



**Workshop On:**

***“Re-Thinking Pensions in Pakistan”***

## **Pension Funds and Capital Markets in Pakistan**

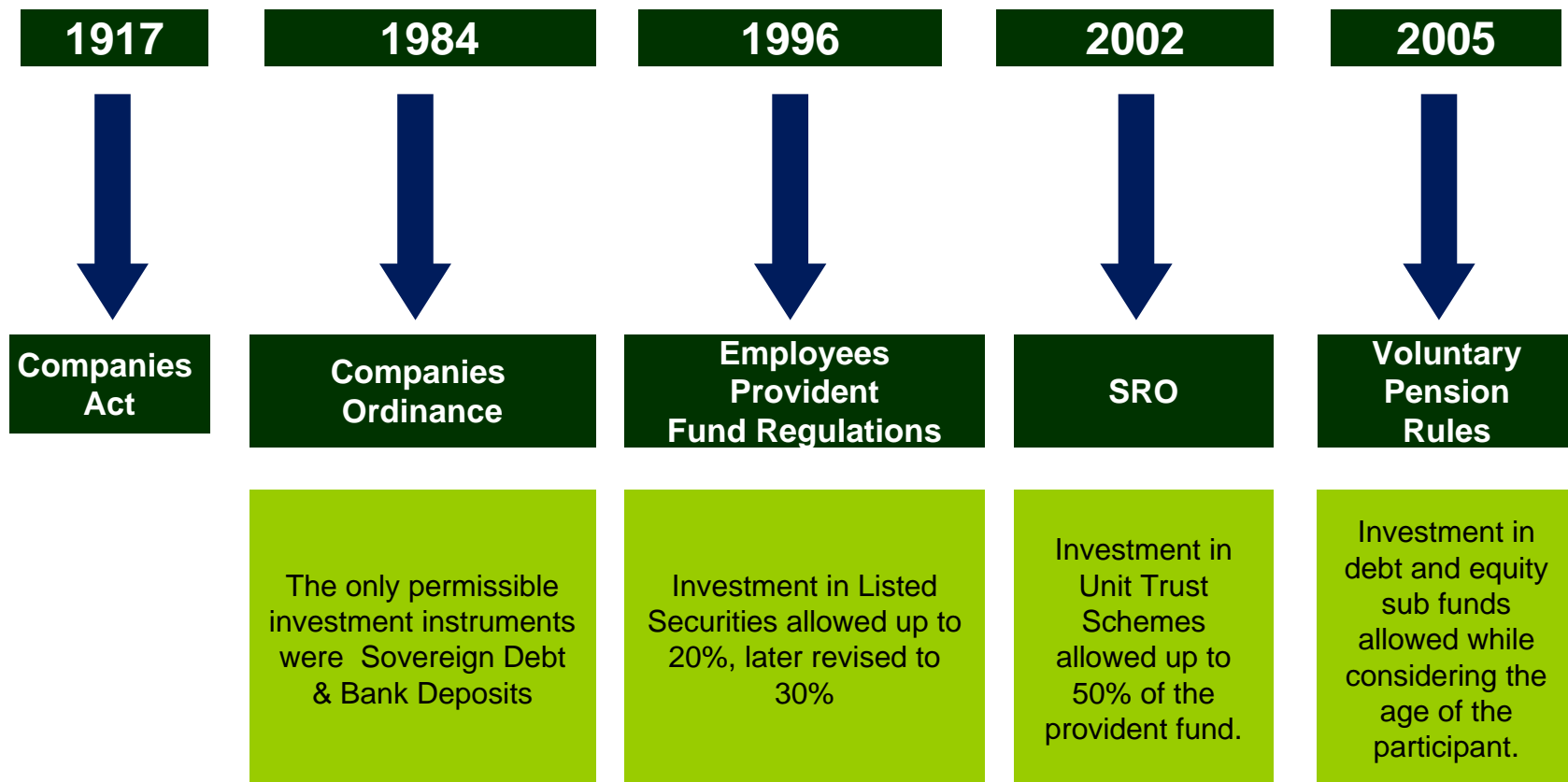
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## Pension Funds – Global Perspective

- Pension Funds are means for individuals to save for their retirement encompassing a broad array of savings plan from social security to individual contribution defined or benefit defined company plans.
- After commercial banks and mutual funds, pension funds represent the third largest global pool of private capital available for lending or investment purposes.
- Globally a re-appraisal of pension schemes is taking place and pension funds are reassessing their investment policies falling into three essential categories:
  - Market Capitalization: With the current trend allowing a greater part of investment to be committed to stock markets;
  - Investment in Fixed Income and Bonds: both drawn upon large firms or governments; and
  - Investment in Fixed Assets, primarily real estate.

## Employee Benefit Fund Regulations - Historical Perspective



## Enigma

- Although the introduction of the Voluntary Pension Scheme will allow for creating investment pool for the capital markets, however; there are supply side issues related to investment options, that need to be addressed simultaneously.

### Supply Side Issues - Summary

- Government is typically the largest borrower, however; in Pakistan last long term bond issue was in early 2004;
- Corporate bond market has yet to develop. Mere size of PKR 42 billion against bank advances of approximately 2.0 trillion; and
- Low free float and few IPO issues in the equity market.

### Investment Restrictions - Summary

- As pension/provident funds are investment vehicles with long term horizon, they internationally invest in riskier asset classes like Private Equity, REITs, and Convertibles etc. Not allowed in Pakistan.

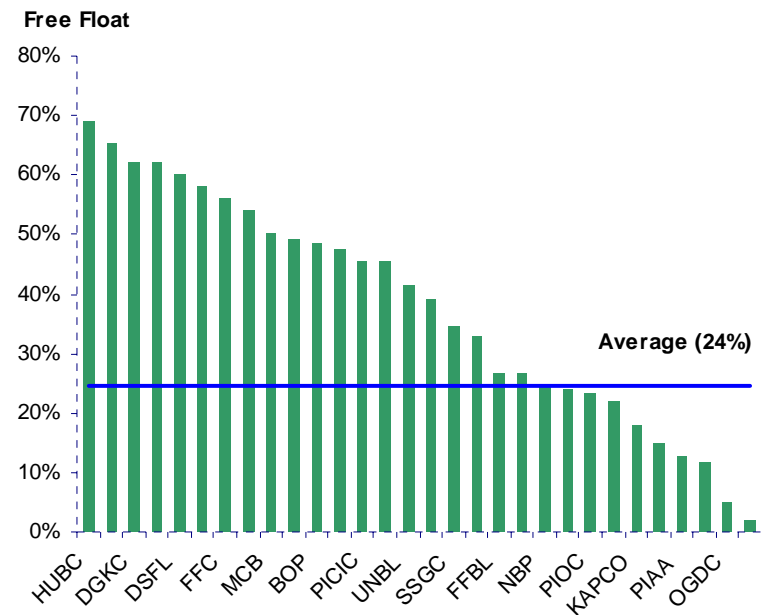
## Investment Supply Side Issues - Equity

## Equity Supply Side Issues

- Low Free float to Market Capitalization Ratio for existing listed companies;
- Very Few “Initial Public Offerings” are in the pipeline;
- Convertible and Warrants Market; and
- No Derivatives

## Equity Supply Side Issues

- Free float to Market Cap is not very attractive
  - Pakistan average Free float for top 30 companies representing 70% (approx.) of total market cap. is merely 24% as compared to 70% to 80% in United States.
  - Government owned entities constitute 50% of the total market capitalization which have a low free float.
  - Low free float is also a threat to institutional investors, and Fund Managers. Mutual Fund Investment in equity markets is PKR 134 bn (approx.) representing 26% (approx.) of available free float.

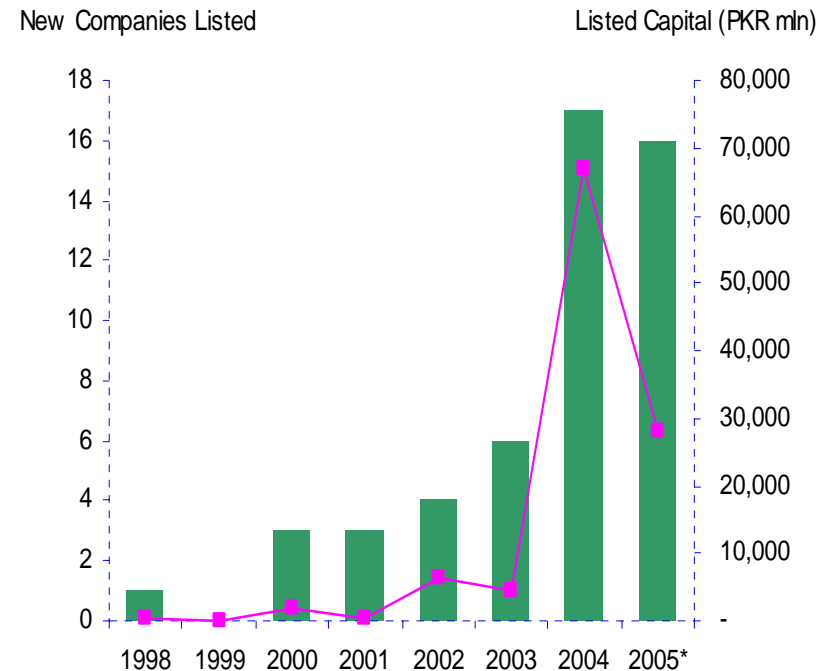


Source: KASB Estimates

*Weighted Average Free float stands at mere 24%.*

## Equity Supply Side Issues

- There have been very few IPOs. The intuitive reasoning is:
  - The transformation of “family owned businesses” to “corporate entities” is at a very slow pace.
  - The primary concern for “business owners” is control.
  - Incentive for Listing was there in the form of lower tax rate on listed companies but has been abolished.
  - The time factor is the key. It may take only 45 days to obtain a bank loan compared to approximately six months to process an equity IPO.
  - The financing need has generally been sufficiently met by the bank borrowings.
  - There are significant Government owned entities that are not listed.



Source: KSE

*The number of IPOs and their size is very insignificant.*

## Equity Supply Side Issues

- No Convertible and Warrants:
  - Convertibles and warrants are usually issued by high risk entities to mitigate the investors fear in taking equity stake straight away. They can thus enjoy the guaranteed return on their investments in the form of interest for the period leading up to the point where conversion price becomes attractive.
  - The convertible and warrant structures are not recognized as investment securities in Pakistan.
  - The key hurdle pertaining to the issuance of convertibles and warrants are lack of a defined set of regulations that recognizes and govern the convertibles and warrants.
- Investment Restrictions:
  - Employee Benefit Funds are not allowed to invest in private equity, real estate investment trusts, commodities, currencies, etc.
  - Equity exposure is limited to stringent requirements, which at times results in selecting companies that have relatively low liquidity.

## Addressing Supply Side Issues

- Low Free Float to Market Cap. Ratio :
  - Privatization and Government Divestment process should continue at a steady pace....
    - “Its not the business of the government to be in business” Shaukat Aziz during an interview to NewsWeek.
  - Companies should be allowed to issue fresh equity without having to issue right shares based on free pricing. Let the market decide the price and not the regulator.
  - Market Makers should be encouraged.
  - Private Equity Investment Should be promoted.
    - Pension Funds should be allowed to invest in Private Equity (PE) Funds (given the long term nature) as this would broaden the supply base for investment.
    - PE Funds may not be the solution for increasing free float, however, since an exit is also possible through an IPO, ultimately would result in a positive impact on the stock exchange.
  - ECNs should be promoted to initiate derivatives, convertibles, etc.
  - Brokerage Houses should be encouraged to undertake derivatives business.

## Addressing Supply Side Issues- Equity Initial Public Offerings

- IPO Process
  - IPO process should be straight through, and Pre-IPO – IPO Process should be done away with not being an international practice. The three month gap should not be there and book building should be allowed.
  - Retail Investors should participate in equity IPOs through financial intermediaries such as Mutual Funds, Pension Funds, etc. therefore the regulator should not be overly concerned about keeping all at PAR.
  - The IPOs should be allowed at free pricing.
- The Soft Issues
  - Entrepreneurs' should understand that simple majority shareholding is sufficient enough to control the board and they should concentrate on diversification into various business propositions.
  - Investment Bankers should educate Entrepreneurs' to create enough value in the company to increase its market price to avoid takeovers.
  - Holding Company concept should find its way to Pakistan as well. Incidence of Double taxation should be addressed.
  - Example: Bill Gates owns only 10% of Microsoft, yet controls the board.

## Addressing Supply Side Issues – Convertible Bonds

- SECP should relax the provisions of Rule 8 thereunder as under the Companies (Issues of Capital) Rules, 1996 it is technically not possible to issue shares against cancellation of debt, as the same would be deemed to be issuance of shares for non-cash consideration.
- In case the convertibles are structured based on reset clauses, issuance of shares below par to investors should also be recognized. As such, in the context of convertibles, the restriction on issuance of shares at a discount needs to be revisited, including provisions of Section 84 of the Companies Ordinance, 1984 and 'Guidelines on Issue of Shares At a Discount'. In any event the concept of par is antiquated and there is hardly any nexus with the underlying value of the security. In the United States, for example, shares may be issued at zero par value.
- Asset management companies, mutual funds, financial institutions and banks, pension schemes, body corporates, insurance companies, trusts, retirement funds and individuals should be allowed to invest in various kinds of convertibles structures.
- Issuance of shares without a right share issue should be permitted once the issuance of convertibles is approved by the Issuer's Board. Presently, under Section 86 of the Companies Ordinance, SECP approval and a special resolution is required to waive preemptive rights. It is suggested that the same be substituted with guidelines which if followed would permit issuance of shares upon conversion of the underlying instrument.
- Rules also need to be framed by the State Bank of Pakistan that provide general permissions are granted for the purposes of Pakistani companies procuring convertible loans and for issuance of shares upon conversion to non-residents on a fully repatriable basis.

## **Investment Supply Side Issues - Debt**

## Debt Supply Side Issues - Government

- In 2001-02 GoP introduced a system of primary dealers, which provides the infrastructure for the GoP to issue and auction debt.
- However, although the infrastructure exists, the pipeline remains dry. The last PIB issue was in April 2004, two years ago.
- For the last two years, GoP meets its borrowing needs through
  - Short term borrowing in domestic markets; and
  - Long term borrowing from the International Markets.

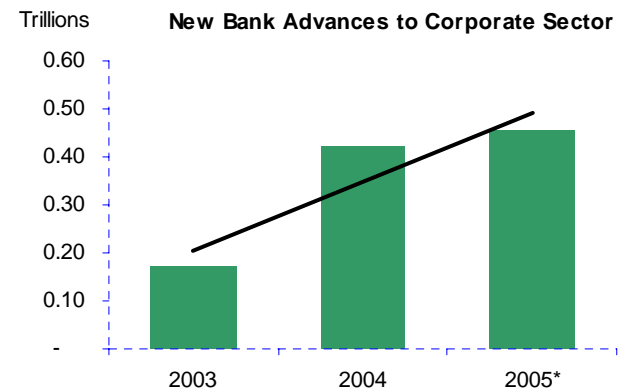
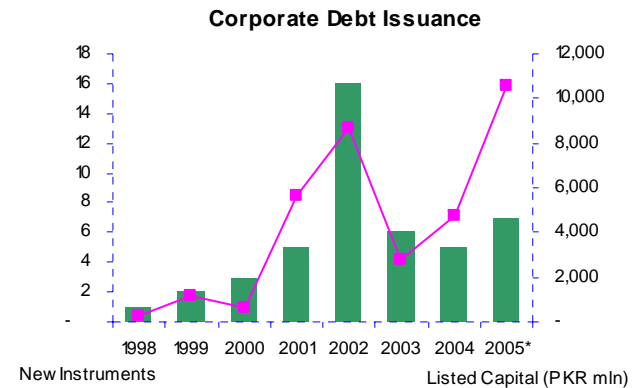
***No supply of long bonds in primary market.***

- In the secondary markets with interest rates moving up, bonds have been parked in “held till maturity” by banks on their balance sheets.

***No supply of long bonds in secondary market.***

## Debt Supply Side Issues – Corporate Debt

- The process of financial intermediation through pooled funds has not taken place completely.
  - Banking sector deposits stand at PKR 2.6 trillion (as of December 2005).
  - The ultimate lenders /investors invest in corporate debt through banks, and not through funds.
- Bank have generally been meeting the needs of their corporate clients (bank advances).
- New issuance of corporate debt has been very scarce vs. increase in advances towards corporate sector.
- Municipal and Junk Bond Markets have yet to develop.
- BBB and above borrowers already have easy access to bank money.
- Credit Derivative Markets have yet to develop.



## Addressing Debt Supply Side Issues

- Sovereign Debt:
  - Generally GoP has to have consistent borrowing policy both at the short end and at long end of the curve.
  - GoP needs to put out enough supply in the long term papers thus satisfying borrowing needs from the domestic market;
  - Recent international sovereign issue of GoP has created arbitrage in the market.
    - The current yield for 3 month t-bill yield is at 8.40% in domestic market while 30 year Euro Bond yield is approximately 7.7%;
- Corporate Debt:
  - Banking sector Advances to Deposit Ratio now stands at 76% with little lending room available. Therefore, corporates should now be pushed to tap the corporate debt market.
  - Process and costs need to be streamlined to bring TFC issuance at par with bank loans.
  - The cash flows from the loan books may be securitized and the pooled fund managers may take ownership of these assets, allowing the risk to be transferred to the ultimate lenders.

## Addressing Debt Supply Side Issues

- Municipal Bonds:
  - The City Government Setup is almost complete.
  - They should be encouraged to get rated and issue papers to undertake infrastructure development projects.
  - This would further strengthen and enhance the pace of infrastructure development as well as improve the supply of debt in the capital markets.
- Junk Bond Markets:
  - Below Investment Grade Corporate Debt can't be offered to the public under current regulations.
  - Since the markets are becoming intelligent enough to assess risk and trade them therefore this restriction should be removed and market should be able to assess whether they wish to undertake such risk.
- Credit Derivatives;
  - Credit Derivatives Volume usually surpasses the volumes in the debt markets.
  - Investment Banks should be encouraged to structure and market Credit Derivatives to provide investment vehicle to pooled fund managers.

