"No Capital"

Pakistan's Capital Markets and Resource Mobilization for Housing Finance

The State Bank

Commercial Banks

Investment Banks

Stock Exchanges

Development Finance Institutions

Housing Finance Companies

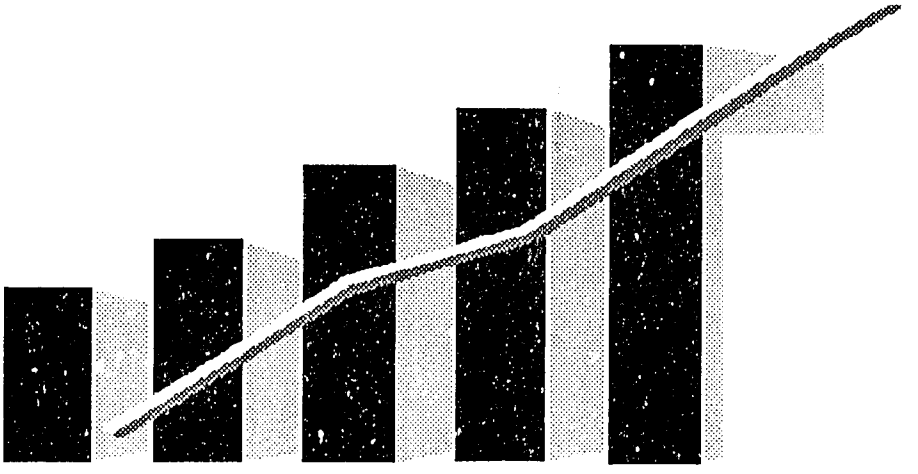
Leasing Companies

Modarabas

Mutual Funds

Pension Funds

Life Insurance Funds



by the

Pakistan Shelter Resource Mobilization Program

Office of Private Enterprise and Energy

U.S. Agency for International Development Mission to Pakistan

Pakistan Shelter Resource Mobilization Program
Government of Pakistan / U.S. Agency for International Development
Fourth Floor, 30 West Blue Area, Islamabad, Pakistan
Telephone: (92-51) 818463/826226 Fax: (92-51) 822052

Staff:
Jon Wegge, Chief Technical Advisor
William J. Strong, Housing Finance Advisor
Javaid I. Qureshi, Program Management Specialist
Javed Akthar, Project Management Specialist
Jeanne Russell, Publications Editor
Tahira Younis, Secretary

This report relies heavily on research carried out by ANZ Grindlays Bank, of Karachi, under contract with the United States Agency for International Development Mission to Pakistan. Material from the World Bank, especially its policy paper "Enabling Housing Markets to Work" was also a vital source of information.

The views expressed herein are those of the authors and do not necessarily reflect those of the United States Agency for International Development, the USAID Mission to Pakistan, or the Government of Pakistan.

December, 1993

Note: At the time this report was written, 30 Pakistani rupees (Rs. 30) were equivalent to one US dollar (US $1).

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Executive Summary

The Shelter Resource Mobilization Program (SRMP) of USAID Pakistan is assisting Pakistan to establish a market-oriented housing finance system. One of the most immediate housing sector challenges for housing finance companies will be access to capital at rates which will allow for a reasonable mark-up and an on-lending rate that ultimate mortgage clients can afford. Until housing finance institutions are developed as mature deposit-taking institutions, resources must flow into the housing sector from the capital markets.

This report relies on research conducted by ANZ Grindlays Bank of Karachi, Pakistan, under contract with the SRMP. Its objective is to develop an understanding of how the housing sector contributes to the economy, why it should be interlinked with the domestic capital markets, and what policy, financial, legal, procedural, and institutional steps should be taken to improve capital market performance. It focuses on the relationship between Pakistan's capital markets, it's emerging housing finance system, and national economic development. The study is based on the results of extensive interviews and a review of available data and policy documentation.

The first section of this report, which draws extensively on World Bank research and particularly the World Bank policy paper titled "Enabling Housing Markets to Work," discusses the important contribution the housing sector can make to the economy, and describes policy considerations to create an "enabling environment" not only for housing finance but for the housing sector as a whole. Subsequent sections of the report describe Pakistan's emerging housing finance system and the issues facing its development; the economy and recent economic and financial reforms; the finance sector, its financial institutions, and financial performance; the stock markets; constraints on the development of capital markets, including the growing budget deficit and domestic debt; the implications for housing finance; and a series of recommendations by the SRMP designed to address housing finance policy, capital market improvements, and institutional strengthening of the financial sector.

The last section of the report summarizes the conclusions and recommendations from an SRMP sponsored national seminar held in Karachi June 19, 1993 on Pakistan's Capital Markets and Resource Mobilization for Housing Finance. Participants representing the legal, government, and financial sectors, including housing finance companies and commercial banks, attended the seminar, which was chaired by Mian Mumtaz Abdullah, Chairman of the Corporate Law Authority (CLA) of Pakistan. Notable speakers included Mr. Dennis P. Armstrong, General and Country Manager of ANZ Grindlays Bank; Mr. Jon Wegge, Chief Technical Advisor, SRMP; Mr. Tariq Hussain, Area Manager and Treasurer of ANZ Grindlays Bank; and Mr. Amjad Virk, Joint Secretary, Internal Finance Wing, Ministry of Finance. A draft of this report was distributed to participants in preparation for the seminar. During the course of the seminar, several recommendations were formulated, and are summarized below:

Refinance Window: *HFCs will be under-capitalized in their first few years of operation. A refinance window at the State Bank of Pakistan is a first step toward eventual development of a secondary market in housing finance and could lead to the development of mortgage-backed securities. Subsequently, in view of this recommendation, USAID, through the SRMP, has offered to provide a US $15 million Housing Guaranty loan and technical assistance to start the window. The conditions of the loan, which are detailed in the last section of this report, are endorsed by the Ministry of Finance and at the time of this publication, were under consideration by the State Bank of Pakistan.*

Apex Bank: *Over time, with growth of the housing finance industry, it may be prudent to establish a specialized financial institution to take over the role of housing loan refinance and to facilitate financial flows in the housing finance industry.*

Toward a "Level Playing Field": *There is an urgent need for government to rationalize the high costs of property transfer fees and taxes. This is a provincial government issue that is critical to the future growth of mortgage lending. Meanwhile, at the federal level, participants strongly urged lowering the stamp duty on mortgage registration for HFCs to 1%, which is the prevailing rate for commercial banks. Secondly, licensed HFCs should be given greater latitude to mobilize resources. This includes the right to offer passbook savings accounts and a broader range of term deposit schemes than presently authorized, and permission to mobilize foreign currency deposits on the same terms and conditions as commercial and investment banks. As a third measure toward operating conditions that are commensurate with their status as licensed and regulated financial institutions, HFCs should be allowed access to inter-bank borrowing.*

Pension, Provident, and Insurance Funds: *Seminar participants supported a recommendation to make pension and provident funds available for investments in the housing sector, and proposed that the appropriate legal, procedural, and institutional framework for the flow of these funds in low risk capital market ventures—for example, the use of provident funds in a government guaranteed refinance window in the housing sector—should be developed. In addition, investment of insurance funds in the securitization of mortgages, development of insurance company housing finance subsidiaries, and deposit insurance and mortgage related life insurance packages would facilitate the development of secondary mortgage markets.*

Deposit Insurance: *It would be prudent to set up deposit insurance schemes to instill confidence in the safety of deposits with HFCs and with the increasing number of newly emerging financial institutions. Insurance premiums deposited by institutions into a general fund managed by the State Bank or an apex bank would be used by regulators to secure depositor funds.*

Fiscal Incentives: *One way to make the high cost (currently about 20%) of taking out a home mortgage loan more affordable to the borrower is to allow home buyers to deduct interest payments from taxable income. This facility is currently available to homeowners who have rented their property, and should be available to homeowners who reside in the mortgaged property. In order to enhance the capital base of HFCs, several participants recommended that HFCs be allowed a tax holiday for an initial period of time. Others suggested that HFCs be allowed to transfer up to 40% of gross earnings to general reserves prior to computation of their tax liability. Any funds removed from reserves would then become subject to taxation.*

Attract Foreign Lending and Investment: *Seminar participants felt that the country should take full advantage of the opportunity to mobilize the flow of foreign sources of lending (which are available at much lower rates than domestically) into the housing sector.*

Commercial Banks and Housing Finance: *The 1% ceiling on housing loans by commercial banks constrains the growth of housing finance, inhibits the diversification of commercial bank portfolios into an essentially low risk area of investment, and should be abolished. Many seminar participants further recommended that Pakistan adopt a policy similar to India and Malaysia, where a percentage of the deposits of the commercial banks are required to be invested in the housing sector.*

Development of Secondary Markets: *Seminar participants strongly felt that efforts should be made to start a mortgaged backed securities program, and that government should take the initiative in this regard and frame the necessary rules and regulations for securitization of such a program.*

Government Policy Issues: *Participants made several recommendations concerning broad issues of government policy that directly influence the future success of the housing sector. These include reductions in government spending, uniform treatment of tax deductions, elimination of the multiplicity of organizations regulating the finance sector, and development of uniform, long term fiscal and economic policy.*

Foreword

Over the past five years, Pakistan has been moving toward a more liberal, less-regulated finance system, one that relies far more on market forces to allocate credit and establish rates of mark-up. This movement has created a number of opportunities for new types of financial firms to establish themselves. As directed credit is reduced and subsidies become more constricted, there is an increasing need to develop financial intermediaries to channel market-rate funds into a number of sectors that urgently need to be integrated into the financial system.

No sector offers greater potential in terms of economic scope than does housing finance. Housing has long been neglected, and reliance solely on subsidized housing loans through House Building Finance Corporation has never begun to meet demand for loans. Enormous potential exists for banks and specialized housing finance companies to enter the market for funding of new construction, home improvement, and mass housing development.

Over the past five years, the U.S. Agency for International Development, through its Shelter Resource Mobilization Program (SRMP), has assisted the Government to begin establishing a market-based housing finance system dominated by private housing lenders. For these lenders, the most immediate issue is resource mobilization. Since they do not yet have branch networks to provide access to deposits, they can not function as savings institutions but must look to the capital markets, or to borrow from banks.

The volume of housing lending taking place is a strong indicator of the level of development of an economy and its finance sector. Typically, housing lending rises to account for 25% to 40% of all financial flows as various types of housing bonds and mortgage-backed securities are developed. In the short term, to make housing finance succeed in Pakistan, housing finance companies need access to resources through new capital market instruments; in the longer term, housing finance needs to be integrated fully into the finance sector.

We are pleased to offer this study of Pakistan's capital markets, with its focus on resource mobilization for housing finance. We hope that it will assist in the development of sound policies and mechanisms to channel capital resources into housing.

Jon Wegge
Chief Technical Advisor
Shelter Resource Mobilization Program

December, 1993

Housing and the Economy

Pakistan has embarked on the development of a market-based housing finance system. The potential economic and social influence of this system is enormous, and the success of the system is closely linked to Pakistan's capability for economic success. Many issues face housing finance in Pakistan; none are more important, more critical, or more immediate than the development of mortgage lending as an integral component and substantial feature of the finance sector.

The performance of the housing sector has broad implications for the economy. Housing is too often viewed solely as a "social" good; in reality, the sector is of great economic importance and is often the backbone of the financial sector and a leading source of jobs, savings, and wealth.

Housing is a key economic sector and must be perceived as an integral component to overall economic management.

Housing sector policy in Pakistan needs urgently to be re-oriented, moving away from subsidized lending and direct production toward a role as manager of the economic performance of the housing sector. The social goals implicit and explicit in housing policy can best be achieved by enabling resources to flow into housing investment through the private sector on a market-determined basis.

Research shows that typically, a given investment in housing generates an investment double that size in other economic sectors; one job created in housing generates two jobs in infrastructure, materials supply, and services.

In developing countries, housing investment ranges from 2% to 8% of GNP and from 10% to 30% of gross capital formation. The flow of services related to housing usually equals another 5% to 10% of GNP. Combined, housing investment and services are typically the origin of 7% to 18% of GNP.

At the same time, housing is a major motivation for saving and has a major influence on consumption patterns. Generally,

A productive housing sector benefits all of its participants:

- ***housing consumers***
- ***housing producers***
- ***housing finance institutions***
- ***local governments***
- ***central government***

Lack of formal long-term lending is a mark of low economic development and thin, weak financial sectors.

Countries that have successful housing finance systems have overall finance sectors that are broadening, deepening, and expanding.

housing forms an asset that represents from 20% to 50% of total reproducible wealth.

Macro economic performance and the performance of the housing sector are linked in a circular pattern through the real, fiscal, and financial sides of the economy. Economic growth and rising incomes impact on the quantity and quality of housing produced. Inflation, interest rates, savings rates, taxation, and other broad economic concerns directly impact the housing sector; simultaneously, choices made by consumers about housing directly impact the same economic concerns.

Presently in Pakistan little of what is invested in housing is "captured" by or "flows through" the formal financial sector. Housing investment levels are greatly constrained by lack of infrastructure, lack of mortgage finance, lack of planned development and mass construction, and inadequate property rights. The lack of supply and choice, combined with costs that are high relative to incomes, especially when mortgage credit is unavailable, leaves most Pakistani families with little choice except to under-invest in sub-standard housing.

Such housing is an indicator of not only poverty, but of failed policy. Inadequate housing simply contributes to poverty while providing few if any economic benefits. Improved housing and services contributes directly to health, labor force participation, and income, enabling people to save and create an asset that can be used as collateral for increased consumption and investment.

Countries that have well-functioning housing sectors are countries that have well-functioning housing finance systems. Countries that have well-functioning housing finance systems also have overall finance sectors that are broadening, deepening, and expanding.

A lack of formal long-term lending is a mark of low economic development and thin, weak financial sectors. In particular, adequate housing and the infrastructure that support it can not be produced without the development of long-term lending.

In Pakistan, there is little long-term finance available for housing — virtually all housing finance is informal.

As economic development proceeds, the economy becomes more "monetized," financial institutions increase in depth and breadth, and capital markets become more integrated. At very low levels of economic development, the portfolios of finance institutions are virtually all very short term assets and liabilities. As development proceeds, longer-term investment develops to finance infrastructure, industry, and housing.

Financial institutions seek to diversify portfolios to mitigate risk and match the term structure of assets and liabilities. Secondary markets develop to enhance financial flows. Mortgage lending, which typically provides instruments with 5 to 30 year terms, becomes a key component of the financial sector and the secondary markets. The "real" side of the economy becomes a principal source of collateral for the "financial" side of the economy.

As economies move from low to moderate rates of economic development, residential mortgage lending moves from virtually zero to about 25% of the assets of the financial sector. In highly developed countries, housing loans constitute about 40% of the portfolios of financial institutions. In countries with rapid economic growth, expanding urban populations, and well-functioning housing finance, mortgage lending is usually the

fastest-growing component of the loan portfolios of banks

Research has shown that financial sector depth alone may contribute to economic growth. Mortgage lending is a principal means by which financial sector depth can be achieved. Ability to maintain and increase financial sector depth can be correlated to continuity of economic growth. Mortgage lending is a principal means by which financial sector depth can be maintained and increased.

Demand is a regular and fairly predictable product of income.

Demand is being stifled by lack of appropriate "solutions" and lack of mortgage finance.

Almost all households are unable to purchase or build the housing they can actually afford.

The pace of development of housing finance depends on the pace of overall economic and financial sector development, and on policies that impact the housing sector. High and/or variable inflation rates impede the growth of housing finance, as do financial systems marked by directed credit, housing subsidies, negative real rates on deposits or loans, inflexible loan terms, inadequate property rights and procedures, and unworkable tenure and foreclosure systems. On the "real" side of the economy, development planning and regulation must encourage the physical development of housing through market-oriented and demand-driven land use and infrastructure development and development of the construction and building materials industries, so that sufficient and appropriately priced housing are produced.

The housing sector may directly impact the household savings rate. Household investment in housing correlates directly to household income and the availability of supply. As incomes rise, demand rises. Households have few options for investment, and housing is virtually the sole long-term investment available to most households. In many instances, price appreciation for housing constitutes a major share of growth in household net worth.

Typically, demand for housing is quite regular and fairly predictable. As incomes rise, demand rises. Supply, however, is far more erratic and is impacted by many aspects of the economy, policy, and regulation. Even when income levels and economic performance are similar, the housing actually produced, and the extent to which the housing sector contributes to the economy, depends on the policy environment.

For example, household incomes in Kuala Lumpur are higher than in Bangkok. Both Malaysia and Thailand have expanding housing finance systems. Malaysia's housing sector is well-managed, but overly regulated, while Thailand's is highly de-regulated. The result: people are better housed in Bangkok in terms of price, quality, and space. Research suggests that if policy enables competitive and efficient housing delivery, a lower-income country can produce housing of similar quality and quantity to that produced by a far wealthier country with inadequate policy.

If the supply is inadequate or over-priced, or finance is unavailable, households do not

Mortgage lending is a principal means by which financial sector depth can be achieved.

A vibrant housing sector is essential to the economy and critical to people's social and economic well-being.

invest in housing, but choose other consumption patterns. Lack of opportunity to invest in housing increases the propensity to consume non-durable goods rather than invest at all, and the savings rate declines. In Poland in the 1970s, for example, rigid housing policy and a lack of housing supply and home ownership opportunities meant that urban households spent only 3% to 4% of income on housing, but 11% to 15% on alcohol and tobacco; the personal savings rate was very low.

What is the role of Government as "manager" of the housing sector? Mainly, it is to create a policy and regulatory environment that enables the sector to function well. Such a policy has two goals: first, to improve the performance of the sector as a whole; second, to leverage limited public resources as much as possible. Neither subsidies or direct housing production are likely to achieve these goals.

A rupee invested in housing generates two rupees of investment in related sectors.

A job created in housing generates two jobs in related sectors.

Housing subsidies, especially off-budget subsidies such as interest rate subsidies and "forgiveness" of loans, contribute to inflation. Generally, housing subsidies are a very small part of budget expenditure, but they have a huge influence on housing pricing and housing demand decisions.

Using government funds to "stimulate" housing production and boost employment generally simply displaces private investment. A study in the US found that for each unit of publicly-subsidized housing built, private construction dropped by about 0.85 units.

In Pakistan, the most immediate housing sector challenge is to create a policy environment that enables housing finance to "take off." Housing sector performance is unlikely to improve unless resources become available to it. Mortgage lending and construction bridge finance are both required. Until housing finance institutions are developed as mature deposit-taking institutions, resources must flow into the housing sector from the capital markets.

As manager of the housing sector, a first priority of the Government should be to create a well-functioning housing finance system. The hallmarks of a well-functioning housing finance system are:

- Housing finance institutions can compete for deposits on terms equal to other financial institutions.
- Credit is not "directed" at the housing sector.
- All housing lending is at positive rates that include sufficient margin to enable positive rates to be paid on deposits.
- Subsidized parastatal lenders are absent, and HFCs are not required to lend at subsidized or negative rates.
- The term structure of deposit instruments are appropriate to the term structure of mortgage instruments.
- Where long-term deposits are insufficient, housing finance institutions are permitted to borrow long-term from international sources, even in highly indebted countries, when the internal rate of return from housing investment exceeds that of export-producing industry.

- A range of mortgage instruments are available appropriate to the needs of all borrowers, permitting purchase of completed single-family and multi-unit housing, home improvement, and home construction.

- Variable rate mortgages, or other mortgage types that provide lenders with security in times of inflation, are permitted.

- Systems of property rights, tenure, and foreclosure protect the interest of lenders without compromising the rights of borrowers.

- The entry of new lenders, including commercial banks, is encouraged; competition among lenders is adequate to maintain reasonable margins between the cost of funds and mortgage rates.

- The development of housing finance is proceeding "hand-in-hand" with development of the banking sector.

- The policy and regulatory environment is neutral to lending to all income groups and for all types of housing.

To accomplish the development of a well-functioning housing finance system, it is necessary that Government take steps to improve the policy and regulatory environment in which the overall capital market operates.

Financial resources are the critical foundation of the housing sector. At the same time, a well-functioning housing sector is a strong contributor to the economy and the finance sector.

The flow of capital between the housing sector and the finance sector forms a so-called "seamless web" in which savings generate capital that in turn generate investment in real assets that mobilize additional savings and form the collateral for further investment. Mortgage lending is not only the foundation of housing development, but arguably the single most important mechanism for deepening and broadening the finance sector.

In Pakistan, mortgage lending has been initiated. With appropriate housing finance policy support, it should develop into a substantial aspect of the finance sector, forming up to 25% of the finance system's assets within as short a period as the next 10 years, assuming that present macro economic performance is maintained and demand continues to rise with income growth.

Clearly, to enable housing finance to develop and contribute to economic and financial sector growth at this pace, a number of other policy aspects of the housing sector must also be supportive, so that the quantity, quality, and range of housing produced matches demand.

Demand fuels housing growth, but is greatly constrained in Pakistan by inadequacies in land use planning, tenure, building regulation, construction, infrastructure, and housing policy. In summary, in order for resources to be applied efficiently to the housing delivery system, the performance of the entire housing sector must be greatly enhanced. Without enhanced performance of the housing sector, the economic, social, and financial benefits to be gained from developing mortgage finance will only be realized slowly, if at all.

The table that follows, adapted from the World Bank policy paper titled "Enabling Housing Markets to Work," presents a series of policy strategies that should be adopted and practiced to make Pakistan's housing sector perform adequately and meet the housing needs of the country. Taken together, the strategies make up an overall policy that would enable Pakistan to develop a well-functioning housing sector.

The components of the housing sector—physical, financial, and social—need to be viewed as a whole.

The role of Government should only be that of "manager" of the sector, and its principal goal should be to maximize the sector's economic performance.

Enabling Pakistan's

The "DOs" and "DON'Ts"

Policy Area: Mortgage Finance

DO:

- *Allow the private sector to lend.*
- *Encourage competition in mortgage lending.*
- *Ensure lending is at positive/market rates.*
- *Enforce foreclosure laws and debt recovery mechanisms.*
- *Ensure prudential regulation.*
- *Introduce appropriate and standardized loan instruments.*

DON'T:

- *Allow interest-rate subsidies.*
- *Neglect or disadvantage resource mobilization.*
- *Allow high default rates.*
- *Discriminate against rental housing investment.*

Policy Area: Property Rights

DO:

- *Regularize land tenure.*
- *Expand land registration.*
- *Privatize public housing stock.*
- *Establish effective property taxation.*

DON'T:

- *Make land titling expensive.*
- *Discourage land transactions.*
- *Engage in mass evictions.*
- *Nationalize land.*

Policy Area: Subsidies

DO:

- *Make subsidies transparent.*
- *Target subsidies to the poor.*
- *Subsidize people, not houses.*
- *Regularly review subsidies.*

DON'T:

- *Build subsidized housing.*
- *Allow hidden subsidies.*
- *Let subsidies distort prices.*
- *Use rent control as a subsidy.*

Housing Market to Work

of Housing Policy

Policy Area: Infrastructure

DO:

- *Coordinate land development*
- *Emphasize cost recovery.*
- *Base provision on demand.*
- *Improve slum infrastructure.*

DON'T:

- *Neglect infrastructure investment.*
- *Use environmental concerns as a reason to clear slums.*

Policy Area: Land and Building Regulation

DO:

- *Reduce regulatory complexity.*
- *Assess the cost of regulation.*
- *Remove price distortions.*
- *Remove artificial shortages.*

DON'T:

- *Impose unaffordable standards.*
- *Maintain unenforceable rules.*
- *Design projects without links to regulatory and institutional reform.*

Policy Area: Building Industry

DO:

- *Eliminate monopoly practices.*
- *Encourage small-firm entry.*
- *Reduce import controls.*
- *Support building research.*

DON'T:

- *Allow long permit delays.*
- *Inhibit competition.*
- *Create or maintain public monopolies.*

Policy Area: Housing Policy and Institutions

DO:

- *Balance public and private roles.*
- *Create a forum for managing the housing sector as a whole.*
- *Develop enabling strategies.*
- *Monitor sector performance.*

DON'T:

- *Engage in direct public housing delivery.*
- *Neglect a role for local government.*
- *Retain financially unsustainable institutions.*

Introduction and Issues

To gain the economic, financial, and social benefits related to having a vigorous housing sector that produces the housing people can afford, demand must exist, resources must be available, and housing delivery must be as efficient as possible.

Does demand exist for mortgage credit?

The simple answer to this question is yes. A critical component of demand is income. Incomes are generally low in Pakistan, but that simply means that mortgage loan sizes will typically be small. Incomes are rising and rising income is strongly linked to increased demand volume as people seek to improve their housing.

Research in many countries consistently suggests that when the housing sector functions reasonably well, households are willing to spend a significant portion of income on housing, usually up 30% or even more. Demand is dampened by many factors. If few housing "solutions" are available, demand declines. If no finance is available, demand declines. If housing "solutions" are unreasonably expensive, demand declines.

Demographically, Pakistan is ripe for developing housing finance. The 1990s will mark the transformation of Pakistan from a rural country to an essentially urban country. Pakistan's population, growing at 3.1% annually, reached an estimated 125 million in 1992 and is expected to reach 165 million by the year 2000. The urban population is growing at a rate of about 6% annually and could represent close to 50% of the population by 2000. In effect, demand is not an issue. The real housing sector issues are whether finance is available and whether physical "solutions" that are appropriate and affordable are being produced.

Are housing solutions being produced efficiently?

The simple answer to this question is no. People's housing situations are greatly inadequate. Recent World Development Reports list Pakistan as 79th of 88 developing countries in its summary of factors relating to the quality of life. Pakistan's major cities are marked by large and fast-growing squatter areas, increasing densities, decaying central districts, an inadequate supply of water and sanitation, little maintenance of infrastructure, and poor urban administrations.

The housing situation in Pakistan reflects the failure of housing policy. While it is true that very poor people may not be able afford adequate housing, the housing sector functions so poorly that even the vast majority of people are unable to attain the standard of housing they can afford. In major urban areas, the majority of housing provided is for government servants. A large portion of the plots created and serviced by the public sector have remained vacant, resulting in widespread

The best starting point for housing sector policy is to focus on creating the conditions that enable the housing market to function freely, striving to enable the market to produce appropriate solutions affordable to all.

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The real housing sector issues are whether finance is available and whether physical solutions that are appropriate and affordable are being produced.

speculation and escalation in urban land prices. Land ownership is unclear, and land titling is no guarantee of ownership in Pakistan—land transactions are held up for years in the courts. Formal land ownership is out of reach for most families.

Fortunately, the informal provision of housing has been vigorous over most of the past 25 years. While services are lacking, housing conditions have improved significantly. Although household size has increased, densities per room have declined due to widespread incremental housing expansion. The relatively strong Pakistan economy has helped many families improve their housing.

Are resources available?

The simple answer to this question is "not yet." Tackling the urban problem requires resources. The purpose of the Shelter Resource Mobilization Program (SRMP) is to assist with the establishment of a housing finance system. Without mortgage credit, few people can afford adequate housing. In addition to mortgage credit, however, Pakistan should also concentrate on developing resource mobilization for infrastructure development. A growing body of research shows that urban centers are the major "engine" of economic growth. To contribute economically, Pakistan's cities must function far better than at present.

In Pakistan there is little long-term finance available for housing; virtually all housing finance is informal. The major source of mortgage credit, the parastatal House Building Finance Corporation (HBFC), is effectively bankrupt. The formal private sector house building industry exists only in Karachi and Lahore. Formal sector construction financing is non-existent, and the role of the private sector in housing provision is limited.

Seven applicants have received letters of intent from the Ministry of Finance authorizing them to establish private Housing Finance Companies (HFCs). As of December 1993, only two had completed the licensing process and commenced operations. There are many constraints that HFCs face in starting operations; they will be risking a substantial amount of equity capital and need a reasonable set of circumstances that will permit them to sustain their operations and provide a profit to their investors.

One of the main problems for HFCs will be access to capital at rates which will allow for a reasonable mark up and an on-lending rate that ultimate mortgage clients can afford. High transaction costs involved in mortgage lending are a second major obstacle which, although not directly related to capital markets, do impact directly on the ability of the companies to do business.

Housing finance companies can not currently compete with the Government of Pakistan in the domestic capital markets. The government is paying 13-16% "risk-free" returns on government and public agency debt instruments. Housing finance companies will have to pay at least the rate of 18-20% paid by private sector commercial bank clients.

What are the alternatives? How can the new industry gain access to the capital markets in Pakistan? Can they be allowed to establish passbook savings and foreign exchange accounts for their clients? Will the State Bank and the Ministry of Finance give the new companies equal access to inter bank lending? These and other issues discussed in this report need to be resolved on a priority basis.

The government has made a commitment to the establishment of a new housing finance industry. Private sector firms have invested their money in this new field. Now government has to enable the new industry to be successful. Under existing circumstances it will be difficult for the housing industry to expand and meet the growing demand for housing.

The Macro Environment

Since the mid-sixties Pakistan has been registering an annual growth rate of 2.5% in per capita GNP compared with an average of just under 1.9% in most developing countries, excluding China. These high growth rates have been achieved through a heavy dependence on external capital inflows—there has been a gap of 5 to 6 percentage points between gross domestic investment as a percentage of GDP and domestic savings as a percentage of GDP—and by running down the already limited physical and social infrastructure.

Pakistan's savings rate is rather low, both in absolute terms and relative to other similarly placed countries. The domestic savings rate has remained below 10% for most of Pakistan's history—and between 6.5 to 8.5% since the 1970s—compared with rates in excess of 20% for most low and lower middle income countries. However, as non-financial assets (primarily jewelry) constitute the bulk of household wealth, a comprehensive analysis of total household savings can not be accurately determined.

The national savings rate, at approximately 14% of GNP, has been perceptibly higher than domestic savings, in part due to substantial inflows of remittances from Pakistanis working overseas. Nonetheless, the national savings rate is rather low in comparison to the gross investment rates that are required for sustaining future growth.

It is estimated that the corporate sector in Pakistan is responsible for approximately 12% to 15% of private savings, with the household sector providing the balance. According to a study on earnings of companies registered on the Karachi Stock Exchange, small firms retain nearly all of their profits for financing operations and expansion of production facilities. Large companies retain 85% of their savings, i.e., for every unit increase in profits these firms save 85% of it. This is because corporate sector clients have better access to the banking sector and other sources of finance.

The newly emerging housing finance companies have little or no access to capital or the capital markets in Pakistan. Other than Citibank, which has a worldwide reputation, most of the HFCs, as untried companies, will be unable to promote debt instruments and may even have trouble selling the 50% equity shares required by the end of their second year of operations. The companies will be capitalized at between 50 and 100 million

The newly emerging housing finance companies have little or no access to the capital markets in Pakistan.

To date, unlike much of the world, banks in Pakistan do not regard housing finance as a business opportunity.

rupees, an amount which can not sustain mortgage lending for any extended period of time.

On the positive side, in May 1991, the government began to implement a policy of liberalization of the financial sector and privatization of government commercial and industrial units. One of the first effects of this liberalization came as a result of giving foreign investors access to the stock exchange, and led quickly to a boom in the Karachi and Lahore Stock Exchanges. Capitalization of the stock market increased from 70 billion to over 200 billion rupees. As more shares were traded, a third exchange was opened in Islamabad.

Foreign exchange was being attracted in significant amounts by Citibank and others, and remittances began to increase from a 1991 low as off-shore Pakistanis were given access to foreign exchange accounts. Several banks were privatized, a dozen others were newly created, and in the fiscal year 1991-92, commercial banks registered the largest profits in their histories. In addition, leasing companies and modarabas were showing substantial profits. It appeared that Pakistan was on the verge of attracting substantial new foreign investment to help continue economic growth.

Recently, however, political instability has been a major concern of both domestic and private investors, and this has put a great deal of new downward pressure on the KSE. According to the Karachi Business Recorder, the KSE lost 65 billion rupees in capitalization in 1993. On May 17, 1993 it stood at 1112, its lowest point in several years. It appears that investors are nervous, and are choosing to minimize their exposure in the market.

The growing government budget deficit is also putting a strain on the economy, and in some instances, the government has turned to the financial sector for relief. For example, the government recently reversed policy and placed withholding tax at source on income from Treasury Bills and Federal Investment Bonds. In addition, a 3% exchange charge was assessed on foreign exchange accounts at foreign commercial banks.

The macro environment is marked by:

- ***sustained growth***
- ***liberalization and deregulation***
- ***foreign inflows***
- ***low domestic savings***
- ***high government borrowing***
- ***a nervous stock market***
- ***a thin, weak financial sector***

There is growing realization that current fiscal trends, reflected in the large budget deficits, are not sustainable. Deficit spending was over 96 billion rupees in 1991-92, or about 7.1% of GDP. In 1992-93, the deficit is estimated at 107.7 billion rupees, or 7.9% of GDP. There is also growing pressure on Pakistan's balance of payments. In a worst case scenario, interest rates would go up, discouraging both domestic and foreign private investment. The result would be increased monetization of the deficit, accompanied by high rates of inflation.

The continued rapid expansion of the money supply is another factor which could produce a cycle of inflation, devaluation, and financial instability. The money supply has grown at over 20% in each of the last three years. Conversely, a long term money supply growth of 5% per year is considered by most economist to be the norm—given some cyclical fluctuations. In order to sustain growth

and stability in domestic financial markets and the general economy, it is important to separate monetary policy from fiscal policy.

Yet, if the situation is so bad, why has the Pakistan economy been able to sustain itself over the last ten to fifteen years without experiencing destabilizing rates of inflation? Deficit spending has been rising over the same period. It appears that as spending has increased, the rapid and sustained growth of economic output has provided an expanding base and increased revenues. The question is, can the country continue along the same path? Can growth be sustained in the face of a worldwide recession? What role can the public and private sector capital markets play in the overall economic growth of the country? What needs to be done to strengthen this role?

Pakistan is heavily dependent on the capital markets to finance its deficit spending. Like other developing countries, Pakistan gets a large chunk of its borrowing from the banking system, from non-bank sources (including institutional investors, but mainly from life insurance funds, pension and provident funds), and from external sources. The 5% cash and 30% government securities reserve requirements for banks pre-empts a significant amount of the liquidity in the banking system at below market rates. Banks are required to channel another 30% of their lendable funds into government owned or controlled businesses. The remaining funds are used to provide credit to a small number of financially strong clients, leaving little for the expansion of small and medium sized private sector enterprises in the country. To date, housing finance, other than for employees, has not been considered a business opportunity by commercial banks.

Housing finance has also had a low priority for funding. As a result, little or no capital is available to potential institutions. How can increased discipline be brought to current government borrowing? Is government willing to implement reforms that will allow the capital markets to broaden and deepen? Are there ways to bring housing finance into the capital markets and provide the housing sector with equal access to funds? Will the government provide reforms which will allow the secondary market in government debt to expand and deepen? Is there potential for the creation of new debt instruments in the private sector? Would they be available to the housing finance industry? The purpose of this paper is to discuss these issues and recommend changes that will help bring stability and greater depth to the capital markets in Pakistan.

Government debt servicing has placed a heavy burden on the capital markets and has constrained the liquidity available for development, education, and health.

There are many constraints that HFCs face in starting operations; they will be risking a substantial amount of equity capital and need a reasonable set of circumstances that will permit them to sustain their operations and provide a profit to their investors.

The Developing Capital Markets in Pakistan

Pakistan's capital markets will initially be the source for much of the resources that can flow into housing investment. Presently, the new housing finance institutions do not have the capability to mobilize household savings. Even over the longer term, the capital markets should be a mainstay of resources for housing, providing longer-term funds than are usually available from savings deposits.

Until recently, there was an elaborate system of regulations governing the financial system in general and the banking sector in particular. The flow and level of credit to different sectors of the economy was administered by the government in the form of credit ceilings consisting of general purpose and priority lending. Whereas one portion of government debt was provided by the banking sector at below market rates of interest, another portion was provided by the public directly through government savings schemes that carried high interest rates of 14% to 16%.

Banks had little motivation to mobilize deposits, and there was reason for doubting the financial sector's ability to mobilize savings for growth in a more sophisticated economic environment. There was increasing recognition that the banking system had become highly fragile and that this would eventually reduce its role in the area of development and investment. The government recognized that a structure had to evolve which would be less centered on credit ceilings and entail a diversification of instruments.

Since November, 1990, the government has been implementing a series of policy measures aimed at reforming the economic, commercial, and financial structures. A number of measures have been taken to facilitate the liberalization of the financial sector, to foster the growth of the financial system, and to open the financial markets to new forces by allowing the private sector to play a more positive role in mobilizing domestic resources. The key measures that lie at the heart of the financial sector reform programs are:

- improvement of the competitive environment in which banks operate through privatization and greater reliance on market forces;
- liberalization of exchange controls;
- the deregulation of the structure of interest rates and a gradual dismantling of the system of directed credit;
- permission for foreign ownership of equity; and

Since November, 1990 the government has been implementing a series of policy measures aimed at reforming the economic, commercial, and financial structures.

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- improved bank supervision

As a first step to the introduction of a market-driven pricing system for government debt, an auction system has been introduced for government securities. The commercial banks are the linchpin of this system and play the role of primary dealers.

Credit ceilings have also been relaxed to a degree. The long term strategy of the government is to eventually eliminate all ceilings on lending to the private sector and do away with directed credit schemes and credit availability at concessional interest rates. A primary goal of the reform effort is the efficient allocation of credit in an integrated money market where the private and public sectors compete fairly for available funds.

Although mandatory targets to priority sectors continue, credit is linked to deposits in a transparent manner.

To tackle the problems posed by directed and subsidized credit, government raised the interest rates on most concessional schemes, although they are still below market rates, and reduced the shares of different loan categories in the incremental credit provided to the private sector.

To promote competition in the financial system, the government has allowed the establishment of private leasing companies and commercial and investment banks. In response to this less constricted environment, new institutions and instruments are being set up to cater to special and more sophisticated requirements of industry, trade and commerce, leasing arrangements, merchant banking services, modarabas, and mutual funds.

To improve the safety and security of the capital base and to maintain the operations of financial institutions, well-designed, stringent prudential capital adequacy standards were introduced in 1991 through the State Bank's Prudential Regulations (PRs). One set of regulations pertain to commercial banks and another govern the activities of non-banking financial institutions. PRs are introducing discipline in accounting systems and contributing to improvements in the quality of lending. The State Bank is becoming more sophisticated in its operations through practical experience. However, what is critically needed is a well-trained supervisory staff capable of monitoring institutional compliance with the PRs.

Ceilings

Prior to July-September 1992, the State Bank used ceilings to strictly control the credit available to the market. To promote the flow of credit to priority sectors of agriculture, small scale industry, and small business, mandatory targets were issued. Ceilings were fixed for preshipment export credit, fixed industrial investment, and other items such as housing loans. If mandatory targets were not achieved by a bank or if ceilings were breached, penalties were imposed by the State Bank.

Credit ceilings have a tendency to inhibit deposit mobilization and competition among banks. In mid-1992, there was a shift in policy from direct to indirect monetary control, with the intent to manage money reserves through open market operations. Although mandatory targets to priority sectors continue, credit is linked to deposits in a transparent manner.

The liquidity ratio was raised from 35% to 40% in mid-1992, and to 45% in December 1992. In October 1993, the State Bank lowered the liquidity ratio to 35%, thereby making an additional Rs. 57 billion in credit available to the private sector. Credit/deposit ratios are governed in the following manner:

- Liquidity ratio/reserve requirements: Cash 5%; other reserves (gold, approved securities, FIBs) ; 30%
- Mandatory targets and ceilings: Public sector credit; 30%
- Discretionary: Private sector credit; 35%

In the unregulated private sector, commercial banks concentrate on short-term financing of trade and commerce in areas in which they have knowledge and expertise. In addition to being of short term nature, the risk element is minimum and such financing generates ancillary business. Banks also meet short term working capital requirements for their best customers.

For running finance purposes, banks currently make funds available to customers at interest rates ranging from 12-20%. For term loans, banks have recently lent funds at interest rates ranging from 13-20%. There are other investments of ceiling funds that are short term or long term in nature. Short term investments include equities, while longer term use of funds may include fixed asset purchases.

Banks routinely trade ceiling among themselves to meet State Bank requirements. The market for ceiling funds is strictly a function of supply and demand, and it follows a seasonal trend. For example, in the cotton season, from approximately November to February, the demand for ceiling normally outstrips supply and becomes quite expensive, it has been as high as 25% on occasion.

The Inter-bank Market

Call market borrowing is an overnight inter-bank market which falls outside ceiling. It is available only to scheduled banks with a few concessionary exceptions given to some non-banking financial institutions, for example, Pakistan Industrial Credit and Investment Corporation (PICIC). This is clean lending on an overnight basis strictly within the inter-bank market. Technically, only banks that are subject to ceiling constraints can access the call market—if this were not the case then the potential for arbitrage would exist.

The call rate fluctuates with the demand and supply of call funds in the market. It can be as low as one-half percent or as high as the State Bank repurchase (repo) rate. From 1981 up to the pre-reform period of 1991, it ranged from 5.5% to 8%.

Since the reforms of 1991, call rates have varied from 1% to 14%. Similarly, the State Bank discount/repurchase rate increased from 6.06 % to 14% during the same period; it has now been raised to 15%.

Ceilings are also traded between banks. In the ceiling market, banks that have ceilings in excess of their lending needs can lend them to other banks at the prevailing ceiling rate. Ceilings have more uses than call funds, and the ceiling rate is invariably higher than the call market rate.

To manage short term liquidity requirements, banks can resort to repurchase agreements with other financial institutions, whereby they sell the security and simultaneously buy it back at a marked-up price on a specified date. The State Bank provides a repo facility at 15%, which serves as a bench mark for the call money market. In the absence of the repo facility, banks can liquidate securities to raise funds.

Foreign Exchange

The US dollar/rupee rate is managed by the State Bank and is fixed at the start of any given day. Transactions in the local market are performed between the treasury departments of banks and authorized foreign exchange brokerage houses. In view of the fluctuations and volatility in the international markets, the State Bank allows a certain margin to cater to the volatility in the exchange rate. The uniqueness of this market is that rates are quoted in the morning and remain fixed throughout the day, irrespective of movements in international markets.

In the private sector, commercial banks concentrate on short-term financing of trade and commerce in areas where they have knowledge and expertise.

The Stock Market

At present, there are three stock exchanges in Pakistan. The Karachi Stock Exchange opened in 1948, the Lahore Stock Exchange in 1970, and the Islamabad Stock Exchange only in 1992. The Karachi Stock Exchange is the only actively traded equity market, and accounts for 90% of total volume.

As of November, 1992, there were 623 companies listed on the Karachi Stock Exchange (KSE) and 522 companies on the Lahore Stock Exchange (LSE). The largest increase in listed companies has been in the cotton textiles sector. The aggregate market capitalization at the KSE in late 1992 was approximately Rs. 200 billion, a growth of approximately 426% from 1986. The membership of the KSE is currently around 200, and new members are required to purchase an existing seat. The current base of active members is around 130, with trading dominated by 15 to 20 members. In June, 1990, the constitution of the KSE was amended to permit corporate membership. Corporate members are required to have a minimum paid up capital of Rs. 20 million.

Regulatory Framework

The regulatory framework for the stock and capital markets has evolved over a period of time. The governing legislation is the Securities and Exchange Ordinance of 1969. The KSE regulates and organizes the conduct of its members and establishes standards for listing and dealing in securities. It also operates the clearing house and supervises settlements.

The KSE and its members are regulated by the Corporate Law Authority (CLA), an authority constituted under the Companies Ordinance of 1984. New issues are subject to the approval of the Controller of Capital Issues (CCI) under the Capital Issues (Continuance of Control) Act of 1947, and to regulation under the Monopolies and Restrictive Trade Practices Ordinance of 1970.

The KSE is managed by a board of directors consisting of 16 persons and a president, 14 of whom are elected by the members and two of whom are nominated by the National Investment (Unit) Trust Limited (NIT) and the Investment Corporation of Pakistan (ICP), respectively.

Domestic Institutional Investors

NIT

The National Investment Trust (NIT) is an open-ended mutual fund established by the Government of Pakistan for the benefit of small investors. The NIT is active on the KSE and purchases and sells shares on a regular

The recent economic reforms had an immediate impact on the stock markets.

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basis. Under Islamization policy, NIT cannot invest in securities offering a fixed return, e.g., Treasury Bills and Federal Investment Bonds, and hence has been a stabilizing force in the equities market. The income of NIT was exempt from tax until the fiscal year 1992-93.

It is a condition of every consent issued by the CCI to a company seeking public participation in its equity that it gives to NIT the pre-emptive right of first refusal to 15% of the floated shares. NIT is not allowed to perform any transactions with these shares for two years, and therefore can not disinvest if the company is performing poorly. Frequently, pressure is exerted on NIT to pick up shares to support the market when it is depressed. For example, during the market down turn in August-October 1992, NIT invested Rs. 10 million per day, which appears to have bailed out some speculators and brokers who would have otherwise suffered heavy losses.

The yields from judicious investments in the stock market can be quite attractive.

ICP

Another financial institution established by the Government of Pakistan that trades extensively in shares is the Investment Corporation of Pakistan (ICP). Since its inception, it has sponsored the listing of 21 closed-ended mutual funds on the KSE. The preferential right of the NIT over new issues is not available to the ICP. As a financial institution, the ICP has played a significant role in the underwriting of public flotations and in establishing underwriting syndicates.

State Life

The State Life Insurance Corporation (SLIC) is a public sector company and has a portfolio that includes shares from 206 companies. It holds 33% of the Pakistan Industrial Credit and Investment Corporation's (PICIC) shares and 30% equity in the Karachi Electric Supply Corporation. It currently holds 3.1% of the total market capitalization of the KSE. SLIC's maximum exposure in the case of new companies is limited to 2.5% of the lower of the equity of the new company or its own portfolio.

Private sector insurance companies are subject to fewer restrictions. For instance, they are free to choose their own portfolio of investment and can invest in any paper that can be transacted on the stock market. However a new condition currently under discussion would restrict the maximum permissible holding to the lower of 2.5% of the equity of the new company or 2.5% of the insurance company's portfolio. General insurance companies prefer investments in equities as the solvency requirement test values their investments at market prices.

Ownership Pattern of Securities

Anecdotal evidence and the assessment of major investors suggest that the share holding pattern of a typical company listed on the stock exchange is as follows:

- Sponsors: 60-65%
- Institutional Investors: 25%
- Individual Investors: 10%

Estimates suggest that the scrips of around 100 companies are widely available and have widely dispersed ownership.

The turnover on the KSE has been dominated by individual rather than institutional investors. The average daily turnover in 1986 was half a million shares, growing to over one million in 1990. In late 1992, approximately 300 equities were traded on an average day, mostly in insignificant volumes. Trading in the shares of 10 companies is estimated to account for over 30% of turnover in terms of value.

Corporate Sector Performance

According to one institutional investor interviewed for this study, the yield on their investments in the stock market averages 8% before tax, in cash terms and by recording bonus shares at face value. In their assessment, if capital gains are also taken into account, the yield would be around 15% before taxes.

The State Bank of Pakistan share index doubled between June 1991 and June 1992, while market capitalization increased two times. The average rate of return for investors during the preceding five years was around 17.25%, excluding returns arising from dividends and bonus shares. Returns in the shape of cash and stock dividends can be approximately 3-5% on well constructed portfolios. Therefore, it appears that even if the exceptional increase in the index after the recent reforms is disregarded, the yields from judicious investments in the stock market can be quite attractive.

The average earnings per share (EPS) of profit making companies listed on the KSE was 4.1 in 1990, and 4.0 in 1991 (these figures exclude transportation, where EPS fell from 78.1 to 1.1). However, the rise in prices in 1991 was not fully backed by corporate earnings figures, and this led to unrealistic P/E ratios for some scrips. The correction process lasted through the first half of 1992, and was still continuing in certain sectors in late 1992. The yield for new investors in existing shares has declined significantly because of a low market float. Currently the primary motivation for investors appears to be the capital gains tax exemption.

Small investors have generally preferred investment in scrips of foreign multinational corporations (MNCs). MNCs generally offer high cash and stock dividend payments, credible information disclosure, and highly professional management. This is reflected in the very high P/E ratios for MNCs, some of which exceed 50. A select few domestic groups have also figured prominently in the stock market activities of investors. In such cases, they have successfully gained investor confidence based on past performance.

The Effect of the Reforms on the Stock Market

The economic reforms introduced by the government had an immediate impact on the stock market. They changed the perception of investors and served as the ignition point for an increase in investment and economic activity. The new KSE share price index soared to 1680 early in 1992, until a correction pushed it back to around 1230.

SBP General Index

The State Bank General Index of Share Prices grew by 93.2% during 1991-92 compared with an increase of 38.2% in the preceding year.

Trading Levels

The traded number of stocks increased from 361 million to 725 million during 1991-92, while the value of traded shares rose from Rs. 27.9 billion to Rs. 85.8 billion. In 1991 the average daily turnover was 2.4 million. By 1992 the daily turnover had increased to three million, with a substantial proportion of trading accounted for by foreign investors. Market capitalization increased from Rs. 52 billion in 1989 to Rs. 200 billion in late 1992. The number of shareholders increased from 250,000 to one million, indicating the widening of the culture of equity.

The potential of the stock market to serve as an instrument for raising long-term funds has not been fully exploited.

Pakistan Fund

In April 1991, CitiCorp set up a US $22.6 million closed-end Pakistan fund which was listed on the Hong Kong Stock Exchange. Credit Lyonnais also established a US $25 million open-ended growth fund and a US $10 million special situation fund for investment in unlisted equities. In addition, Asian Development Bank is in the process of setting up a US $60 million closed-end fund in association with Solomon Brothers. However, institutional investors are beginning to lose interest in country funds as the reforms now permit them to deal directly with brokers rather than through fund managers

Privatization

The market for public debt is still relatively undeveloped.

The privatization of state enterprises has also served as a catalyst for the stock markets. The biggest public flotation of unlisted state enterprises after privatization was the Muslim Commercial Bank's issue of Rs. 850 million in mid-1991, which was over-subscribed about seven times. Due to an earlier law which required shares to be issued only at par, new issues in 1991 were generally well received by investors. On the average they were also over-subscribed seven times. An amendment passed by CLA in 1992, which allowed companies to offer shares above par value, permitted some well-established companies to raise capital at high premiums. Subsequently, however, other companies trying this have met with less success

Prudential Regulations

With the introduction of the State Bank's prudential guidelines, credit to the corporate sector has become more restricted. As a result, the traditionally under-capitalized corporate sector's reliance on the equity markets has increased. This trend was in evidence throughout 1992. Most dividend declarations by established concerns have included rights issues at substantial premiums.

Public Debt Market

The market for public debt is still relatively undeveloped. Although a number of federal and provincial debt securities are listed, little trade is seen on the stock markets since most institutional investors and banks either hold such securities until maturity or trade them off-market.

Payout vs. P/E

Originally, the stock market was based on payout ratios. Foreign investors have introduced the concept of P/E ratios, however, the fact that P/E ratios have to have a logical link with interest rates was overlooked. Major fluctuations in the share prices of a handful of companies including ICI, Gratron, Indus Motors, Fauji Fertilizer, and the new private banks have influenced the stock market index significantly.

Sustainability

Most of the players in the stock market interviewed for this study maintained that the market is now settling at levels that can be sustained. There may be good reason to take an optimistic view of the basic outlook for securities. However, a reasonable certainty in conclusion can only come after the market is firmly set on its upward journey.

Other Issues

Underwriting of public issues

The major costs involved with flotation are underwriting fees, brokerage charges, and bankers fees, which, on the average, account for around 4% of a fully subscribed issue In the case of under-subscription, the costs are increased to the extent of take-up fees payable to the underwriters. The CLA has currently set

take-up fees at a maximum of 2.5% of the under-subscribed amount. In other words, in the case of an under-subscribed offer, the maximum cost of an under-written flotation borne by the sponsors is 6.5% of the issue.

Recently, sponsors of large established groups have preferred to underwrite their own public offerings to reflect confidence in the issue, to maintain control, and to save on flotation costs. With shares being offered at premiums, the underwriting risk has considerably increased, while the upper limit for underwriting fees continues to be 2.5%. After big failures of premium issues in the market, underwriters have become apprehensive of large flotations as fees are not commensurate with the risk being taken.

Equity Placements

As capital markets became more volatile, foreign institutional investors have become more interested in the potential offered by tax free capital gains. Their appetite has increased for larger blocks of stocks which offer liquidity at the time of redemption. The sponsors of new companies also tend to prefer private placement of equities as it assures considerably smaller and more manageable public flotations. In addition, foreign investors are not particularly keen to occupy a place on a company's board.

The privatization of state enterprises fueled this idea further as larger blocks were made available without threatening the management control of new owners. Unlisted companies, in particular, provided the potential to capture large tax free capital gains at the time of flotation. One example is the privatization of D.G. Khan Cement Company, in which a group of foreign institutional investors collectively bought equity of over Rs. 500 million. In this case, the issue was ultimately under-subscribed because the shares flotation coincided with generally depressed market conditions. However, private placements will increasingly become the more favorable route as large public sector enterprises like the Water and Power Development Authority, Pakistan Telecommunications Corporation, and Pakistan International Airlines are privatized.

Corporate placements are being placed privately to a limited extent. However, this market is currently restricted to financial institutions. Corporate debt instruments such as Term Finance Certificates (TFCs) are sold to a syndicate of banks and other financial institutions for their own accounts.

Although the stock market is to some extent thin and volatile, the extent to which realistically priced public flotations by reputable industrial and commercial groups are over-subscribed is not only a testimony to the ability of the market to finance privatization through the stock exchange, but also provides evidence on the latent demand for good quality scrips. This is particularly true now that the rules on foreign exchange holdings and foreign investment on the stock exchange have been considerably relaxed and the new Prudential Regulations are forcing companies to increase their capital base and raise finances from equity markets.

Long-Term Funds

The potential of the stock market to serve as an instrument for raising long term funds has not been fully exploited. There is evidence of its capacity to absorb large offerings. Between April 1991 and September 1992 capital of Rs. 22 billion was raised through the Karachi Stock Exchange through new flotations, rights issues and bonus shares over and above the Rs. 4.5 billion raised in cash terms through privatization. Recent data suggests that the stock market can absorb between Rs. 5 to Rs. 10 billion per annum which, based on international experience, appears to be achievable as it represents around 5% of the present levels of capitalization of the market.

The extent to which realistically priced public flotations by reputable industrial and commercial groups are over subscribed is not only a testimony to the ability of the market to finance privatization through the stock exchange, but also provides evidence of the latent demand for good quality scrips.

The Market for Government Debt

High levels of government borrowing, primarily from domestic sources, has resulted in a rapid accumulation of debt servicing obligations. This puts pressure on future borrowing and crowds out private investment.

The total domestic debt of the Federal and Provincial Governments was Rs. 602.4 billion as of June 30, 1993, an increase of Rs. 80.6 billion or 15.4% over the previous year. The broad composition of this debt has changed the share of the permanent debt component to 41.4%, while that of the floating debt has dropped to 35.8%. Growing interest payments now represent approximately 40% of current expenditures.

A critical issue facing the economy has been the trend of rising fiscal deficits. The consolidated fiscal deficit during the period 1980/81 to 1991/92 averaged around 7.2% of gross domestic product (GDP) annually, growing at a rate of almost 22% per annum.

Government expenditures increased to 353.2 billion in 1992-93. In the State Bank of Pakistan's 1992-93 annual report, the revised estimate of the deficit was Rs. 107.7 billion, or 7.9% of GDP.

TBs and FIBs

Since March, 1991 the government has been auctioning Treasury bills (TBs) and Federal Investment Bonds (FIBs), two debt instruments which have the crucial capability of liquidity. Treasury bills, a floating debt instrument, are zero coupon instruments of six month maturity. They are treated as money market instruments and can be discounted with the State Bank. Their liquidity derives from their short term maturity period.

FIBs are fixed income securities, paid half yearly, carrying a rate dependent upon the maturity period; 13% for three years, 14% for four years, and 15% for five years. They are not redeemable before maturity.

For individuals, TBs are subject to a 30% withholding tax, while FIBS are subject to a 10% withholding tax. Corporations and local banks are subject to a 30% withholding tax while foreign banks pay 65%. Six month TBs and three year FIBs are viewed as liquid instruments by financial institutions and are being used in inter-bank trading.

The government's decision to change its debt instruments from the on-tap variety to non-redeemable ones means that it does not have to make arrangements for the early encashment of these securities. This has improved cash flow management. Government's decision to phase out National

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Savings Schemes will improve it even further as there will be no debt redeemable before maturity.

The auction process was accompanied by the gradual raising of the discount rate at the State Bank of Pakistan discount window—from 6.06% to 15%. During this process, the discount window was closed and in its place a repurchase window was opened.

As part of the government's reform measures, the State Bank established the Subsidiary General Ledger Account (SGLA), a book-based system for settling secondary market deals. The establishment of a book-based system at the State Bank has improved the security and efficiency of the system, as physical movement and handling of securities is no longer required.

Auctions

The auctioning process started in March 1991. The government raised Rs. 76 billion through treasury bills in 1991-92, and Rs. 106.2 billion in 1992-93. The cut-off yield, which on average stood at 11.6% per annum during 1991-92, increased to 12.5% during 1992-93.

The State Bank has recently been attempting to push the rates back down, presumably with the objective of achieving a more appropriate yield curve. It is applying pressure on the rates by occasionally rejecting all the bids in an auction. As there are no other immediate avenues for investment, the market becomes awash with liquidity, and the funds remain idle in an account at the State Bank. There were numerous occasions in 1992 when the overnight call rates remained close to 0%. The State Bank has been exploiting this situation and doing short term reverse buy/sells at 1%.

Federal Investment Bond auctions have been more predictable than Treasury Bill auctions; Rs. 44.9 billion was raised by the government through FIBs during 1991-92, while 53.6 billion was raised during 1992-93.

The State Bank has been consistent in picking up all bids at par or at a premium. Bids have been accepted at discount on two occasions for three and five year bonds, and 13 times on 10 year bonds. The more recent trend has been to accept par bids. This practice is in line with attempts to reduce the yields on money market instruments.

Secondary Market for Government Securities

Approved dealers, particularly banks, are under obligation to promote secondary markets for government securities. This may take place through outright sale and purchases to and from the non-banking sector, or through Repo transactions.

According to the State Bank of Pakistan's annual report, the nature of trading both in TBs and FIBs is largely restricted to Repo transactions. These transactions do not contribute to the growth of fresh investment in Government securities, as banks are content to plough back previous investments in these securities at fresh auctions.

A break up of holdings before and after adjusting the effect of secondary markets reveals that the share of the non-bank sector in the purchase of FIBs from banks in the secondary market declined during 1992-93.

Similarly, in the case of six months TBs, the banks' sale to the non-bank sector was lower than their purchases. This tends to substantiate the apprehension that due to relatively higher yields on TBs vis-a-vis other investment opportunities in the secondary market, banks prefer to keep TBs in their own portfolio rather than unloading them in the secondary market.

Constraints to the Development of the Capital Markets

Improvement of the capital markets is essential to meeting Pakistan's development credit needs. The housing sector provides a prime example of a major economic opportunity that has been neglected because policy has deterred investment. Pakistan's new housing finance system needs to be strengthened and integrated into the financial sector. Housing finance needs to be strengthened so that commercial banks are able and willing to start mortgage lending.

Investment in housing, however, provides only one example of the large resource demands that are increasingly being made on the capital markets. In order to broaden and deepen the market to meet these needs, Pakistan needs to address the constraints presently placed on development of its capital markets.

MacroEconomic Stability

A stable macro-economic environment is critical to the successful implementation of financial reforms. Inflation reduces the reliability of prices as a factor of information. Real returns fall, thereby affecting profitability of financial institutions. Long term investments become risky, and considerable efforts and resources are required to overcome or adjust to price distortions. Thus, a high degree of price stability is essential to the success of the government's liberalization program, especially because financial markets in Pakistan today are not only shallow, but have not fully recovered from the financial wounds inflicted upon them by the recent scandals involving the cooperative societies.

A regional example of liberalization may be offered by South Korea, which had a highly regulated financial system until the 1980s. Reforms were undertaken after macro-economic stability was achieved. The inflation rate was barely 3% and fiscal and current account deficits were under control. Currently, these conditions do not exist in Pakistan. The government, therefore, needs to take measures to keep inflation under control if liberalization measures are to achieve their objectives.

It is noteworthy that in the case of South Korea, the housing sector and housing finance both remain heavily regulated. As a result, the financial gains provided by liberalization have barely affected the housing sector, and housing prices remain unusually high in relation to incomes. The focus on mobilizing resources

Investment in housing is only one example of the large resource demands that are increasingly being made on the capital markets.

In Pakistan, housing finance can acquire a more prominent status in the financial system, provided there is improvement in the economic, social, and legal environment that currently constrain its growth.

for industrial development has paid off in terms of rising incomes, but constrained the development of adequate housing.

Policy Consistency

The financial sector is still characterized by uncertainty caused by frequent changes in government policies, some not necessarily consistent with the government's stated objectives for the sector:

- In January 1992, the government ostensibly dismantled the structure of credit ceilings and introduced the concept of a 65% credit/deposit ratio, which was to be effective from July 1992. This gave the banks, in particular the foreign banks, the incentive to mobilize foreign currency deposits. However, after the deposit base had been expanded by US $700 million, the State Bank imposed a 3% exchange cover risk. Later, the credit deposit ratio for private sector lending was reduced to 30% on local currency deposits and 40% on foreign currency deposits.

- The initial issues of Federal Investment Bonds explicitly specified that although the profits on Federal Investment Bonds would be subject to income tax, withholding tax would not be levied on the profits. Subsequently, this stance was changed and the State Bank started deducting withholding tax. These changes took place without any verbal or written notification from the State Bank.

- Until the 1992-93 fiscal year, the government had permitted the private sector to set up modarabas, which were exempt from income tax. Subsequently, an income tax at the rate of 25% has been introduced for all modarabas that have been established for more than three years.

- Dividend income was exempt from taxation until 1988-89. During the last two to three years, the government first withdrew the dividend income tax exemption, and then raised the taxation rate each year. In 1989-90, Rs. 15,000 were exempted and the balance was taxed at 7.5%. In 1990-91, the exemption limit was lowered to Rs. 10,000 and the tax on the balance income was raised to 10%. In 1992-93, all dividend income has become taxable at a flat rate of 10%.

It needs no emphasizing that an uncertain political and economic environment discourages investors. Continuity of policies is critical for introducing the stability that will attract serious investors. Long term reforms announced in advance enhance the government's credibility and also give affected institutions time to adjust.

Fiscal Treatment of Financial Instruments

A major impediment to the development of capital markets is the inconsistency of tax treatment on the profits of various instruments. This inconsistency encompasses not only overall tax treatment but also withholding taxes, where different tax payers are liable for different withholding tax rates.

Despite recent fiscal changes, the investment rate structure continues to be distorted due to tax exemptions granted on incomes from Special Savings Certificates (SSCs), Defense Savings Certificates (DSCs), and foreign currency accounts (these holdings are also exempt from wealth tax). Such measures most likely do not bring about an increase in financial savings, but rather lead to a transfer of savings from one financial asset to another.

Treasury Bills and Federal Investment Bonds are relatively liquid in the inter-bank market. However, Treasury bills and Federal Investment Bonds are sold cum-interest, and on maturity, the holder of the instrument is liable to pay withholding tax on the entire return. This has adversely affected the market for instruments with maturities close to the interest payment date.

Inconsistent fiscal treatment can inhibit the marketability of one financial instrument over another. For example, at the same time that Federal Investment Bonds are being issued, other government guaranteed paper with superior qualities, in that it is bearer in nature (the identity of the holder is not revealed) and exempt from Zakat, are also being issued. These competing instruments tend to restrict the attractiveness of Federal Investment Bonds and consequently the development of secondary markets.

To achieve the objectives of financial reforms, in particular the development of a broad based capital market, income and wealth tax policies require rationalization. To stimulate savings in financial instruments, either net financial savings should be exempt from taxation (such a move would discourage consumption without fragmenting financial markets), or income should be taxed from all sources.

Secondary Markets for Government Debt

The development of secondary markets will take time, as primary markets themselves are in the early phase of development. However, there are several factors that are currently inhibiting the future growth of a secondary market in Pakistan.

For example, the auctions for Treasury Bills and Federal Investment Bonds have evolved into a nearly monthly occurrence. For short-term TBs this is understandable, but in the case of FIBs the auctions are too frequent. Over a period of 18 months, there were 84 issues of FIBs (28 for each period of maturity). This crowding of issues has given rise to a fairly complicated secondary market. Another uncertainty that banks are faced with is the date of future auctions. These can at best be "guestimated," which narrows the market of potential institutional investors.

Frequent auctions have been accompanied by inconsistency in accepting or rejecting bids, and sometimes, bids have been rejected for no apparent reason at all. For example, at one auction, all bids were accepted - at rates above those that were rejected at the previous auction. This somewhat unpredictable behavior has adversely affected market liquidity, and investors are often unable to determine the signals being sent out to the market.

Bids are sent to Islamabad for final decision; this creates a gap of two to four days between bidding and acceptance. During this period, all activity in the market, apart from covering of short positions or investing of long positions, comes to a halt. Considering that on average, TB and FIB auctions take place on a monthly basis, the inter-bank market effectively stops functioning for about five working days every month.

A transparent system is essential for the proper functioning of the market. Since all bids are opened publicly, the bid amounts are known. Thus, it is possible to assess the effect on interest rates and create a reasonably efficient market. However, in the past, the State Bank has received Treasury Bills from the Ministry of Finance that had not been offered to the market, and consequently repo'd them into the market. The bulk of the market was not aware of the existence of these bills or the amount that was issued or repurchased. The lack of transparency in the case of such transactions is detrimental to the development of the market and should, in principle, be discouraged.

The relative absence of instruments in the market other than TBs and FIBs effectively means that except for designated ceiling funds, the government is holding the funds of banks captive. Due to the lack of depth in instruments, it is difficult to ascertain whether the interest rates being offered bear any resemblance to actual interest rates as they prevail in the economy.

The financial sector is still characterized by uncertainty caused by frequent changes in government policies— some not necessarily consistent with the government's stated objectives for the sector.

The current policy of the State Bank is to offer repurchase at 15%. The ostensible objective is to force banks to concentrate on "cash management." However, the State Bank's willingness to repurchase at a fixed rate, which does not adjust to changing market conditions, is negatively impacting upon the development of a secondary market.

Commercial Paper

There are numerous constraints hindering the development of commercial paper in the capital markets.

Large corporations with a good performance record (e.g., banks and multinationals) can theoretically directly issue their own commercial paper without the involvement of banks as intermediaries. The maturity of this paper could even be rolled over for better known companies. The government has taken an active interest in the development of commercial paper and has liberalized many of the rules pertaining to these securities. However, public issues of these instruments have not occurred for several reasons.

Most of the institutional investors interviewed for this study were of the opinion that other than the better known multinationals, only a dozen or so companies have enough market credibility to issue their own commercial paper. This statement runs contrary to the fact that most of these institutional investors have diversified portfolios and hold equity in over 200 enterprises. In particular, the sub-sectors of textile and sugar have a large base and can use the market to satisfy their seasonal demand for credit by floating commercial paper. There are, however, some constraints to the development of such a market.

- Top tier companies have good access to bank credit, so there is little incentive to float commercial paper. In fact, the top tier of the prime corporations can borrow at rates of 10-11%, which are even lower that the risk-free rates being offered on government securities. In addition, instruments like Special Savings Certificates (SSCs) and the ready availability of TBs and FIBs backed by government guarantees make it difficult for private companies to issue their own paper. These companies can not match the attractive features of government paper - its high risk-free return, its tax exempt status in the case of SSCs and Defense Savings Certificates (DSCs), its bearer nature in most cases, and the ability to convert instruments into foreign currency at the official exchange rate without any restrictions.

- Stamp duty (which is at 3.5% in Sindh but varies between provinces) on private sector marketable securities that are transferable by endorsement or delivery also inhibits the development of a market for commercial paper.

- There is no credit rating system for assessing the credit worthiness of issuer's of instruments, although the State Bank has now established a Credit Bureau which maintains information on borrowers that have loans in excess of Rs. 1 million.

- The charters or rules and regulations governing provident and pension funds do not permit investment in corporate debt.

- The Islamic mode of finance impedes development of financial markets. Problems are encountered even in issuing convertible bonds because they carry a fixed interest rate. However, banks have not made a great deal of effort to develop alternative instruments, perhaps due to a perception that such instruments would inhibit the banks' own core business.

- The State Bank has imposed several restrictions that make public issues of commercial paper more difficult. Specifically, private sector companies cannot issue securities in bearer form, placing them at a competitive disadvantage vis-a-vis public sector institutions, which have been allowed to issue bearer securities for the past several years. Furthermore, banks are not permitted to provide bank guarantees on any security issue

by a private sector firm. This makes it particularly hard for all but the best-known companies to raise any money through the issue of securities.

- The State Bank restricts the ability of various entities, primarily foreign banks and companies, to hold instruments issued by private sector firms. The State Bank has recently clarified that foreign banks may trade in such instruments, however, the matter has still not been settled as several issues pertaining to their right to hold such securities remains unresolved. The imposition of these restrictions has made the issue of redeemable capital securities by the private sector rather difficult. As a result, there has been little operational activity in this area.

Real Estate vs. Financial Assets

In Pakistan, there are fewer incentives to invest in financial assets than other assets. This is particularly true in the case of investments in urban land. Historically, such an investment has offered the best after-tax rate of return. In view of the high returns, the highly liquid characteristics of property, and the security it provides in times of unforeseen hardship, it is a more attractive investment than a financial asset. Although the market for real estate has declined, leading to the diversion of funds into other channels like the stock market, and, following the collapse of the cooperatives, into other financial instruments, the long term environment for investment in land has not substantially altered.

The legal and fiscal instruments and institutional arrangements that enable or facilitate speculation in land for long periods include the following:

- The non-utilization charges levied by development authorities for leaving land vacant continue to be maintained at a low level. This penalty has not effectively discouraged land speculation.

- The current property tax structure enables owners to virtually escape property tax on vacant land.

- The provincial governments abolished capital gains tax in 1986.

- Land can be transferred through an agreement to sell, coupled with powers of attorney. A property may exchange hands several times without transactions being legally liable for stamp duty and registration fees, which become payable only on the execution of a lease or a sale. About 6 to 8 years ago, 15-20% of registered documents consisted of powers of attorney. Now as much as 40% to 50% of transactions in land are through powers of attorney.

- The legal system permits ownership of land in fictitious names and in the name of a person other than the real owner, i.e., holding it "benami," enabling the investment of black money in land and potentially high rates of tax free returns.

Business Culture and Legal Constraints

In Pakistan, business is generally carried out with people with whom prior trust has been developed. This severely reduces the scope for business and curbs the entry of newcomers.

The legal system is inadequate and slow in enforcing contractual obligations, and has not been as responsive as desirable to the needs of financial liberalization. A supportive legal, administrative, and regulatory structure is required to protect depositors of private banks and to provide adequate mechanisms for enforcing foreclosures. The inability to enforce contracts through legal channels is perhaps one of the primary causes of inefficiency in the economy. The legal and institutional arrangements the government devises to tackle this fundamental issue will be critical for the pattern and pace of growth in the economy.

The legal system is inadequate and slow in enforcing contractual obligations, and has not been as responsive as desirable to the needs of financial liberalization.

An important element of a smooth transition from a highly regulated financial system is the institutional cabability and integrity of the domestic financial sector.

The recent decision of the Shariat Court that interest and all fixed pre-determined rates of return amount to usury and are un-Islamic will play an important role in the future structure of interest rates and the functioning of capital markets. Many feel that the imposition of such a ruling will undermine the development of financial markets, particularly because foreign investors will be turned away. The government has appealed to the Supreme Court and is requesting a more practical interpretation of interest under Islamic law.

Prudential Regulations

The Prudential Regulations (PRs) restrict the activities of banks by limiting overall exposure to ten times the paid capital, even in cases where there are counter-guarantees from foreign banks. Some bankers argue that under the PRs, capital, rather than assets, should serve as the bench mark for the extent of capital adequacy, and that capital adequacy should be a function of the risk profile of assets rather than the gearing ratio.

The foreign banks also argue that for determining capital adequacy requirements, the capital of parent institutions in other countries should be taken into consideration, as this will enable them to expand their operations. The State Bank maintains that using locally invested capital to determine the capital adequacy requirement is standard practice in other countries, and that capital which may be constrained (invested in other countries) can not be taken into consideration.

Currently, the PRs require that the return on deposits should be uniform for the same maturity period. This acts as an anti-savings clause; banks should not be prevented from offering a higher return on larger deposits. Furthermore, strict implementation of this condition may encourage corruption if savings are routed through quoted companies to which this restriction does not apply.

The PRs restrict lending against shares to 50% if market price is greater than two times par value of future. This requirement is stunting investment growth by adversely affecting the market for equities.

Regulatory Compliance

Financial markets tend to be fragile and susceptible to manipulation and unsound practices. An important pre-requisite of smooth transition from a regulated to a deregulated system is the institutional capability and integrity of the domestic financial sector. Fair trading, diligence, and information disclosure are the basic pillars of a dependable financial structure. Flow of reliable and detailed information to investors is the sine qua non of a successful financial market. However, it is interesting to note that very few institutional investors interviewed for this study placed much reliance or faith in the financial results declared by private sector companies.

The State Bank has not been given the freedom by the Ministry of Finance to play the monitoring role that is generally assigned to such institutions. The State Bank and the Corporate Law Authority (CLA) have started making efforts to enforce the various regulations governing the operations of financial institutions.

These institutions, mainly because of lack of institutional capacity, face difficulties in enforcing regulations pertaining to disclosures, ensuring compliance with accounting standards and legal requirements, and levying penalties in cases of non-compliance. Early indications are encouraging, however, much needs to be done to strengthen enforcement mechanisms for timely action.

Capital markets are currently being regulated by several government agencies, including the Ministry of Finance, the State Bank of Pakistan, the Corporate Law Authority, and the

Controller of Capital Issues. The existence of multiple regulators hinders the smooth functioning of capital markets. The Corporate Law Authority was initially established to handle legal matters pertaining to companies. However, many issues are still being handled by other regulatory agencies. For instance, flotations of commercial paper are subject to several approval processes. Such agencies as the Controller of Capital Issues, the Corporate Law Authority, the State Bank and the Stock Exchanges are involved in various aspects of the approval and flotation process, making this process rather long-winded and cumbersome. The general response of companies has been to avoid issuing these securities.

It would be prudent to authorize one agency, such as the Corporate Law Authority, to deal with all capital market issues. For example, in the United States, all issues pertaining to the functioning of the securities market are handled by the Securities and Exchange Commission (SEC). Because this regulation is the primary work of the SEC, it can ensure that the application of rules balances the requirements of a dynamic marketplace with the need to protect investors from unscrupulous parties.

Constraints on Stock Markets

The limited supply of shares in the stock market has been influenced by several factors. Presently, returns on short term, fixed return, and larger risk-free instruments offered through national savings schemes tend to be higher than on many equities, thereby reducing the attractiveness of shares. Although share prices may have grown in line with that of alternative investments, dividend yields have not kept pace.

Liberal debt/equity ratio requirements enable companies to meet their long term needs for funds by borrowing rather than by issuing shares. Trading activity tends to be concentrated in a few shares, highlighting the narrow base and the shallow character of the market. Adverse movements in the prices of scripts or poor performance can seriously impact upon the operations of the market. In view of the resulting thin markets for shares of well-run companies, prices tend to be volatile.

This market volatility is enhanced by the high degree of speculation in some shares, as the system allows share buying without payment or margin deposits for a 14 day period. It is estimated that over 90% of trading is speculative in nature and that many investors have no intention of taking delivery. Speculation is also fueled by the tendency of large institutions to hold large blocks of shares, by the pricing policy of new shares, and by the quality of settlement procedures.

Settlement processes are affected by the procedures for the matching of transactions, the recording of the settlement, and the physical delivery of the scrips. Legally, companies have 45 days to effect a share transfer in their books. However, the entire process of buying a scrip and ensuring its registration with the Registrar of Companies is currently taking as long as 90 days. Due to problems posed by the requirement of physical delivery of shares and time limits for effecting share transfers, the market suffers from liquidity, which further fuels speculation.

The infrastructure of the stock exchange has not kept pace with the growth in trading volumes. Long delays in share allotments, payments, deliveries, and the different aspects of the system of settlements—matching of transactions, procedures for recording settlement, and physical delivery of shares—are incapable of tackling the huge trading volume.

The development of the market has been inhibited by a lack of investor confidence. Corporate disclosures are poor, accounting procedures are non-standardized, and perceptions that profits are understated persist.

Fair trading, diligence, and information disclosure are the basic pillars of a dependable financial structure.

Trading activity in the stock market tends to be concentrated in a few shares, highlighting the narrow base and the shallow structure of the market.

Estimates indicate that approximately 40% to 50% of transactions are not routed through the clearing house, and are therefore not reported by the market information facility (FASCOM). There have been reports that brokers sometimes quote to their clients the highest prices for purchases and the lowest prices for sales of a particular stock recorded during the day. In a market where the range can vary significantly, there is the potential for a dishonest broker to exploit the situation to personal benefit. Allegations of insider trading are common.

Stock exchange brokers challenge the widely held perception that the market is manipulated by cartels. They argue that a Rs. 200 billion market cannot be manipulated, and that whenever some speculators have tried to do so they have paid a rather heavy penalty.

Despite the above, recent improvements are discernible, and positive attempts are being made to educate investors through provision of information. The stock exchange has been computerized to improve the quality and timeliness of information available to investors. The Karachi Stock Exchange is constructing a new building with modern facilities, and a large central depository is being established to facilitate the handling of large volumes by doing away with physical delivery

Implications for Housing Finance Institutions

Housing and home ownership are important objectives for social and economic stability, as shown by the size of housing finance flows, which make up a significant share of the entire financial system in developed countries. Savings for housing is perhaps the single largest source of funds for the financial system.

In the United Kingdom, the household sector's holding in financial assets in Building Societies was 32.1% of total financial savings in 1989. In the United States, outstanding debt for residential accommodation was US $2.2 trillion. The level of mortgage debt as a percentage of GDP was 58.3% in the United Kingdom, 45.2% in the US, and 25.1% in Japan.

In the United Kingdom, the share of Building Societies in the household sector's holding of financial assets is 32% compared with 20.5% of that of commercial banks. In the United States, of the total savings of $2.7 trillion, the savings and loan associations hold 35%, while commercial banks hold 50%. In other words, in developed economies, institutions dealing with housing finance hold a high proportion of household savings.

In Pakistan, housing finance can acquire a more prominent status in the financial system provided there is an improvement in the economic, social, and legal environment that currently constrain its growth.

Alternative Investments

Existing financial institutions have alternative options for advancing credit that reduce the attractiveness of housing loans. In a market starved for funds, banks are not under any pressure to venture into activities other than those they have performed traditionally. Not only is there a huge demand for credit against which "better quality" collateral is being offered than would be provided by an individual seeking a housing loan; the government, in view of its massive deficit, is offering risk-free returns of between 13-15%.

Currently, competition is not exacting enough to compel these institutions to look for other areas in which to invest. Considering that they are not organizationally equipped to extend their activities into the sector of housing finance, the banking sector can hardly be expected to show a great deal of enthusiasm for extending housing loans that would invariably be much smaller in size, and yet require the devotion of more administrative resources.

In view of the risk free yield of 15% on long term government bonds, the interest rates of 16-18% being earned on most corporate credit,

In a market starved for funds, banks are not under any pressure to venture into activities other than those they have performed traditionally.

The burgeoning budget deficit of the government has been placing a huge demand on funds from the financial system, setting a bench mark for the price of credit in the financial system.

and the relatively small administrative costs of handling these large value transactions, financial institutions would broaden their base of operations into relatively riskier areas only if the profit margins were higher, which would mean an interest rate of at least 20%, excluding the 1% excise duty payable on capital loans. In particular, the burgeoning budget deficit of the government has been placing a huge demand for funds on the financial system, setting a bench mark for the price of credit

High Rates

Only a small segment of the population would be able to service debts for new housing at rates of interest exceeding 20%, unless the banks express willingness to extend considerably smaller home improvement loans It is, therefore, not quite clear if in the current environment, in particular considering the prevailing cost of funds, housing finance is commercially viable.

Deposits

New special purpose companies that deal with housing finance will experience problems with deposit mobilization Without a widely acknowledged track record, they will have to pay higher rates of return to attract term deposits, and in any case, they are not presently allowed to take savings account deposits. In the present financial environment, where interest rates are pegged to rates being offered on government securities, the high cost of funds would inevitably push up lending rates to levels even more formidable, making the debt servicing costs of new housing prohibitive for lower, middle income, and a substantial portion of upper income groups.

Cost of Funds

Methods and instruments have to be found for lowering the cost of funds. One way of reducing the cost of credit for housing finance would be to induce commercial banks, who pay a lower price for mobilizing deposits, to extend finance for housing related activity. As they have more attractive alternative investment opportunities, their interest could be stimulated through fiscal incentives

Attempts to reduce the cost of capital through direct or indirect subsidies should be avoided as they will introduce distortions in the financial markets and the benefits are likely to be appropriated by the more privileged segments of society. This system of concessional financing is currently being followed, quite unsuccessfully, by the HBFC. Not only will it be difficult to sustain this level of subsidy, it also lacks transparency, neither can the beneficiaries be identified nor can the subsidies that they have availed be costed readily.

Taxation Issues

In the case of self occupied property, the government does not permit the tax payer to set off the expenditure on debt servicing against other income. According to income tax experts, housing finance companies (HFCs) could also become liable for a 2 5% turnover tax. In view of the fact that the mortgaged property would be registered in the name of the company, the tax authorities may deem their business to be property trade for income tax purposes even if under the approved charter they were specifically prohibited from trading in property.

Furthermore, according to some tax practitioners, the nature of the mortgage agreement, under which the property would be in the name of the company, is such that the occupant of the house could be deemed to be a tenant. Such an interpretation could potentially lead to the company being liable for property tax at rates applicable to rented out properties—which are 25% of the annual rent. The government needs to clarify the law will not be interpreted in this manner for HFCs.

Another factor hindering the growth of housing finance is the high cost of registering property related transactions. For example, the costs in urban areas of Sindh include a 1% registration fee, a 8.5% provincial stamp duty, a 2.5% property transfer fee charged by local government, a 5% capital value tax on residential plots exceeding 240 square yards, professional charges, brokerage fees, and court fees. Charges for loans include a 1% fee for registration of mortgage documents, a 3% stamp duty for a non-bank financial institution (1% for banking companies), and charges for fire insurance and professional services.

Foreclosure

A large problem in developing housing finance in Pakistan is the difficulty of enforcing foreclosure laws in the event of a default. Delays in the courts are characterized by procedural defects, overworked and understaffed courts, reluctance by the courts to compel compliance with statutory time limits, ancient and archaic office management methods and systems used by court registries, liberal granting of appeals, and alleged corruption on the part of court officials, banking officials, defendants, and counsel.

As a result, the judicial system fails to resolve disputes in an efficient, effective, and timely manner. Even in rent related cases where a separate Rent Control Ordinance has been ostensibly promulgated and Rent Controllers with special jurisdiction have been established to simplify and expedite justice, it takes two to four years to receive a decision from the court. Moreover, when the court finally passes an order, it becomes difficult to execute the decision.

Problems related to foreclosure can be resolved by strengthening institutional capacities and by enforcing relevant legislation, creating an environment which emits a clear signal that the government and the courts mean business and that defaulters will not be able to escape the penalties laid out in the law.

Short-Term vs. Long Term

It is generally believed that because housing finance is a long term investment the resources for financing such operations should not venture into the market for short term credit for financing their operations. Although concerns regarding cost of capital—the mix of deposits, equity, and long term financing—are well placed, they exaggerate the dilemma of resource mobilization.

The role of all financial intermediaries is to raise funds for onward lending, taking into consideration liquidity requirements. How well they cover these risks, barring, of course, unforeseen events, will determine the efficiency with which they manage their operations. In a primarily stable economy, in which inflation rates are moderate, savings deposits can be a very stable resource base for housing finance institutions. Admittedly, however, in Pakistan there are fears that the underlying inflationary pressures could destabilize an already delicate macro-economic environment.

Problems related to foreclosure can be resolved by strengthening institutional capacities and by enforcing relevant legislation.

The high costs of registering property related transactions is hindering the growth of housing finance.

Issues for Action

Policy, legal and institutional reforms are critical for creating the enabling environment for the long term development of capital markets in general and the housing finance sector in particular. The following broad policy areas are regarded by the SRMP as critical to the future development of the housing finance industry and to the strengthening, broadening, and deepening of the capital markets. On the following pages are a series of recommendations designed to enhance the development of housing finance, improve the performance of the capital markets, and strenghthen Pakistan's financial institutions.

The Deficit: Down Measures to bring down the government's budget deficit, touching 8% of the GDP, are urgently needed. By soaking up the liquidity in the financial system, the government is raising the level of interest rates in the economy, capturing the majority of scheduled bank deposits at artificial interest rates, crowding out the private sector, and thwarting the development of vibrant capital markets.

State Bank Autonomy Granting of greater autonomy to the State Bank to pursue a consistent monetary policy without interference from higher levels of government.

A More Open Market Making capital markets more efficient by a phased movement towards open market operations.

Effective Foreclosure More effective foreclosure mechanisms through appropriate strengthening of the judicial machinery.

State Bank Supervision Development of well trained supervisory staff at the State Bank to ensure compliance with the new Prudential Regulations by the rapidly expanding group of financial institutions. The financial sector cannot afford a cooperative society type scandal at this critical stage of its development.

Secondary Market Development of a secondary market for a wide range of financial instruments.

Apex Securities Institution Development of an apex institution for regulating the securities markets.

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Specific Recommendations

Housing Finance Policy

Savings Deposits

HFCs should be allowed to mobilize resources through savings account deposits. Currently, they are only allowed to take term deposits. Almost every developed country in the world allows Building Societies and Savings and Loan Institutions access to passbook savings accounts. This is an important source of clients for housing finance companies, as passbook savers can demonstrate their ability to set aside certain amounts of capital at regular intervals. Passbook savings accounts can serve as a vehicle to float various land and home purchase schemes. And most importantly, passbook savings can serve as a growing source of capital for mortgage lending.

HFCs need to become integrated into the financial system and accorded operating conditions commensurate with their status as licensed and regulated financial institutions.

Bank of "Last Resort"

Housing finance companies have no "Bank of Last Resort" and will be under capitalized in their early years of operation. HFCs should be accorded the same status as commercial banks for the purpose of inter-bank borrowing. Although the current inter-bank market is limited to seven days duration, longer term agreements would likely emerge if HFCs were players in the market. There is clearly a need for more players in this market, and giving HFCs access to inter-bank funds would be a logical step towards expansion.

Reduce Transaction Costs

Taxation, stamp duties, and costs of registering property related transactions are major problems for registering land and mortgage documentation, and are hindering the development of a housing finance market. The government must rationalize its fee structure for property transactions. To facilitate the development of a market for commercial paper, the Federal Government should persuade the Provincial Governments to reconsider the high rate of stamp duty and the stage at which it is to be levied. Currently, 3.5% duty is payable both at the time of issue of paper and at all subsequent transfers. Although these issues are beyond the scope of this study, they are critical if the housing finance industry is to flourish in Pakistan.

Tax Deductions for Borrowers

The government should allow tax payers a deduction against the taxable income of the interest element of a housing loan—placing an upper limit on the value of the loan. This measure can play a critical role in facilitating the development of a market for housing finance.

Fiscal Incentives

Fiscal incentives for housing finance, such as concessions in income tax for a specific period for those providing housing finance, should be considered.

Capital Markets and the Financial Sector

Regular Auctions

Regular auctions for fixed interest securities held by banks should be reasonably spaced to give the secondary market time to develop.

Over the course of 18 months in 1992-93, there were 84 issues of FIBs (28 for each period of maturity), which has given rise to a fairly complicated secondary market. The market could be simplified considerably if there was only one issue per annum. Any auction during the year would then open up the issue, resulting in a settlement amount at the price tendered plus the accrued interest up to the settlement date.

Uniform Tax Treatment

The State Bank should develop a uniform policy for all securities in respect of Zakat (charity) tax, wealth tax, and income tax liabilities.

Underwriting

Underwriting is a requirement for public issues; it gives the market liquidity. Current restrictions on the number of issues and fees should be removed. The market should determine these factors, in particular the risk/reward. If the reward is not linked to the risk there will be little motivation to move out of a low risk environment. This requirement will result in the growth of a security market biased in favor of large and better known names.

Secondary Markets

Efforts should be made to further develop secondary markets to enable the market to provide liquidity rather than the State Bank's discount/repurchase window, as is currently the case.

Pension and Provident Funds

Pension and provident funds should be allowed to operate in the equities market. This will give the market both depth and liquidity. Therefore, specific recommendations—legal, procedural, and institutional—need to be developed regarding the manner in which these funds should be authorized to function in the market for equities.

Deposit Insurance

As the framework for credit and risk exposure has been established through the Prudential Regulations, it would be wise to set up deposit insurance schemes to instill confidence in the safety of savings with banks. This is particularly important in view of the history of financial scams and given the recent proliferation of financial institutions.

Capital Adequacy Ratios

The capital adequacy ratios of banks should be based on Bank for International Settlements (BIS) guidelines where capital adequacy is a function of risk weighted assets rather than of the gearing ratio.

Reduce Directed Credit

Credit ceilings and credit lines to specialized financial institutions like the Agricultural Development Bank, House Building Finance Corporation, and Industrial Development Bank should be reduced and ultimately phased out. This will encourage these institutions to increasingly mobilize their own resources for lending activities.

Phase Out Concessional Finance

Concessional financing (e.g., export refinance, Locally Manufactured Machinery) should be phased out. This sort of financing skews the term structure of interest rates, and makes development of an efficient capital market difficult. Fiscal incentives to support such activities would serve as a better alternative.

Government should involve the private sector in policy.

Institutional Strengthening

Involve the Market in Policy

The government should involve the private sector in formulating policies, making legislative changes, and in devising implementation mechanisms and instruments. Formal participation of the private sector is necessary for both formulating policies (including a regulatory framework), and for devising the institutional arrangements and mechanisms for implementing them

However, the financial system will function effectively only if the private sector also responds positively to government initiatives in this direction. Industrialists, stock brokers, and other professionals, like auditors, are adept at protecting and promoting their individual or trade interests, and would be wise to collaborate with each other to develop codes of conduct and standards for self-regulation. In essence, a structure needs to evolve that disciplines and publicly reprimands those who do not abide by the rules, at both the individual and institutional level. For instance, while the government maintains a vigilant eye against fraud and unfair practices, the stock exchange should also exercise self-regulation so that it does not have to rely primarily on the government to perform these functions.

Due to the recent reforms, enterprises can now borrow abroad freely.

Control of the money supply has therefore become a more sophisticated exercise—reinforcing the need for qualified regulatory staff.

Credit Rating Agency

To enable investors to properly evaluate the credit-worthiness of potential issuers, an impartial credit rating agency should be established that will allow the public to make informed investment decisions. (Note: In the interim since this report was initially written in mid-1993, progress has been made to establish the Pakistan Credit Rating Agency.)

Monetary Management

Monetary management is not just a question of the right mix of policies but also depends upon institutional capacities. One of the lessons of financial disasters is that competitive financial markets, although efficient at mobilizing and allocating funds and managing risks, make costly mistakes. Regulators, therefore, will have to continually strive for an appropriate balance between stimulating competition and checking fraud and instability. The Prudential Regulations have a critical role in this regard

The regulations, however, can not promote a safe, stable and efficient system unless they are effectively enforced by well-trained staff. Due to the recent reforms, enterprises can now borrow abroad freely. This implies that the supply of credit does not only come from the domestic banking system. Controlling money supply has, therefore, become a more sophisticated exercise and reinforces the need for qualified staff to perform regulatory functions.

State Bank Reform and Strengthening

With the onerous responsibility of having to regulate over 110 financial institutions, the State Bank will have to make strenuous efforts to improve its data bases and the quality of staff through formal training and cross training programs with commercial banks.

A number of new financial institutions are being created in the private sector and the introduction of new complicated financial instruments is making it difficult for regulators to assess the risk of the bank's balance sheet and determine capital adequacy rules. In this regard the State Bank's decision to allow external auditors to review the operations of financial institutions on a selective basis is a laudable step.

An important reform measure that can facilitate the State Bank in fulfilling its supervisory role

and in promoting financial stability is wider disclosure of information relating to banking, for example, bad debts and deposit composition.

Attract Foreign Investment

Government can at best create a conducive environment for attracting foreign investment. In turn, the private sector will have to make marketing efforts and invite foreign investors and expertise to enter into joint venture arrangements.

Efficient supervision, which provides for redress and minimizes the risk of fraud, is essential for attracting foreign investors. For instance, the office of the CLA had been created to control and regulate the corporate sector's activities, and to safeguard the interests of minority shareholders.

The CLA has experienced difficulty in the past in protecting the rights of minority shareholders. How can minority holders exercise their rights and check the malpractice of management? Is giving the latter representation on the company board justified, and if so, what mechanism could achieve this objective—for example, should the maximum holding of the sponsors be reduced?

The Stock Market

The basic requirements of a good trading system for servicing customers are information, transparency, liquidity, efficiency, and reliability. The retail customer lacks information. The problem is not just poor disclosure but also lack of infrastructure in the market to service customers, for example, computerization of settlements and a method to register complaints and settle grievances.

Increased availability and access to the records of listed companies should be the right of all potential investors, the public at large. In turn, greater public awareness and increased public access to company information would reduce the likelihood of abuse. There is an urgent need to disseminate information on the status of listed companies and ensure that legal requirements on timely disclosure of material information are met. Furthermore, heavy penalties should be strictly enforced against those found guilty of negligence, misreporting, or concealing information.

Despite widespread rumors of manipulation, insider trading, and malpractice, no concrete action has been taken to either confirm or dispel these rumors. For example, problems arising out of over-trading do not result in permanent corrective measures. To perform the role envisaged, the CLA has to be fully equipped, in terms of qualified personnel and adequate funding, to deal effectively with such violations. For the long term development of the market and because of the huge growth in the volume of transactions, a larger body of transactors is required who should perceive the market to be operating in an orderly fashion and ensure that trade practices are open and fair.

Settlement procedures have to change to enable the market to function smoothly, particularly after the recent rapid growth in trading volumes. To improve the functioning of the market, the system of transferring share deeds needs to be simplified, and the time period for companies to make the transfer related entries in their books and records needs to be reduced.

The Government of Pakistan would be taking a significant step in ensuring efforts to streamline the regulatory structure do not become misdirected if one regulatory body were responsible for handling all legal issues pertaining to the securities market. The Securities and Exchange Commission in the US provides a model to examine the legal and procedural mechanisms for setting up such an institution.

Government would be taking a significant step in ensuring efforts to streamline the regulatory structure do not become misdirected if one regulatory body were responsible for handling all legal issues pertaining to the securities market.

Seminar Conclusions and Recommendations

One of the most immediate housing sector challenges for housing finance companies in Pakistan is access to capital at rates which allow for a reasonable mark-up and an on-lending rate that ultimate mortgage clients can afford. Until housing finance institutions are developed as mature deposit-taking institutions, resources must flow into the housing sector from the capital markets.

On June 19, 1993, the Shelter Resource Mobilization Program of USAID, in conjunction with 21st Century Consultancy and Management Services, sponsored a national seminar on Capital Markets and Resource Mobilization for Housing Finance. The purpose of the seminar was to promote greater understanding among policy makers on the constraints that these firms face in starting operations, and to identify methods in which the housing sector in Pakistan can gain access to the capital markets.

Over eighty participants representing the legal, government, and financial sectors, including housing finance companies and commercial banks, attended this one-day seminar. The seminar was chaired by Mr. Mian Mumtaz Abdullah, Chairman of the Corporate Law Authority (CLA) of Pakistan. Notable speakers included Mr. Dennis P. Armstrong, General Manager and Country Manager of ANZ Grindlays Bank, Mr. Jon Wegge, Chief Technical Advisor, SRMP; Mr. Tariq Hussain, Area Manager and Treasurer of ANZ Grindlays Bank; and Mr. Amjad Virk, Joint Secretary, Internal Finance Wing, Ministry of Finance.

The concept of private sector housing finance is a new one in Pakistan. As such, HFCs are acutely aware of the need to establish their credibility both with government and the public. And they must do this in an environment of general distrust—rooted in the recent housing cooperatives scandals, the poor performance of the public sector House Building Finance Corporation (HBFC) in the past, and a perhaps healthy suspicion about the unknown and unfamiliar.

Unfortunately, at the same time, HFCs are at a distinct disadvantage in relation to other non-banking financial institutions, commercial banks, and the government in competing for the scarce resources that they need in order to establish their trustworthiness as sound business entities. New HFCs, unlike the commercial banks, do not have branching networks to generate deposits that would lower their cost of funds and provide capital for on

HFCs are acutely aware of the need to establish their credibility with government and the public.

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lending. By the very nature of the housing finance industry, there is an inherent mismatch of funds; lending for long term and borrowing short term. Unlike commercial banks, HFCs do not have a bank of last resort when short term liquidity problems arise. HFCs do not have access to inter-bank borrowing and foreign exchange deposits.

It is nearly impossible for HFCs to structure debt instruments that can be underwritten and traded in the capital markets. They currently do not have the capacity to issue mortgage backed securities or bond instruments to raise capital. There is an urgent need to provide for long term liquidity needs through some type of discount or refinance window which would lower interest and liquidity risks, and provide a greater level of matching funds at lower cost for long term lending at affordable rates.

The seminar proceeded with a full day of presentations and discussion of the various resource mobilization issues confronting the housing finance industry. A consensus was reached on the following recommendations during the concluding session of the seminar:

A refinance window at the State Bank is a first step toward eventual development of a secondary market in housing finance.

Refinance Window

HFCs will be under-capitalized in the first few years of operation. A refinance window at the State Bank of Pakistan is a first step toward eventual development of a secondary market in housing finance and could lead to the development of mortgage-backed securities.

In view of this recommendation, USAID, through the Shelter Resource Mobilization Program, has offered to provide a US $15 million Housing Guaranty (HG) loan to start the window, and has offered technical assistance to structure the operations of the refinance window and develop adequate loan underwriting standards and documentation.

USAID has outlined the following policy environment for operation of the window:

- the window would operate at the State Bank of Pakistan to re-finance eligible mortgages and loans made by licensed housing finance companies and private commercial banks for house purchase, construction, and improvement;
- the rupee equivalent of $15 million, at the time of disbursement of the HG Loan of $15 million, will be made available for such re-financing;
- all re-finance provided through the State Bank window will be at essentially market rates and include realistic additional charges that reflect the actual cost of operating the window;
- State Bank will examine all housing loans presented to ensure that they comply with minimum underwriting standards, assure that title to the mortgaged property is valid, that the amount of the loan is commensurate with the value of the property and the re-payment capacity of the borrower, and that the loans conform to other criteria established to govern the sizes and types of housing loans eligible for re-financing;

  that, as refinancing of mortgages proceeds, financial support additional to that provided in respect of the HG Loan will be sought from either or both domestic and international sources to enable the window to continue operating

The Ministry of Finance supports and endorses the establishment of a refinance window at the State Bank under the conditions outlined above. At the time this publication went to press, the proposal was under consideration by the State Bank of Pakistan.

Apex Bank

With growth of the housing finance industry over time, it may be feasible to create a

specialized financial institution to take over the role of housing loan refinance and facilitation of financial flows in the housing finance industry. A national mortgage bank could expand and continue resource mobilization through meeting short and long term requirements of funds from both public and private sectors at home and abroad. It could issue various capital market instruments like house bonds, commercial paper, and mortgage backed securities, and design home linked savings and other deposit schemes including passbook savings and foreign exchange deposits.

Toward a "Level Playing Field"

The new HFCs are at a disadvantage, especially compared to commercial banks, in mobilizing resources, meeting liquidity needs, and lending. HFCs need to become integrated into the financial system and accorded operating conditions commensurate with their role as licensed and regulated financial institutions. The following actions have been proposed:

- There is an urgent need for government to rationalize the high costs of registration fees, stamp duties, and other property transfer costs and taxes. This is a provincial government issue that requires serious attention. Meanwhile, at the federal level, for the purposes of stamp duty on mortgage registration, licensed HFCs should be treated like commercial banks, for which the stamp duty is 1%;

- licensed HFCs should be given greater latitude to mobilize resources, including the right to offer passbook savings accounts and a broader range of term deposit schemes than presently authorized, and permission to mobilize foreign currency deposits on the same terms and conditions as commercial and investment banks. While the terms and conditions of such savings schemes, and the capability of an HFC to prudently manage them, should be subject to State Bank approval, HFCs should have greater freedom to establish the terms and conditions of such schemes and mobilize resources as they find financially feasible;

  for the purposes of access to inter-bank borrowing to meet liquidity needs, HFCs be treated at par with commercial banks.

Pension and Provident Funds

Pension and provident funds are currently not allowed to operate in the equities market. The seminar participants generally supported the recommendation to make pension and provident funds available for investment in the housing sector, like, for example, the use of provident funds in a government guaranteed refinance window in the housing sector. These funds would not be used for speculative or high risk investments, and the appropriate legal, procedural, and institutional framework for the flow of these funds in the capital market should be developed.

Insurance Funds

Insurance funds have played a very important role in the development of housing finance systems in most countries. In addition to investing insurance funds in the securitization of mortgages, insurance companies have found it profitable to set up housing finance subsidiaries. Likewise, insurance companies have played a crucial role in offering deposit insurance and mortgage related life insurance packages, which in turn, facilitates the development of secondary mortgage markets.

Deposit Insurance

HFCs are a new phenomenon in the financial market of Pakistan. Although Prudential Regulations under the State Bank have

It would be prudent to set up deposit insurance schemes to instill confidence in the safety of deposits, not only with HFCs, but with the increasing number of newly emerging financial institutions.

established a framework for credit and risk exposure, it would be prudent to set up deposit insurance schemes to instill confidence in the safety of deposits not only with HFCs, but with the increasing number of newly emerging financial institutions. Institutions would be required to pay insurance premiums into a general fund managed by the State Bank or an apex bank, and this general fund would be a resource for regulators to secure depositor's funds.

Fiscal Incentives

The cost of taking out a home mortgage loan is very high. Twenty percent interest rates have been dictated by the market. One way to make these transactions more affordable to the HFC customer is to allow home buyers to deduct interest payments on home mortgages from taxable income. This will indirectly reward those who are currently paying taxes, and may bring more people under the income tax umbrella. This facility is currently available to homeowners who have rented their property, and should be available to homeowners who reside in the mortgaged property.

If housing finance is going to expand and reach the maximum number of people in the country, HFCs need ways and means to expand their capital base.

If housing finance is going to expand and reach the maximum number of people in the country, HFCs need to broaden their capital base. Several seminar participants recommended that HFCs be allowed a tax holiday for an initial period to be determined by the government. Conversely, others have suggested that the government allow HFCs to transfer up to 40% of their gross earnings to general reserves prior to computation of their tax liability. Any funds that are removed from the general reserves would become subject to taxation. This is a positive incentive which would benefit the industry at little cost to the government. The SRMP believes this type of incentive would be more productive than a tax holiday, as it allows the industry to broaden its capital base and helps strengthen the overall savings in the economy.

Attract Foreign Lending and Investment

The prospects for the availability of foreign sources of lending are encouraging. Seminar participants felt that the country should take full advantage of the opportunities to mobilize the flow of these funds, which are available at lower rates than those prevalent domestically, into the housing sector.

The government must provide a conducive environment for attracting foreign investment. Likewise, the private sector will have to make marketing efforts and invite foreign expertise and investors to enter into joint venture arrangements.

Housing Finance and the Commercial Banks

Commercial banks are constrained from housing lending by a 1% ceiling on such loans, which inhibits them from developing mortgage lending as a significant part of their portfolios.

Several of the Seminar participants recommended that Pakistan adopt a similar policy to that of Malaysia and India, where a percentage of the deposits of the commercial banks are required to be invested in the housing sector.

The SRMP believes that increased commercial bank involvement in housing finance can be a very profitable undertaking for commercial banks. Housing finance is a stable profit center, and when managed properly, offers the opportunity to diversify portfolios into an essentially low risk area of investment.

However, the SRMP does not necessarily support a mandate for commercial bank investment in housing, and would rather see banks developing housing finance on a market level as part of their overall business plan. Therefore, the SRMP supports the abolition of the ceiling on housing lending by commercial

banks, and recommends that all housing sector lending by commercial banks, including residential mortgage loans, home improvement loans, and housing sector construction bridge financing, be considered as "outside" of this ceiling system.

Development of Secondary Markets

The secondary mortgage market is a fundamental vehicle for financial integration of the housing finance system in the overall financial system. The Seminar participants strongly felt that efforts should be made to start a mortgaged backed securities program, and that the government should take the initiative in this regard and frame the necessary rules and regulations for securitization of such a program.

Government Policy Issues

During the course of the seminar, participants made several recommendations concerning broad issues of government policy that directly impact the future success of the housing sector. These include reductions in government spending, uniform treatment of Zakat (charity) tax deductions, elimination of the multiplicity of organizations regulating the finance sector; and development of long term uniform government fiscal and economic policy.

Seminar Recommendations:

Refinance Window at the State Bank; eventually establish an apex bank for refinance

Establish a "Level Playing Field"— reduce fees, allow HFCs mechanisms to mobilize resources commensurate with banks

Allow pension and provident funds in the equities market

Invest insurance funds in the housing sector

Establish deposit insurance

Provide fiscal incentives

Attract foreign lending and investment

Remove housing loan ceilings in banking sector

Develop secondary markets

Develop long-term, uniform fiscal and economic policy

The secondary mortgage market is a fundamental vehicle for financial integration of the housing finance system in the overall financing system.

Appendix A: Agenda

Seminar on Pakistan's Capital Markets and Resource Mobilization for Housing Finance

June 19, 1993 Karachi, Pakistan

9:30	Participant Registration
10:00	Recitation from the Holy Quran
10:05	Welcome address by Mr. Askari Taqvi, Chairman, Twenty-First Century Consultancy and Management Services (Pvt) Ltd.
10:10	Introductory remarks by Mr. Dennis P. Armstrong, General Manager and Country Representative, ANZ Grindlays Bank
10:20	Keynote Address by Syed Tariq Hussain, Area Manager, Treasury of ANZ Grindlays Bank
10:50	Inaugural Address by Mian Mumtaz Abdullah, Chairman, Corporate Law Authority
11:05	Break
11:20	Discussion of issues and formulation of recommendations
1:00	Break
2:00	Discussion of issues and formulation of recommendations
4:00	Concluding remarks by Mian Mumtaz Abdullah

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Appendix B: List of Participants

Mr. Sohaib Abbasi
Economic Consultant
Defense Housing
Authority
Karachi

Mr. Mumtaz Abdullah
Chairman
Corporate Law Authority
Islamabad

Mr. S.M. Abdullah
Chairman and
Chief Executive
Assets Investment
Bank Ltd.
Karachi

Mr. A. Razzak Adamjee
Chairman
Adamjee Flooring Ltd.
Karachi

Mr. Mohammed Adil
Press Reporter APP
Karachi

Mr. Gohar-ulayn Afzal
Director
Marketing and Regional
Sales Manager North
Citibank Housing Finance
Co. Ltd.
Lahore

Mr. Aftab Ahmed
Secretary
Pakistan Resource
Mobilization and
Tax Reforms Commission
Karachi

Mr. Bashir Ahmed
Legal Advisor
Cheman Ltd
Karachi

Mr. Hameed Ahmed
Defence Housing Authority
Karachi

Mr. Iqbal Ahmed
Joint Secretary
(Development)
Ministry of Finance
Islamabad

Mr. S. Nadeem Ahmed
NBFI Directorate
State Bank of Pakistan
Karachi

Syed Shamim Ahmed
Regional Manager
International Multi Leasing
Corporation Ltd.
Karachi

Mr. Sheikh Iftikhar
Ahmed
Former President
D.G. Khan
Chamber of Commerce
and Industry
Former Vice President
Lahore Stock Exchange
Chairman
Al-Hamd Textile Mills Ltd.
Lahore

Mr. Ahadullah Akmal
Chairman
Bankers Equity Ltd.
Karachi

Syed Iftikhar Ali
Reporter
The News
Karachi

Mr. Idrees Allawala
Director
Kohinoor Chemical
Co. (pvt.) Ltd.
Karachi

Mr. Dennis P. Armstrong
General Manager
ANZ Grindlays Bank
Karachi

Ms. Qudsia Ashgar
21st Century Consultancy
and Management Services
(pvt.) Ltd.
Karachi

Mr. Mahmudul Aziz
Managing Editor
United Press
of Pakistan Ltd.
Karachi

Mr. A.H. Bukhari
21st Century Consultancy
and Management Services
(pvt.) Ltd.
Karachi

Mr. M. Bashir Chaudhry
Executive Vice President
Resources, Planning and
Development
National Development
Finance Corporation
(NDFC)
Karachi

Mr. Rajab Ali Chawla
Khalid Majid
Husain Shah Rahman
Chartered Accountants
Karachi

Mr. I.A. Farooq
Director
State Bank of Pakistan
Karachi

Mr. Iqbal
Ashruffali Gangjee
Member
Karachi Stock Exchange
Chief Executive
Gangjee Investment and
Finance Consultants
Karachi

Mr. Inamul Haq
Chairman
Inter-Asia Leasing
Co. Ltd.
Islamabad

Mr. Inaamul Haque
Chairman
State Life Insurance
Corporation of Pakistan
Karachi

Mr. Farooq Hassan
Chairman
ABAD and
Hassan Associates
(pvt.) Ltd.
Karachi

Mr. S.M. Hassan
Member
Islamabad Stock Exchange
Rawalpindi

Mr. Akhtar Hussain
Deputy Director General
National Housing Authority
Government of Pakistan
Karachi

Syed Mohammed Hussain
Khalid Majid
Partner
Husain Shah Rahman
Chartered Accountants
Karachi

Syed Shamshad Hussain
Khalid Majid
Husain Shah Rahman
Chartered Accountants
Karachi

Mr. Shujaat Hussain
21st Century Consultancy
and Management Services
(pvt.) Ltd.
Karachi

Syed Tariq Hussain
Country Manager Treasury
ANZ Grindlays Bank
Karachi

Mr. Ariful Islam
Executive Vice President
Muslim Commercial
Bank Ltd.
Karachi

Mr. Haamid N. Jaffer
Chief Executive Officer
Jaffer Brothers Housing
Finance Co. Ltd.
Karachi

Mr. Arif Kamal
General Manager and
Executive Vice President
Prudential Investment
Bank Ltd.
Karachi

Mr. M.M. Kazim
21st Century Consultancy
and Management Services
(pvt.) Ltd
Karachi

Dr. Akdas Kazmi
Chief
Physical and Monetary
Planning Division
Government of Pakistan
Islamabad

Mr. Abdul Moid Khan
Executive Director
House Building
Finance Corporation
Karachi

Nawab Abdul Sattar Khan
President
Mirpurkhas Chamber of
Commerce and Industry
Mirpurkhas

Mr. Amanullah Khan
President
Islamabad Stock Exchange
(Guarantee) Ltd.
Islamabad

Mr. Hameed Khan
Managing Director
International Housing
Finance Ltd.
Karachi

Mr. Javed Saifullah Khan
Member
Islamabad Stock Exchange
and Chairman, Saif Group
of Companies
Peshawar

Mr. Rukunuddin Khan
Chairman
Rukunuddin (pvt.) Ltd
Karachi

Mr. Tariq Iqbal Khan
Member
Islamabad Stock Exchange
Rawalpindi

Mr. Zubair Ahmed Khan
Business Recorder
Karachi

Raja Tariq Kiyani
President
Rawalpindi Chamber of
Commerce and Industry
Rawalpindi

Mian Shaukat Masud
Former President
Islamabad Chamber of
Commerce and Industry
Managing Director
Fazal Industries
(pvt.) Ltd.
Islamabad

Mr. Qaiser Mufti
Chief Executive
Paramount Investments
Ltd.
Karachi

Agha Syed
Said Muhammed
Chairman
Banking and Insurance
Committee, Chamber of
Commerce and Industry
Quetta

Mr. Saqib Mukhtar
Prudential Discount and
Guarantee House Ltd
Karachi

Mr. Tabassum Munir
Director
Lahore Stock Exchange
(Guarantee) Ltd
Lahore

Syed Muniruddin
21st Century Consultancy
and Management Services
(pvt.) Ltd.
Karachi

Mr. Hasan Mustafa
Managing Director
Indus Bank Ltd
Karachi

Mr. S.A. Mustafa
Member
CBR (Rtd.)
Karachi

Mr. Muzaffar
Business Recorder
Karachi

Mr. Masood Naqvi
Empire Housing Finance
Co. Ltd.
Islamabad

Syed Abu Nasar
Regional Commissioner,
Incom Tax (Retd.)
Karachi

Mr. R.K. Pasha
Jaffer Brothers
Housing Finance
Co. Ltd.
Karachi

Dr. F.A. Rabbani
Managing Director
21st Century Consultancy
and Management Services
(pvt.) Ltd.
Karachi

Mr. Marc Rachman
Chief Operating Officer
International Housing
Finance Ltd.
Karachi

Mr. Pervaiz Rana
Senior Reporter
Daily Dawn
Karachi

Mr. Mutiur Rehman
Chairman
National Development
Finance Corporation
Karachi

Mr. A.A. Rizvi
Chairman
P.C.I. Ltd.
Karachi

Ms. Samina Rizvi
Karachi

Ms. Ismat Sabir
Research Economist
Association of Builders
and Developers (ABAD)
Karachi

Shaikh Tariq Sadiq
Member
Islamabad Stock Exchange
Islamabad

Mr. Saeed-ur-Rahman
Chief Executive
Empire Housing Finance
Company
Islamabad

Shaikh Mohammed
Shabbir
Member
Islamabad Stock Exchange
Islamabad

Mr. Mumtaz Ali Shaikh
President
Larkana Chamber of
Commerce and Industry
Larkana

Mr. Ali Azam Shirazee
Member
Karachi Stock Exchange
(Guarantee) Ltd.
Karachi

Mr. Jahangir Siddiqui
Member
Karachi Stock Exchange
Karachi

Mr. Nazar Abbas Siddiqui
Former Chairman HBFC
Additional Secretary
Ministry of Industries
Government of Pakistan
Islamabad

Mr. Shamsuddin Siddiqui
21st Century Consultancy
and Management Services
(pvt.) Ltd.
Karachi

Mr. Iftikhar Soomro
Member
Managing Committee
FPCC & I;
Chief Executive Director
Sind Fine Textile Mills Ltd.
Shikarpur

Shaikh Suleman
Chief Financial Officer
Jaffer Brothers
Housing Finance
Co. Ltd.
Karachi

Mr. Askari Taqvi
President
21st Century Consultancy
and Management Services
(pvt.) Ltd.
Karachi

Mr. Tahir Ali Tayabi
Former Member PBC
Karachi

Mr. Amjad Virk
Joint Secretary (IF)
Ministry of Finance
Internal Finance Wing
Government of Pakistan
Islamabad

Mr. Khalid Yacob
Finance Manager
Packages Ltd.
Lahore

Mr. S.M. Zaeem
Executive Director
Prudential Investment
Bank Ltd.
Karachi

Colonel Javed Zahoor
Director
Administration and
Finance
National Housing
Authority
Government of Pakistan
Islamabad

Mr. Abid Ali Zaidi
Former Chairman
Association of Builders
and Developers
Zaidi Abid and Co.
Karachi

Mr. Jamal Abbas Zaidi
First Grindlays Modaraba
ANZ Grindlays Bank
Karachi

Mr. Naveed Zaidi
Director
Assets Investment
Bank Ltd.
Islamabad

Mr. Qamar Zaidi
Chairman
Masco Enterprises
Lahore

Mr. Khalil Zobairi
Empire Housing Finance
Co. Ltd
Islamabad

Mr. Wamiq Zuberi
The Daily Business
Recorder
Islamabad

USAID Participants:

Mr. Jon Wegge
Chief Technical Advisor
Shelter Resource
Mobilization Program
(SRMP) O/PEN
Islamabad

Mr. William Strong
Housing Finance
Advisor
Shelter Resource
Mobillization Program
(SRMP) O/PEN
Islamabad

Mr. Javaid I. Qureshi
Program Management
Specialist
Shelter Resource
Mobilization Program
(SRMP) O/PEN
Islamabad

Mr. Javed Akhtar
Project Management
Specialist
Shelter Resource
Mobilization Program
(SRMP) O/PEN
Islamabad

Ms. Jeanne Russell
Publications Editor
Shelter Resource
Mobilization Program
(SRMP) O/PEN
Islamabad

Appendix C: Reporting Cable

R 300744Z JUNE 93
FM AMEMBASSY ISLAMABAD
TO:AMEMBASSY ABIDJAN
AMEMBASSY BANGKOK
AMEMBASSY CAIRO
AMEMBASSY COLOMBO
AMEMBASSY DHAKA
AMEMBASSY GUATEMALA
AMEMBASSY HARARE
AMEMBASSY JAKARTA
AMEMBASSY KATHMANDU
AMEMBASSY KINGSTON
AMEMBASSY LISBON
AMEMBASSY MANILA
AMEMBASSY NAIROBI
AMEMBASSY NEW DELHI
AMEMBASSY PANAMA
AMEMBASSY RABAT
AMEMBASSY TEGUCIGALPA
AMEMBASSY TUNIS
UNCLAS ISLAMABAD

AIDAC

FOR RHUDOS; USAID REPS AND MISSION DIRECTORS; MISSION HOUSING ADVISORS; PRE/H JIM STEIN

E.O. 12356: N/A

SUBJECT: NATIONAL SEMINAR ON CAPITAL MARKETS AND RESOURCE MOBILIZATION FOR HOUSING FINANCE.

1. PURPOSE. THE PURPOSE OF THIS CABLE IS TO INFORM YOU ABOUT A NATIONAL SEMINAR ON CAPITAL MARKETS AND RESOURCE MOBILIZATION FOR HOUSING FINANCE HELD IN KARACHI, PAKISTAN ON JUNE 19, 1993.

2. BACKGROUND. THE SHELTER RESOURCE MOBILIZATION PROGRAM (SRMP) OF AID/PAKISTAN IS ASSISTING PAKISTAN TO ESTABLISH A MARKET-ORIENTED HOUSING FINANCE SYSTEM. UNDER THE SRMP, PRIVATE FIRMS ARE ESTABLISHING MORTGAGE LENDING OPERATIONS. ONE OF THE MOST IMMEDIATE HOUSING SECTOR CHALLENGES FOR HOUSING FINANCE COMPANIES WILL BE ACCESS TO CAPITAL AT RATES WHICH WILL ALLOW FOR A REASONABLE MARK UP AND AN ON-LENDING RATE THAT ULTIMATE MORTGAGE CLIENTS CAN AFFORD. UNTIL HOUSING FINANCE INSTITUTIONS ARE DEVELOPED AS MATURE DEPOSIT-TAKING INSTITUTIONS, RESOURCES MUST FLOW INTO THE HOUSING SECTOR FROM THE CAPITAL MARKETS. THE PURPOSE OF THIS SEMINAR WAS TO PROMOTE GREATER UNDERSTANDING OF THE CONSTRAINTS THAT THESE FIRMS FACE IN STARTING OPERATIONS, AND TO IDENTIFY METHODS IN WHICH THE HOUSING SECTOR CAN GAIN ACCESS TO THE CAPITAL MARKETS IN PAKISTAN.

3. THE EVENT. EIGHTY PARTICIPANTS REPRESENTING THE

LEGAL, GOVERNMENT, AND FINANCIAL SECTORS, INCLUDING HOUSING FINANCE COMPANIES AND COMMERCIAL BANKS, ATTENDED THIS ONE-DAY SEMINAR. THE SEMINAR WAS CHAIRED BY MR MIAN MUMTAZ ABDULLAH, CHAIRMAN OF THE CORPORATE LAW AUTHORITY OF PAKISTAN. NOTABLE SPEAKERS INCLUDED MR. DENNIS P. ARMSTRONG, GENERAL MANAGER AND COUNTRY MANAGER OF ANZ GRINDLAYS BANK, MR. JON WEGGE, CHIEF TECHNICAL ADVISOR, SRMP, MR. SYED TARIQ HUSSAIN, AREA MANAGER, TREASURER OF ANZ GRINDLAYS BANK, AND MR. AMJAD VIRK, JOINT SECRETARY, INTERNAL FINANCE WING, MINISTRY OF FINANCE.

SOME OF THE MAJOR RECOMMENDATIONS FOR RESOURCE MOBILIZATION THAT WERE FORMULATED AT THE CONCLUSION OF THE SEMINAR INCLUDED ESTABLISHMENT OF A NATIONAL MORTGAGE BANK IN THE PRIVATE SECTOR TO SERVE AS A REFINANCE INSTITUTION FOR HOUSING FINANCE COMPANIES; STATUTORY REQUIREMENTS FOR COMMERCIAL BANKS TO INVEST A FIXED PERCENTAGE OF THEIR INCREMENTAL DEPOSITS IN THE HOUSING SECTOR; EQUAL ACCESS TO THE CAPITAL MARKETS AND TREATMENT AS BANKS FOR PURPOSES OF ACCESS TO INTERBANK LENDING AND OPERATION OF PASSBOOK SAVINGS ACCOUNTS; DEVELOPMENT OF A SECONDARY MARKET FOR MORTGAGE BACKED SECURITIES; RESOURCE MOBILIZATION THROUGH THE DEVELOPMENT OF COMMERCIAL PAPER FOR HOUSING FINANCE INSTITUTIONS, INVESTMENT OF A PERCENTAGE OF LIFE INSURANCE COMPANY AND PENSION AND PROVIDENT FUNDS IN EQUITY SHARES AND LONG TERM DEBT INSTRUMENTS CREATED FOR THE HOUSING FINANCE INDUSTRY; DEDUCTION OF MORTGAGE PAYMENTS FROM INCOME TAXES; AND AN INITIAL FIXED PERIOD OF TAX CONCESSIONS TO NEWLY ESTABLISHED HOUSING FINANCE INSTITUTIONS.

IN ADDITION, THE SEMINAR PARTICIPANTS MADE SEVERAL RECOMMENDATIONS CONCERNING BROAD ISSUES OF GOVERNMENT POLICY THAT DIRECTLY IMPACT THE FUTURE SUCCESS OF THE HOUSING SECTOR. THESE INCLUDE REDUCTIONS IN GOVERNMENT SPENDING, RATIONALIZATION OF PROPERTY TRANSACTION COSTS, UNIFORM TREATMENT OF ZAKAT (CHARITY) TAX DEDUCTIONS, ELIMINATION OF THE MULTIPLICITY OF ORGANIZATIONS REGULATING THE FINANCE SECTOR; AND DEVELOPMENT OF LONG-TERM UNIFORM GOVERNMENT FISCAL AND ECONOMIC POLICY.

IN PREPARATION FOR THE SEMINAR, THE SRMP PRODUCED A REPORT, "NO CAPITAL", ON PAKISTAN'S CAPITAL MARKETS AND RESOURCE MOBILIZATION FOR HOUSING FINANCE. THIS REPORT IS CURRENTLY BEING REVISED TO INCLUDE THE SEMINAR FINDINGS AND RECOMMENDATIONS. TO REQUEST A COPY OF THE REPORT OR FOR FURTHER INFORMATION ON THIS TOPIC, PLEASE CONTACT RANDALL C. CUMMINGS, CHIEF, OFFICE OF PRIVATE ENTERPRISE AND ENERGY, AID/PAKISTAN, OR JON WEGGE, CHIEF TECHNICAL ADVISOR, SRMP, O/PEN, AID/PAKISTAN.
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