Debt Management Office

Vitalizing the Government's Debt management function in Pakistan

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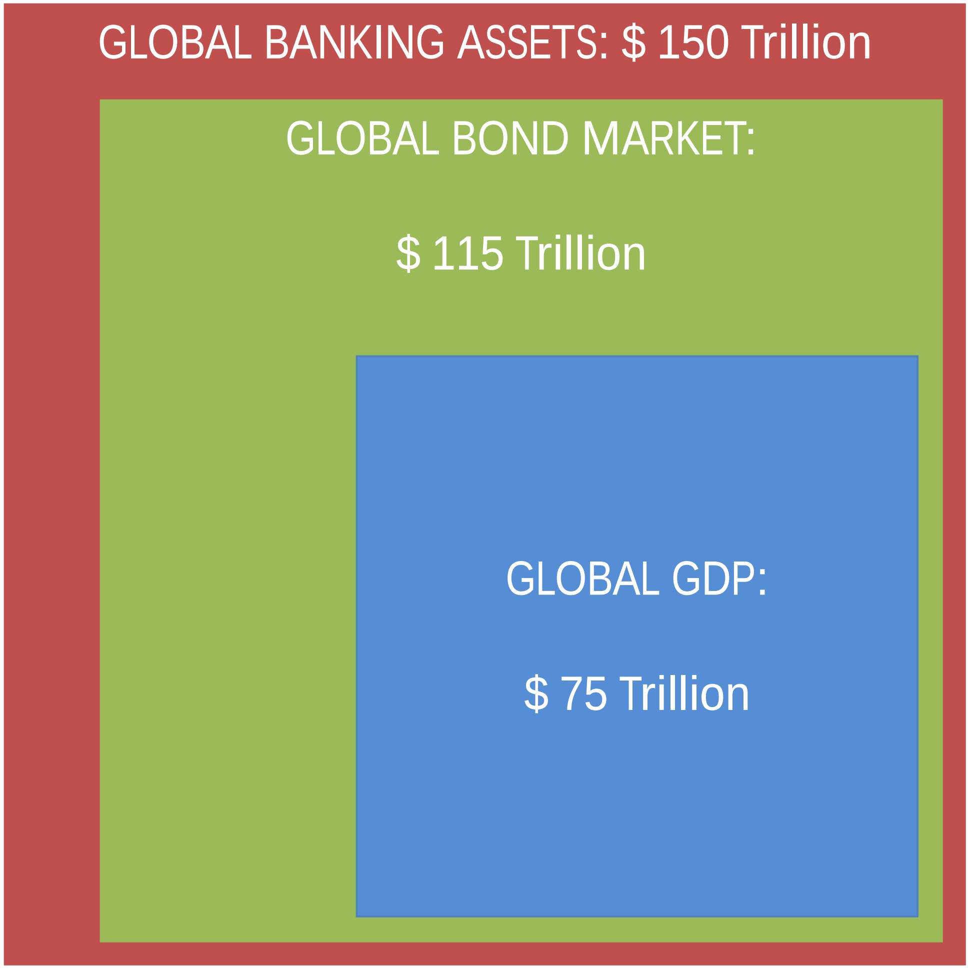
Section 1

Domestic Govt. Bond issues are base for Debt Capital Markets.

DCM=channels that supply capital from savers and investors (Institutional and retail) directly to users (govts, businesses)

Global Bond market is about $ 115trn, or 1.5 times global GDP of $75trn…and 80% of global banking assets of about $130trn.



In **Developed world, Govt. Bonds compose 50% of market, and Private, 50%. In larger EMs+, Private bonds average 25**%.

Characteristics of Efficient Bond Markets

Govt. Debt issues: The "Steel Frame"

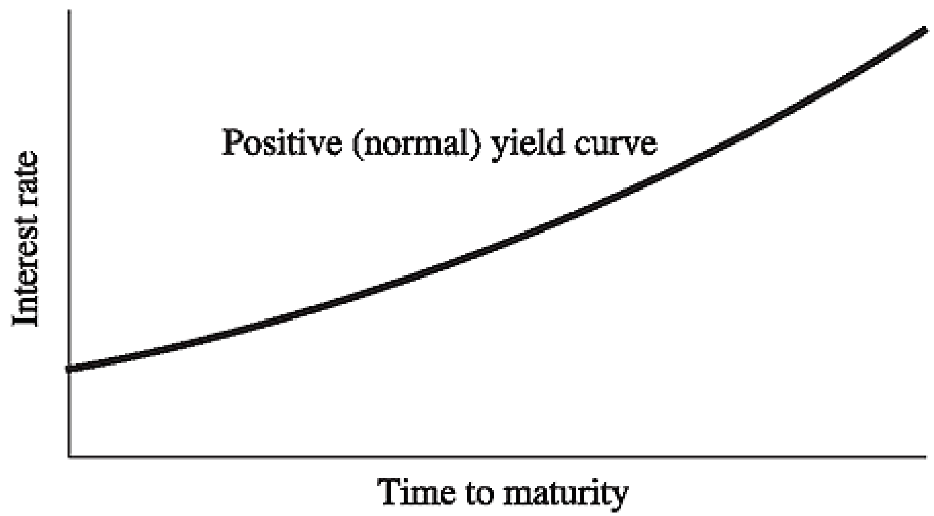
- Distributed over maturities.
  - 80% of bond issues are greater than 1 Year
- Distributed between Groups of investors
  - No Dominant Investor Group

Requirement Based Debt profile

- Maturity of Govt. debt issues aligned with requirements of Issuers and Investors
- Govt. must ensure liquidity in benchmark issues.

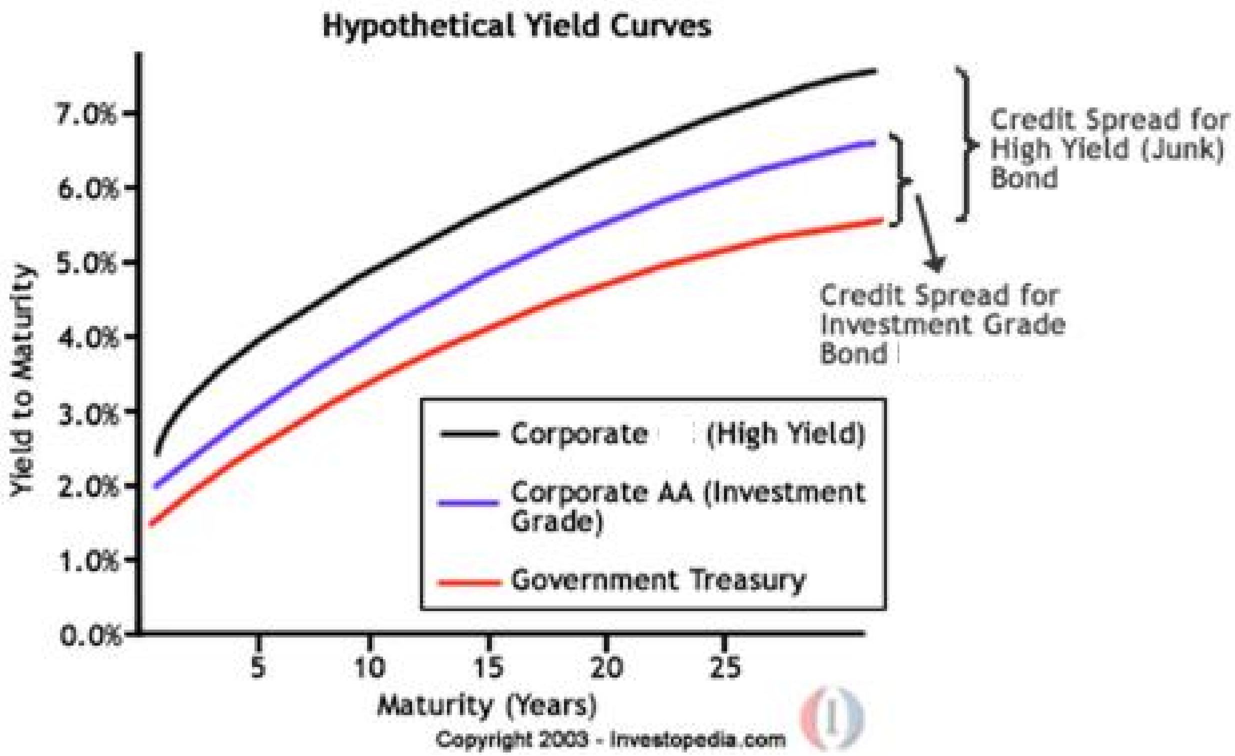
Bond Market sets long-term rates

- Central Banks 'policy' rate only affects short-term rates
- Bond markets set long-term rate, and 'signal' expectations through changes in shape of yield-curve.



- Normally upward sloping, risk-free Sovereign yield curve <u>– benchmark 'pegs' made liquid by trading activity .</u>.

Characteristics of Efficient Bond Markets



Govt. rate is market ‘floor’ price

- Once Govt. benchmark crystallised, all other credit risk is priced upwards of it.

DMO function is fundamental .

- Govt. debt strategy is executed by DMO, working with Central Bank, and supported by market participant framework. i.e. (Banks; Primary dealers; Market-Makers; Electronic trading platforms; Rating Agencies, etc)

Benefits of Efficient Bond Markets

Efficient Bond markets:

a)Lower sustainable cost of Govt debt through effective distribution;

b)Open path for **private sector bond issues** – usually lower cost than Bank loans, with greater flexibility for structures that suit Issuer cash flow.

c)Provide fixed rates that are essential for Plant, and Mortgage and Infrastructure finance. Also, **encourage Securitisation**.

d) "Rated' companies **migrate to bond market**; Banks then divert lending to other sectors, I,e., Mortgages, Consumer, smaller Corporate, and SME .

e) Corporate Bonds greatly **diversify Investor opportunity** spectrum.

f) Trading expertise **enables derivatives markets** to develop: for diversification, for IR and CD swaps/ other forms of hedging or for speculative purposes.

- Diversification of credit risk through investor base **lowers risk of Banking sector 'shock', with systemic outcome**..

Section 2

Capital Markets for Domestic Debt in Pakistan are inefficient and limited.

Capital Markets for Domestic Debt in Pakistan are constrained…

- Debt markets have accommodated accelerated Govt debt only at high cost. Private sector lending squeezed.
- Between ’07 – ‘14, Banks’ Investment in **Govt. securities up 400%; private sector Loans only 40%** (these have contracted from 29%/GDP in ‘07, to 15%/GDP now).
- **TBs cost to Govt. is 1.5% higher** than matching tenor Bank deposits(Bank ‘spread” goes up to 5%, for average of TB/PIB return, less actual cost of funds).
- **U.S. TBs pay less** than period Bank deposit rates; historically 3 month TBs 4.5% vs. 3 month $ deposits 6%….which should be the case in all efficient markets……
- ….**because Govt. is price ‘maker**’, not price ‘taker’, for short-term paper. Govt paper rated ‘riskless’ for domestic issues, i.e., no capital requirement

Concentration issue in Pakistan:

Govt. PIBs are 97% of all Bond issues. On investor side, Banks hold 70% of PIBs/Suk., also 85% of market TBs. ....thus setting the price for all other Govt. debt...(SBP charges 6m TB rate, NSS rate linked to PIBs)

Total Government Debt (6/14)

By investor (PKR Trn)			
1	**Banks**	**6.7**	**62%**
	Comm. Banks	4.2	37%
	SBP	2.4	25%
2	**Institutions**	**1.5**	**13%**
3	**NSS (+P.O.)**	**2.7**	**25%**
		10.9	100

By Instrument (PKR Trn)	
TB	**4.4**
Comm. Banks +Inst.	2.0
SBP	2.4
PIB (ComB+Inst)	**3.8**
NSS	**2.7**
	10.9

Note: Total (listed) Private Bonds Issued Rs. 65 Billion; Privately placed bonds figure not available, may be up to 3x, or Rs 200bn

Banks Govt. Investment exposure exceeds loans, reversing traditional portfolio allocation...

Large Banks

(Rs. Bn)	Investment (95% in Govt TBs/PIBs/Suk).		Loans (incl PSE)	
a)	826	60%	563	40%
b)	396	40%	620	60%
c)	458	52%	415	48%
d)	453	65%	248	35%
e)	363	58%	267	42%
f)	219	46%	260	54%
Total	**2,718**	**54%**	**2,375**	**46%**

Medium & Small Banks

Medium	1,327		1,376	
Small	281		305	
Total	**1,608**	**49%**	**1,681**	**51%**
Grand Total	**4,326**	**52%**	**4056**	**48%**

Source: KPMG Survey 12/31

.....If Bank Govt and private sector exposure returned to ratios of 2007:

(actual 2007, was 28% G/72% L):

	Govt. Secs.		Pvt. Loans	
Banking Exposure ('07 ratios)	**2,514**	**30%**	**5867**	**70%**

….compared to the current scenario:

	Govt. Secs.		Pvt. Loans	
Actual 12/31	**4,326**	**52%**	**4056**	**48%**
	-1,811		**+1,811**	

Domestic Debt virtual dominated Banks; competing market initiatives remain unformed.....

- **Institutional assets only 5% of GDP**, vs over 100% for Developed world; commonly over 25% for mid-size EMs**. Investment Banks too small** to play significant role.
- Lack of competition for Com Banks. means – in terms of resource mobilisation – results of **Pakistan's financial 'liberalization' limited**.

  (C in C to Deposits still around historical level of 30% (India 18%, BD 15%, Turkey 8%, Korea 4%); private credit has contracted in real terms, and financial sector has done little to promote market depth).
- **Banks** maintain total control over all financial pricing, **because DCMs have not developed**.

Way forward – evolution of efficient markets:

- Indispensable precondition is professional, empowered and independent **Debt Management Office (DMO)** at MoF.

- **Primary mandate:** to reduce cost, develop sustainability, of Government debt, and contribute to building the framework for broad-based Debt Capital markets.

- **Primary challenge:** strategy and initiatives to broaden Govt Debt distribution outside banks, by fostering institutional changes in our DCMs.

Section 3

Market Scan & Background

Market Scan & Background

To provide clarity and context to the proposed DMO function.......

- it may be useful to review relevant features of Pakistan financial economy,
- and to review maturity and investor profile in regional Bond markets for viable models.

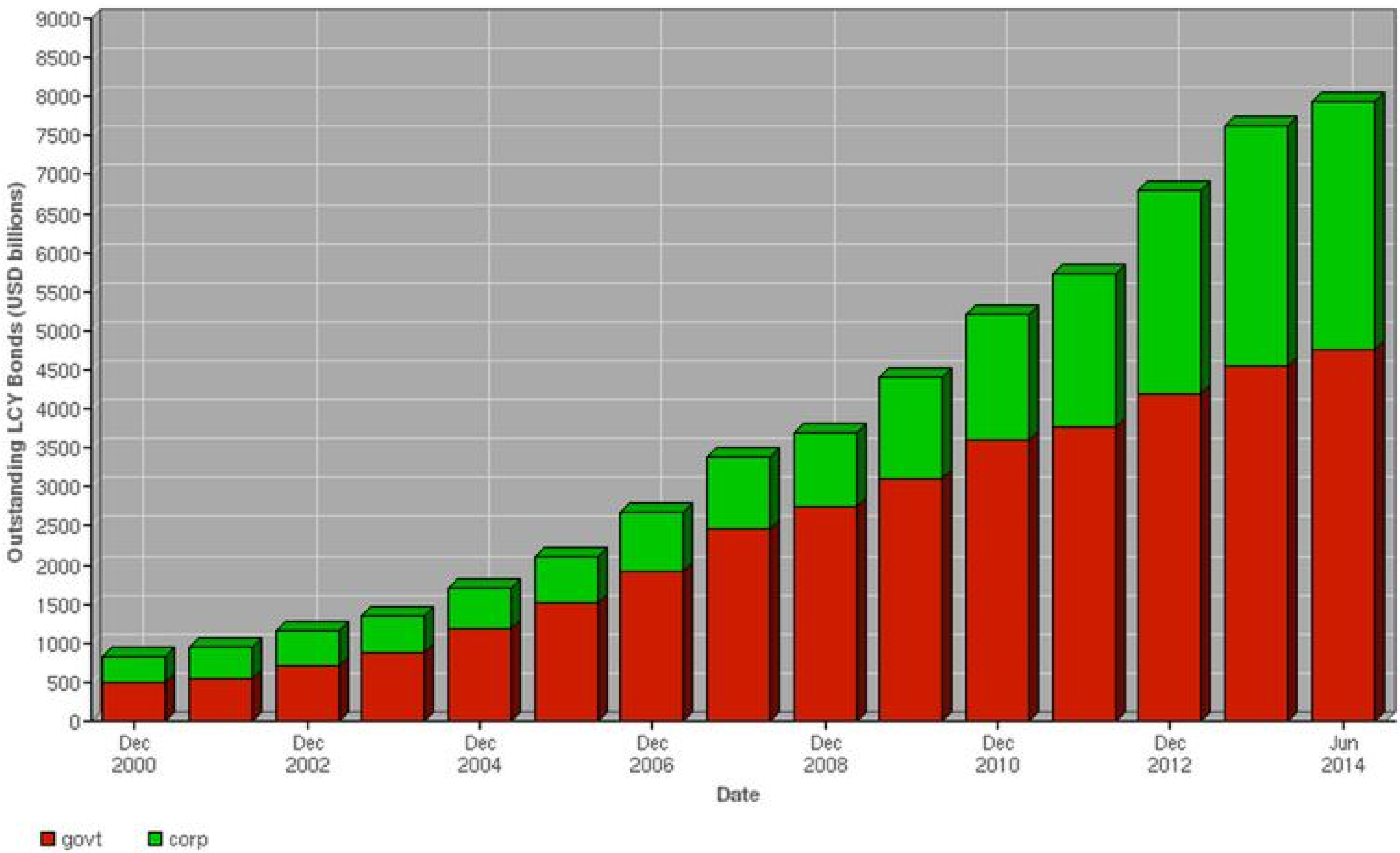
Govt Debt to GDP insufficient indicator for debt sustainability.

Measured for financial depth, Pakistan shows clear constraints

%	UK	US	TH	MY	IND	PK	BD
Govt Debt/GDP	93	102	44	55	66	66	32
Deposits/GDP	164	80	100	147	62	31	52
Debt S/Tax Revenue	7	10	6	9	25	40	20
Private Credit/GDP	158	48	82	115	44	15	48
Investment/GDP	18	17	27	27	35	14	28
Domestic Savings/GDP	11	18	31	35	30	12	30
Tax/GDP	42	33	17	16	18	9.5	9

Source: Economy Watch, Helgi Analysis, ADB, World Bank

Historical Growth of Asian LCY Bond Market



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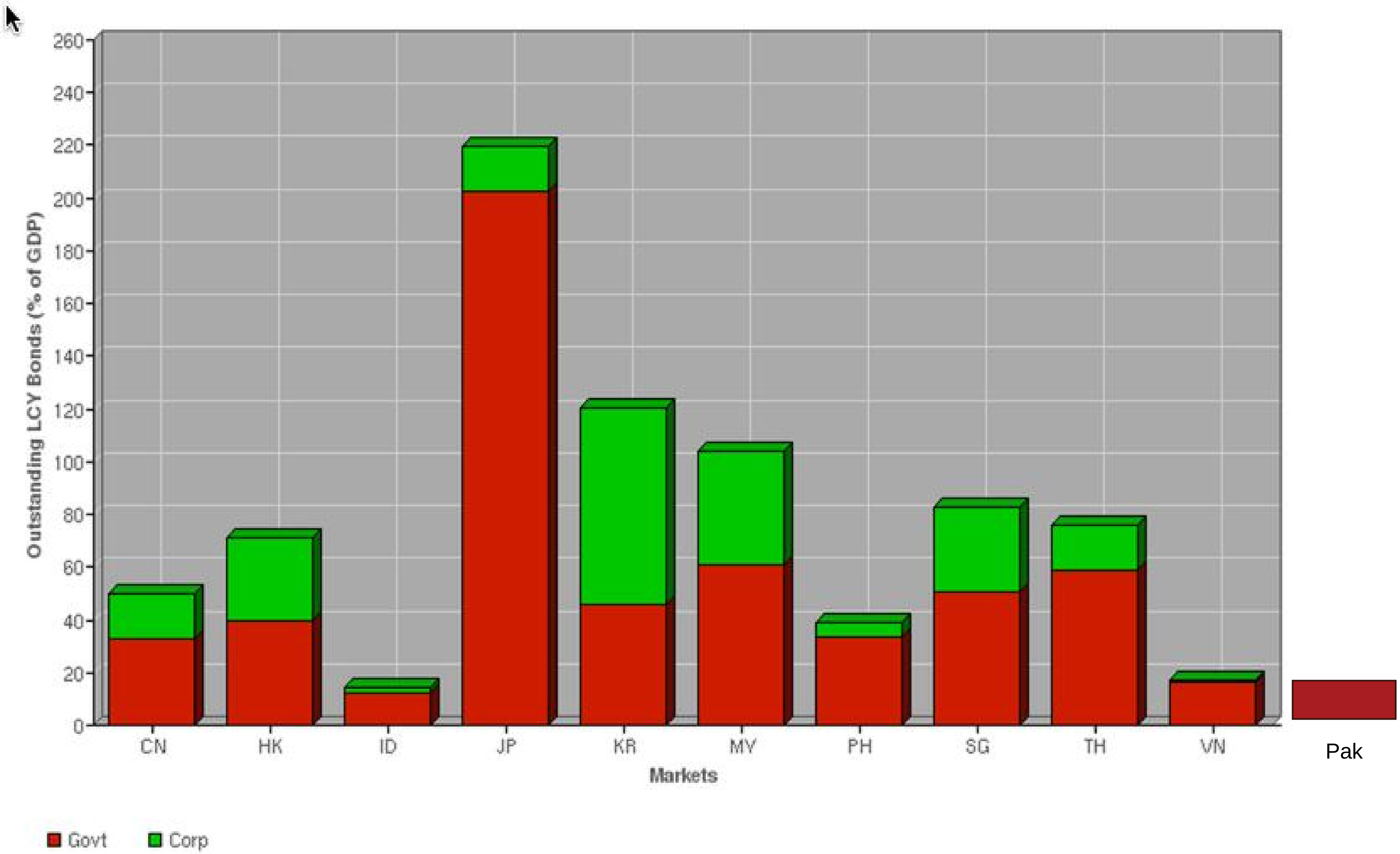
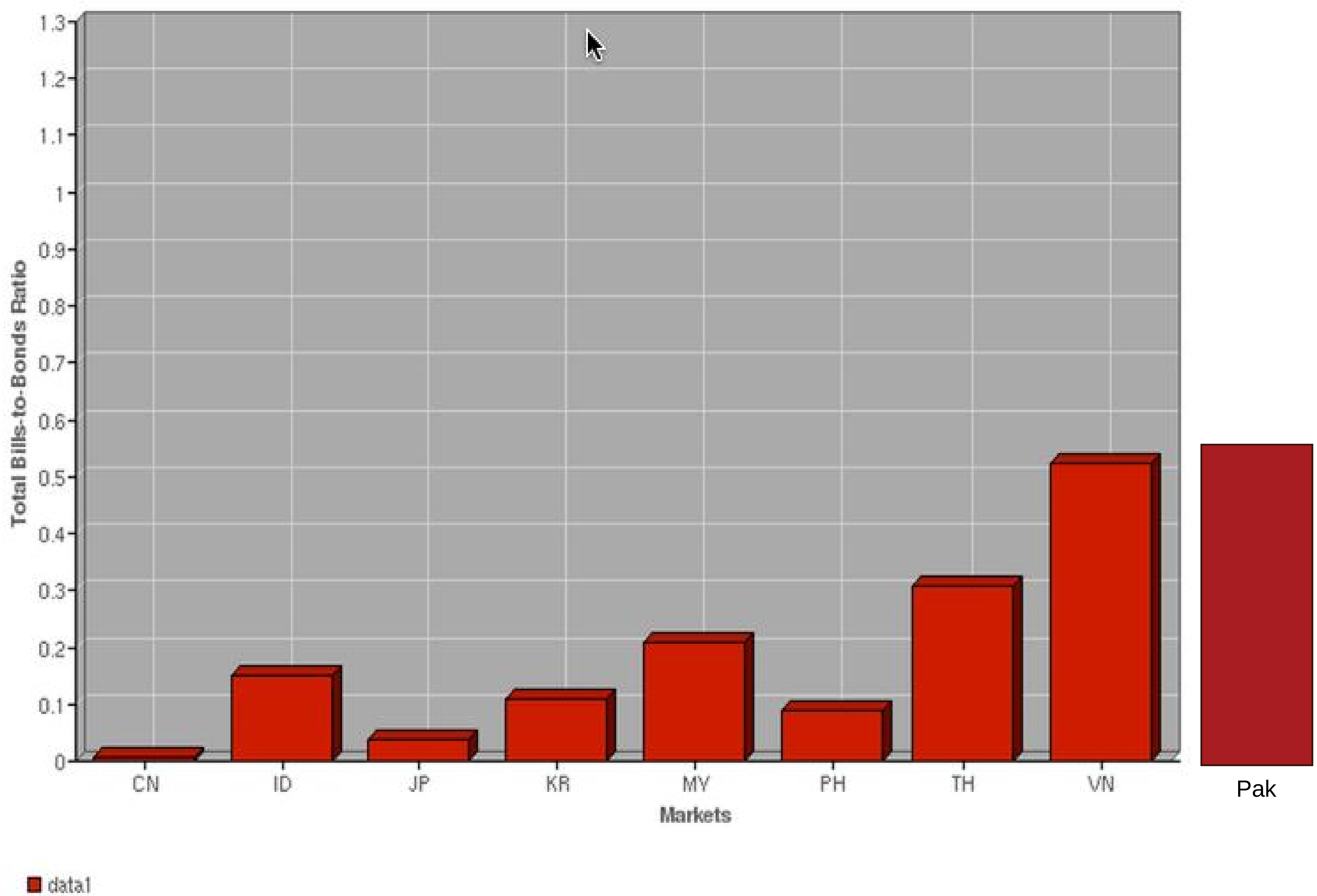
Source: ADB Bonds online

Size of LCY Bond Market in % of GDP: depth, and issuer distribution.



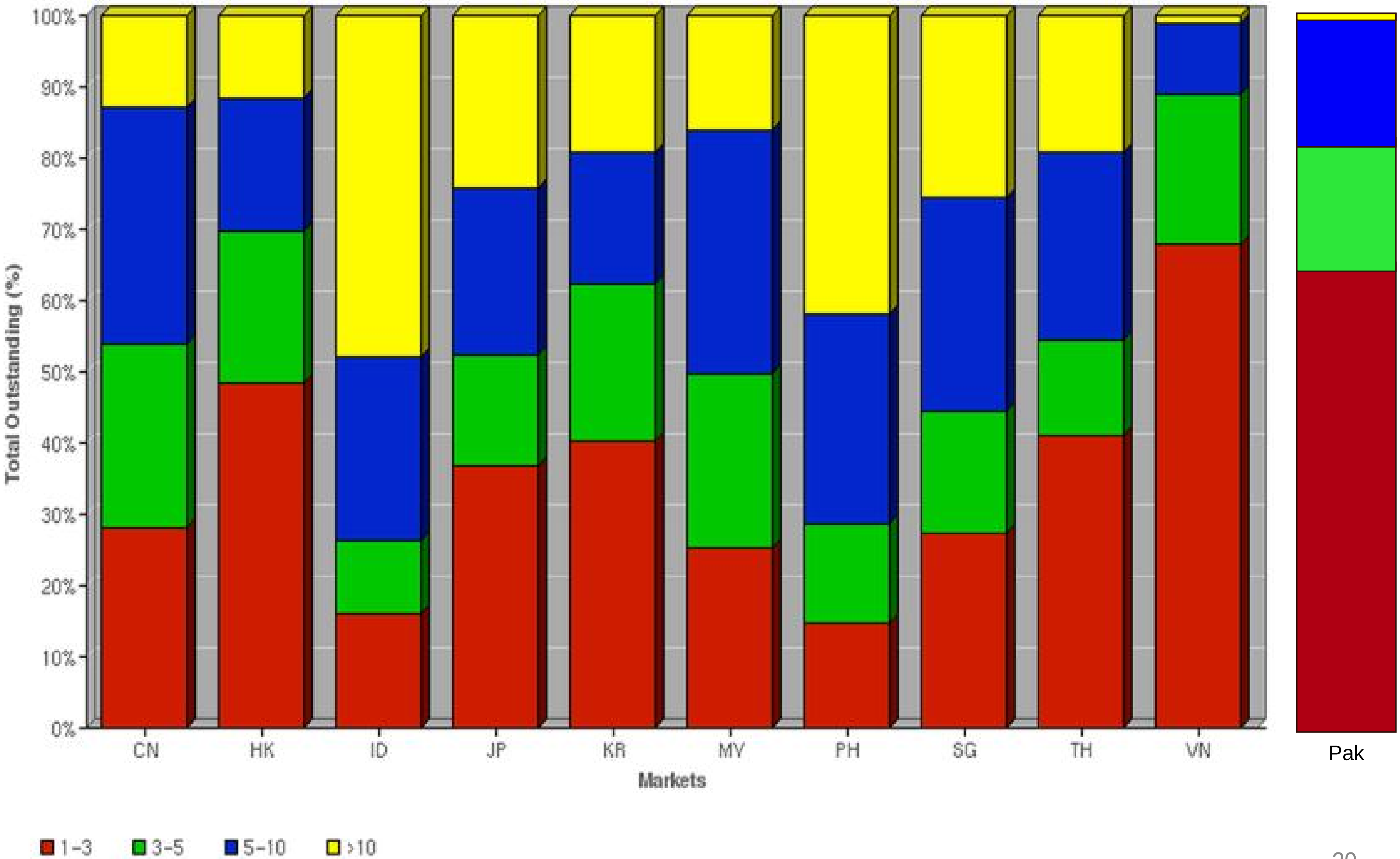
Source: ADB Bonds online

Total Bills-to-Bonds Ratio: shows funding pressure and maturity depth.



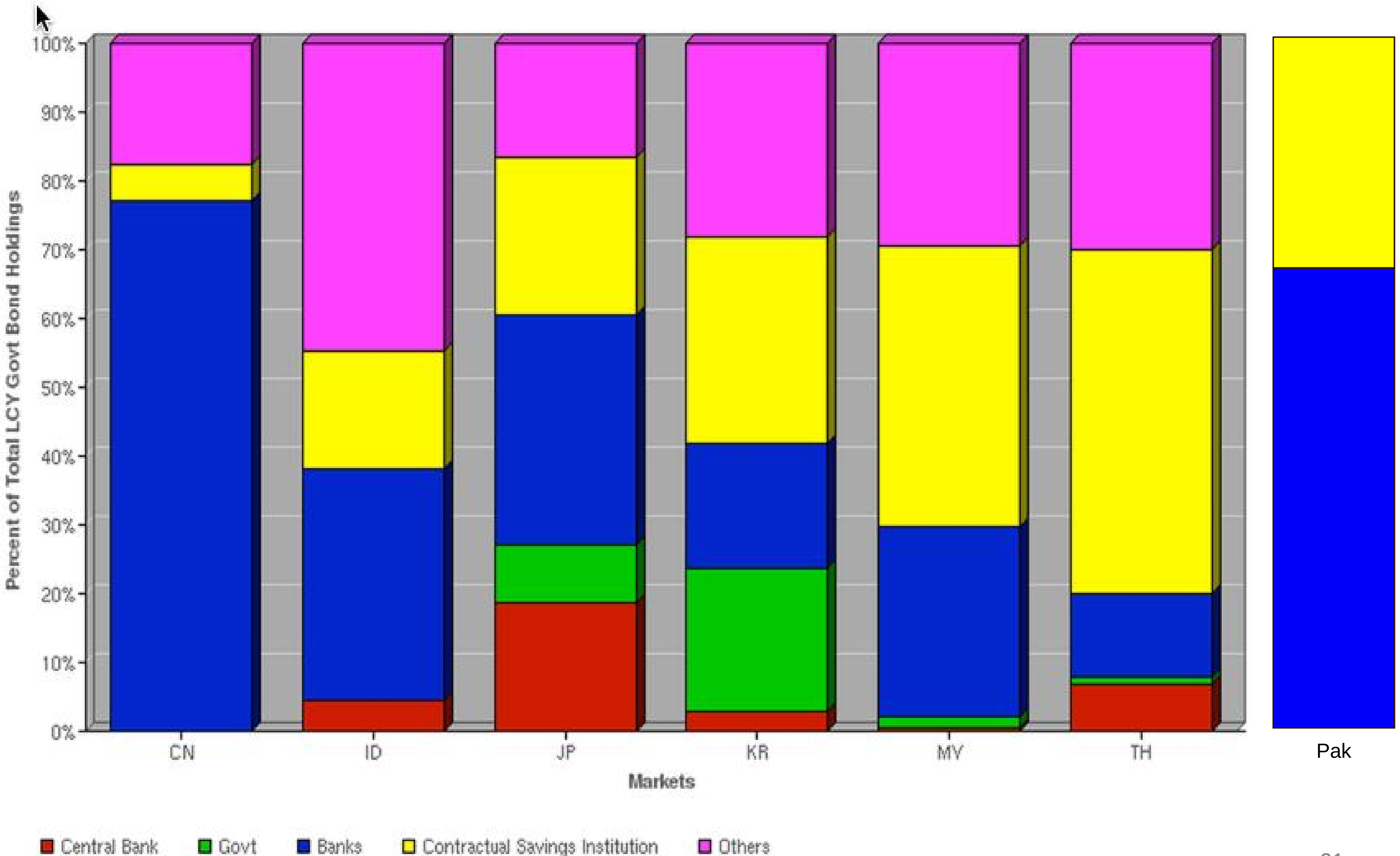
Source: ADB Bonds online

Govt. Securities Maturity Profile – LCY (over 1 year)



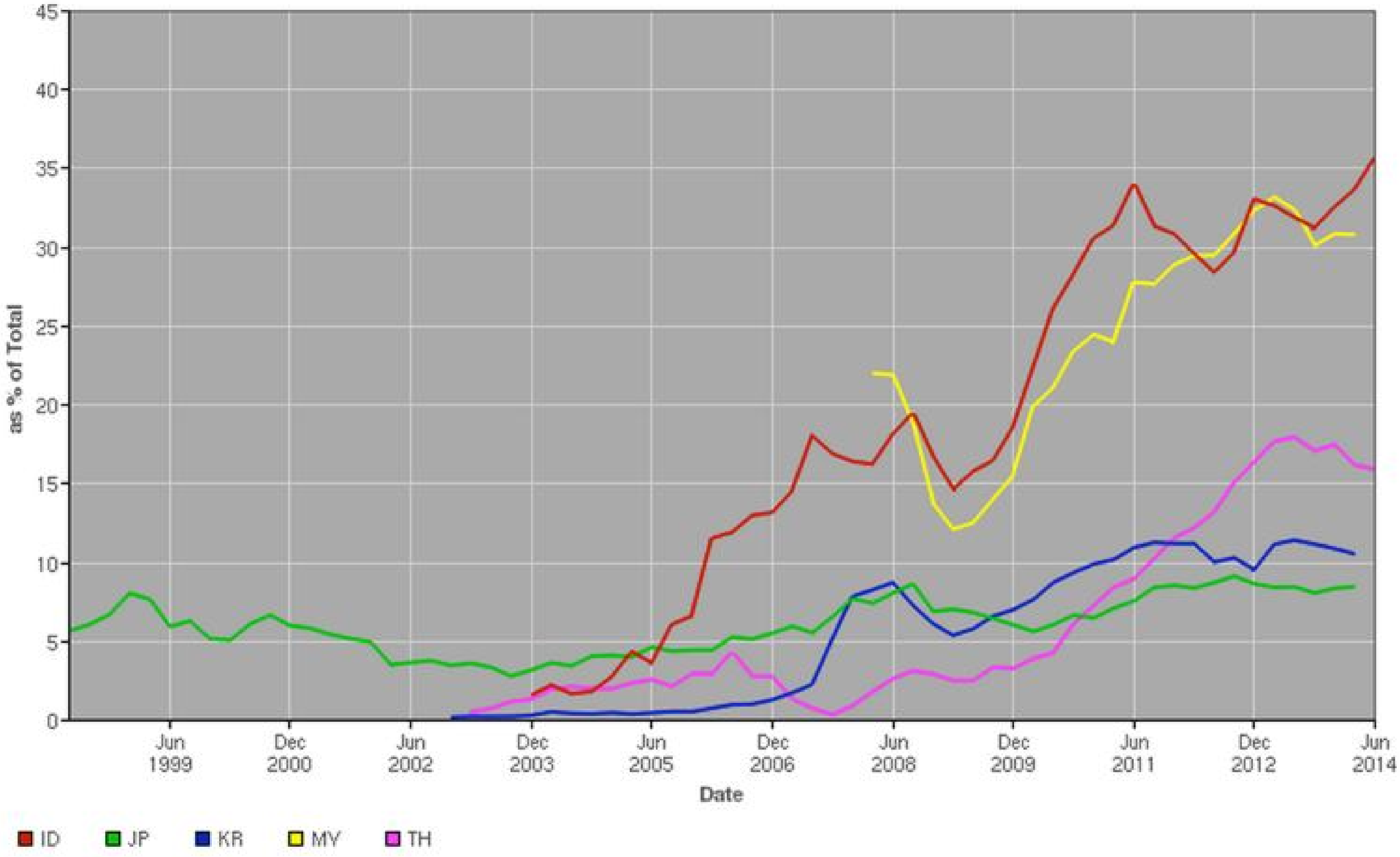
Source: ADB Bonds online

Investor Profile – Government Bonds(PIBs)



Source: ADB Bonds online

Foreign Holdings in LCY Government Bonds



Source: ADB Bonds online

Section 4

Debt Management Office: Responsibilities & Recommendations

Core Responsibilities of the DMO

- **Control of Consolidated National Debt database**, and **Centralised authority** for planning, structuring, execution and market intervention, for Govt. debt.

- **Controls of spectrum of Debt Management functions**, i.e. Front Office (Trading) – Middle Office (Strategy, Policy, Risk Management) – Back Office (Settlement, Accounting).

- **Maintenance of market stability, supported by Regulation and oversight by SECP/SBP** covering market functionaries: Primary Dealers; Market-Makers; Trading platform; Rating Agencies, etc.

Functions of the DMO

1. Production of **annual PSBR**, alongside Budget, for Parliamentary approval; must avoid fragmentation.
2. Establishment and institution of **long-term benchmark profile**
3. **Issuance of Time-table** for TB/PIB issues.
4. D**iversification of interest-rate risk**, targets for fixed/floating debt, together with active use of swaps.
5. Assurance of market integrity, via SBP/SECP, by requiring **regular financial appraisal of Issuers/Market Makers**, and its disclosure to investors .

Functions of the DMO

6. **Risk Management, to ensure market stability** and liquidity, mindful of forward-looking indicators, i.e.
   - FX Reserves;
   - Maturity 'bunching';
   - Contingent liabilities;
   - 'Hedging' thresholds;
   - Monetary policy requirements, etc.
7. **Regular market dialogue** with domestic market intermediaries, and liaison with foreign Rating Agencies, Fixed-Income Fund managers and investors (road-shows).

Recommendations for the DMO

- Highly desirable to have **independent DMO Board** with MinFin/FS, Governor/DG-SBP, Secs of EAD, Budget wing; CDNS: and key private market participants.

- DMO ideally should have **professional market experience**, and will need 2 or 3 other supporting market professionals, in Trading and Strategy functions

Section 5

Key Challenges for Market Development

Fundamental Challenges

A. To broaden distribution to new groups of investors, and to increase trading and liquidity, some shorter term are suggested, and….

B. also, to galvanise Corporate Bond markets.

A. Broadening Distribution.

1. CDNS could maintain part of NSS' Rs 2.7trn pool in TBs/PIBs – 40% of this sum would expand market by Rs 1trn, or 25%.

2. 40% of of Govt's approx Rs 850bn of deposits with Banks could be invested in TBs…this will add another Rs 340bn, or7%, to pool.

3. Consider converting some part of SBP MTBs into PIBs…though current market liquidity conditions unfavourable.

4. Eliminate option for Banks to hold Govt securities in HTM – MTM requirement will encourage both hedging derivatives, and trading.

5.. Actively promote entry of Pakistan Bonds into global EM Bond indexes; market to NRPs.

Cont'd.

6. Early opportunity for Pakistan is **rapid expansion of MFs - 1.4% of GDP, vs 10% plus for EMs**

A target of 2.8 % of GDP would create Rs 400bn of incremental MF investment in TBs/PIBs.

To hasten progress, Govt. could consider mobilising NIT as MF arm for Fixed-income MF, or establishing new institution in PPP model with IFC/other agency, and local Investors, as partners.

B. Galvanising Corporate Bond markets –

Bond issues can be accelerated, led by, for example, initiatives similar to the following:

- Issue of landmark fixed-rate issues would be a key requirements.

  Govt could consider fixed-rate, 3 to 5 year issues, by leading PSEs;

•Leading commercial banks **issue 3 to 7 year Bonds**, to underpin deposit base funding, mix of fixed-floating.

•Top 15-20 **corporates use Bonds for incremental funding**, mix of fixed-floating.

•Widening portfolios of Govt/Corporate Bonds will crystallise need for Hedging; Swaps; speculation, etc – **galvanising market liquidity**.

Concluding Points

- To support fiscal objectives, **deepen and diversify financial markets**, and enhance contribution of finance to development, **Pakistan must begin rapid development of its DCMs**.

- **A professional DMO, able and empowered to structure and manage Govt. debt is critical** for the sustained viability of the Govt. debt market…which is a precondition for DCMs.

- **Many legal and transactional capabilities to support DCM development are already in place**; others, all identifiable, need to be added.

End of Presentation