corporate bonds fetched \$ 10 billion or 3 percent of GDP. In my view exploring the factors responsible for this huge differential should be the major focus of the Conference participants.

. Evidence points out that the development of the banking sector tends to strengthen the securities market and vice-versa .How do these two sources of financing differ and in what ways do they influence firm performance? Firms tend to behave differently when they fund themselves through bank credits or through securities market. Banks typically finance established businesses with good track record and provide financing for short term. Banks are neither geared nor willing to extend their time horizon nor equipped to take risk on innovative and not fully known ways of businesses. Capital markets bring together a range of investors with differing perceptions and risk-bearing capacities. These investors are thus willing to provide more long term capital for financing new business or technology. Governments have in the past attempted to fill in this demand for long term financing by providing subsidized and directed credit administered through development financial institutions but by and large these institutions (DFIs) have been a failure and distorted the markets.

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. Bank loans can no longer offer the volumes, terms, maturity structures as these firms would like. Prudential regulations limiting exposures to a single party or group also act as a constraint in addition to asset-liability maturity mismatches. It is not realistic to expect that the commercial banks will act as the leader in supply of long term investible funds. Corporate bond market allows both the flexibility to retain control as well as avoid some of the constraints faced by the

banks. The banks can provide working capital and other non funded facilities to the companies raising funds for fixed investment through capital markets.

Let me illustrate the symbiotic relationship between the banks and capital markets. The banks have a relative advantage in originating mortgages because of their widespread network of distribution. But it is not in their interest to carry large concentrated portfolios of mortgage loans on their balance sheets. It is to the advantage of the banks if these mortgages are pooled, securitized and sold by the banks to those institutional investors who have the appetite for holding this pool of asset backed securities because of their trade ability, liquidity, risk profile, tenor and price discovery. The distribution of risk through this mechanism from those who are least willing and able to those who are better equipped makes a lot of sense from system-wide risk management viewpoint.

Pakistan's low investment ratio does not permit public sector to finance 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 as they 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 types, collective savings institutions (CSIs) in form of mutual funds, life insurance, pension and retirement funds, provident funds, endowments and trust funds. This group of investors is not contented with earning meager returns on bank deposits and are keen to earn higher returns. Financial innovations such as asset-backed securities, structured finance and derivative products and synthetic products have been possible due to the support of these institutional investors. These innovations help to enhance the quality of risk management throughout the economy and the main channel for these innovative product development has been the interaction between the banks and capital markets . These CSIs are among 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.

Most households in Pakistan resort to real estate, gold and precious metals, foreign assets as vehicles for long term 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 CSIs 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. We have to ponder as why are insurance penetration ratios so low? Why aren't the Pension Funds, Provident Funds and Endowment Fund big players in mobilizing these savings?

I would now turn to address the question: Why have we seen such heavy reliance on bank lending in Pakistan, while it is obvious on grounds of efficiency that capital markets could be an important source in many cases? There are many reasons for this hesitant approach towards capital markets in general and bond markets in particular.

First, the relationship between corporates and the banks have evolved over a long period of time and a sense of trust and comfort has developed on both sides- the borrowers and the lenders. The cost of switching from banks to capital markets may therefore have to be much lower than the perceived benefits derived from this relationship.

Second, the adoption of Universal banking model has enabled the banks to offer tailor made one window financial solutions to the corporate borrowers thereby holding them tied to the apron strings of the banks. The borrowers can raise large capital volumes through syndicated loans.

Third, it is only in last few years or so that capital markets have begun to be properly regulated and supervised by SECP. In absence of such regulatory oversight the markets were considered to be illiquid, narrow, and manipulated by insiders who indulged in collusive practices that proved detrimental to the interests of investors.

Fourth, the cost to issuers of bringing their securities for listing and floatation of their bonds on the markets may be quite significant acting as a deterrent. The supporting infrastructure may also be deficient or missing.

Fifth, the public disclosure requirements, the standards of transparency about the holdings and financial strength of the sponsors do not meet the threshold of comfort of

family owned companies which still play a dominant role in the industrial and services sectors.

From the Investors' perspective, they may be willing to invest in securities only if there is enough liquidity for them to sell and exit easily when needed. And, if liquidity is low and price discovery does not function well, the investors that do participate will generally demand a higher interest rate or return to compensate for the low liquidity, and this in turn may further deter companies from listing on the stock exchange or issuing bonds.

Three main factors affect liquidity or the lack of it: the availability of information to price securities accurately; transaction costs; and the size and heterogeneity of the investor base. To enhance the efficiency of the securities markets, policymakers will need to address each of these factors.

Accurate pricing can be facilitated with reference to a "risk-free" benchmark—mostly commonly the interest rate of a government bond. To be a valid comparator, the price of a government bond must be truly driven by supply and demand. Benchmark bond issues must also be large and stretch across the maturity spectrum...

The factors that affect explicit and implicit transaction costs include withholding taxes and fees, the efficiency of the intermediaries, market infrastructure and institutional arrangements, etc..

. It is important to have a wide, heterogeneous investor base with different preferences and risk appetites. Thus, in addition to the contractual savings industry (pensions and insurance), the asset composition of mutual fund industry has to shift further away from money market funds to the types that can cater to heterogeneous needs and risk appetites of retail investors including the ability to provide different types of products to suit the different risk preferences of investors . Are these asset management companies using Digital networks to expand their outreach beyond the major cities?

The regulators, industry players, financial infrastructure providers have to dispassionately examine means to remove constraints mainly on the supply side, as well as improvements in market microstructure. The regulators, before introducing new products or schemes, ought to find out as to why previous initiatives have not proved successful. It is not the number of schemes but their impact that is critical metric. Are

Small and medium-sized enterprises not able to access capital markets because of the inflexible structure of contracts, the high costs associated with issuance, and the need for large issuance size or some other binding factors such lack of financial information? Why aren't the banks willing to develop close linkages with both ends of the financial spectrum i.e. the capital markets and Microfinance?