12

The Development and Regulation of the Capital Market in Pakistan

Khalid A. Mirza*

Abstract

This reflective note, drawing on the author's 40+ years relevant global and local experience, highlights the crucial role of regulation in economic governance. It emphasizes the challenging environment for regulation and capital market development in most emerging economies; including Pakistan. Specific shortcomings in Pakistan's capital market are identified: the regulator's lack of independence and ineffectiveness, the monopolistic structure of the capital market, burdensome regulations, inadequate securities financing, and the absence of robust investment banking. To address these issues, the paper proposes the following corrective measures: ensuring the SECP is appropriately led and staffed, licensing at least one additional, stock exchange and competing support institutions, rationalizing the capital market regulatory framework, re-introducing workable "Badla" financing, and promoting broad-based investment banking in Pakistan.

Keywords: capital market, regulator, imbalance of market forces, systemic risk, risk-adjusted basis, investor confidence, "badla", investment banking, margin financing, securities lending, price discovery

Introduction

This paper reflects upon an aspect of economic management in which the author has been personally involved; and in respect of which Pakistan has experienced both successes and failures. The capital market in Pakistan has clearly had its "ups" and "downs" in terms of intrinsic value addition. It will be readily appreciated that after successfully implementing a program of reforms and

---

* Senior Fellow, Innovation and Technology Center, Lahore School of Economics (LSE). Lahore, Pakistan.
Formerly: Chairman, Securities and Exchange Commission of Pakistan; Chairman, Board; Member, Competition Appellate Tribunal

transformation over a period of three years (2000-2003), the capital market has, for the most part, deteriorated both absolutely and in comparison with regional peers.

Basic Challenges

Before examining the current shortcomings of our capital market and proposing necessary actions to achieve a well-performing and vibrant capital market that effectively mobilizes and allocates resources on a risk-adjusted basis, it is essential to outline the general challenges faced by capital markets and their regulation in developing economies, often referred to as emerging market economies. Fundamentally, establishing a robust economy and the prevention of financial instability require four key elements, which are not easily secured in the fragile environment of emerging markets. The elements are as follows.

- First, the maintenance of macroeconomic stability;
- Second, the building of efficacious financial institutions;
- Third, ensuring compliance with recognized governance norms, and
- Fourth, empowered and independent regulators.

Regarding regulation, particularly capital market regulation, the environment in most emerging markets, including Pakistan, is extremely challenging. This is due to several factors, including:

- the lack of political will to support regulation as needed;
- the constant threat to the independence of regulatory agencies;
- the lack of resources available to effectively implement regulatory programs;
- the dysfunctionality of the legal system, which weakens regulatory enforcement;
- the tendency of other government agencies to act contrary to the spirit of regulatory laws;
- the shortage of necessary technical skills.

It is important to recognize that regardless of a country's level of development, the lack of competent regulation in critical can adversely affect economic activity in those sectors and debilitate the overall economy. In this regard, capital market regulation holds paramount significance, surpassing the regulation of other economic sectors.

Any economic sector, particularly the capital market, that experiences a market force imbalance due to its peculiar structure or historical legacy requires ongoing, adaptable measures to rectify this imbalance, prevent systemic risk, and safeguard the legitimate interests of all economic players, including vulnerable groups. Conversely, poorly designed or implemented regulation can be more harmful than no regulation. It is universally recognized that effective regulation necessitates a regulator with adequate authority, professional competence, operational independence, and a clear public perception of integrity.

It is paramount that regulation remains unbiased, free from political influence and consistently applied. The regulator serves as a monitor, enforcer, adjudicator, mentor and supporter of the market. In developing countries, fostering market development through effective regulatory measures is an especially crucial role for the regulator, particularly in the context of capital market regulation as compared to other form sectoral regulations.

Shortcomings in capital market development and regulation

When comparing Pakistan to its regional peers, India and Bangladesh, several significant shortcomings in Pakistan's capital market development become apparent, especially considering the relative economic size of these countries.

(1) A major concern is the perceived lack of independence of the Securities and Exchange Commission of Pakistan (SECP). The SECP is often seen as subservient to the government, and given the government's historical ties to certain private sector interests, particularly those with significant economic power, there is widespread belief that the SECP may be influenced either the government or undesirable private parties. This perception can negatively impact investor confidence.

(2) Second, Pakistan's capital market is characterized by a lack of competition, with monopolies in securities issuance, trading, platform, depositary, and clearinghouse functions. This lack of rivalry has hindered market growth and efficiency, resulting in poor performance indicators, demonstrating the negative consequences of monopoly.

(3) Third, the SECP as the regulator, has been ineffective and eroded investor confidence. Effective regulation involves both, making and enforcement of regulations. The SECP has largely failed in both areas, particularly since 2004. While a brief period of improvement occurred from 2018 to 2020 under the leadership of the Policy Board, despite internal resistance, the SECP has generally exhibited two detrimental characteristics for the capital market:

    a) Firstly, the imposition of onerous regulations has stifled market activity and hindered new initiatives.

    b) Enforcement, including adjudication, has been inconsistent, legally questionable and ineffective.

These issues stem from the politically motivated and unqualified unsuitable appointments at both the Commission and staff levels, leading to excessive personnel, low-quality staffing, regulatory ineptitude, and a lack of agency effectiveness.

(4) Fourth, the stock market lacks adequate financing. A well-functioning market with credible price discovery requires a robust system for financing stock trades, both for purchasing stocks and for facilitating short-selling through securities lending. Pakistan previously employed a REPO-based system called "Badla", which combined elements of financing and a futures instrument. Badla originated in the unofficial market and was often blamed, rightly or wrongly, for market disruptions. In 2000-2002, Badla was regulated and reforms were implemented to mitigate its risks. While the 2002 version of Badla was viable, it continued to be face criticism, leading to further changes were effectively eliminated it. The market now lacks an effective financing instrument to replace Badla. The elimination of Badla has adversely affected stock trades and price discovery in the Pakistan stock market. In terms of trading volume, Pakistan was once considered a leader in East Asia, but it has since lost that position.

(5) Fifth, investment banks with substantial risk-taking capacity are essential for a vibrant capital market, contributing to both supply and demand. Investment banks are thus a *sine qua non* for capital market development. Large, diversified investment banks, rather than boutique firms, represent the microcosm of the capital market. Primarily, capital markets grow through the supply of securities, not demand. In the absence of supply, demand hardly makes a dent. While this may seem counterintuitive, there is significant evidence to support this claim. Stock exchanges and investment banks promote securities issuance and expand the capital market. In Pakistan, the stock exchange is unfortunately a monopoly and remains a "mutual" club despite recent efforts to demutualize it. Maintaining the current structure benefits those in control and other vested interests for various reasons. Investment banking is virtually nonexistent in Pakistan. The few investment banks established were primarily surrogates for commercial banks, led by risk-averse commercial bankers or chartered accountants, approved by SECP. These individuals lacked the risk-taking mindset and capital market expertise required to design and market securities issuances. Such qualified professionals, whether local or foreign, would likely not be deemed "fit and proper" by SECP.

Corrective Measures

1) The preceding discussion highlights several reasons for the stagnation of Pakistan's capital market, but it is not exhaustive. Addressing these issues requires clear policy actions, as outlined in the following paragraphs.

2) To enhance the SECP's effectiveness and avoid politically motivated appointments, it is recommended that commissioners serve for a single, non-renewal term of 5-7 years. These appointments should be made only upon recommendation by an independent, professional board led by the Chairman of the Public Services Commission. In 2010, the World Bank proposed a similar measure in an unfinished paper shared with the Ministry of Finance.

3) Secondly, the SECP requires significant restructuring and reorientation. This includes reducing excess staff, eliminating unnecessary positions, and investing in substantial capacity, investigation, enforcement, and adjudication.

4) Thirdly, to increase competition, at least one more modern stock exchange should be licensed, and alternative trading networks like electronic trading networks (ECNs) should be encouraged. Additionally, establishing additional securities depositaries and clearinghouses would promote competition.

5) Fourthly, the SECP's burdensome regulations hinder market growth and innovation. Effective capital market regulation should be nuanced, disclosure-based and focus on essential aspects, allowing flexibility to market players. Excessive SECP regulations signal regulatory failure. A comprehensive review and amendment or even rescission of SECP regulations are necessary to achieve rationalization and simplification. While some progress was made during the Securities & Exchange Policy Board's efforts in 2018-2020, more work is needed.

6) Fifth, until globally accepted margin financing and securities lending modalities are implemented, the 2002 version of Badla should be reinstated to ensure adequate securities financing. This would revitalize the secondary market with consequential beneficial effects for the primary market.

7) Sixth, a comprehensive study should be conducted to understand why investment banking has not developed in Pakistan, comparing our situation to India's, where investment banking has been a significant driver of capital market growth. While various reasons exist, an objective study is necessary to identify specific steps and their sequence for promoting robust investment banking in Pakistan.