Structural Changes and Institutional Developments and Their Impact on Capital Market: A Case Study of Karachi Stock Exchange

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Abstract: This paper identifies the position of stock market in Pre-reforms and Post-reforms period and introduction of the technological advancement at Karachi Stock Exchange (KSE) during the period from 1986 to 2010. The study is based on using the information acquired from the Karachi Stock Exchange, Security and Exchange Corporation of Pakistan (SECP) and Government and Corporate sources. The descriptive analysis of policies and comparing of pre-reforms and post-reforms performances and the impact of the institutional developments after the introduction of Karachi Automated Trading (KATS) and Central Depository System (CDS) and other structural changes has been discussed. It is therefore concluded that Pakistan’s equity market is underdeveloped meanwhile the Karachi stock exchange indicates improvements specially after liberalization of economy and removal of restriction on repatriation of capital and dividends

Key words: Structural changes, Liberalization, Investment, and Karachi automated trading.

INTRODUCTION

During 1990s there was an increasing momentum in the emergence of stock markets due to the increase in capital market, such as; the countries like Malaysia, Mexico, Philippines, India and Pakistan. The Pakistan also witnessed the development of capitalization through its privatization of public enterprises policies and inviting of foreign investors through Foreign Direct Investment (FDI) policies on one hand and international political scenario in the favor of direct investment in Pakistan on other hand. This gave opportunities to stock exchanges to grow fast in the region and especially in Pakistan. In the underdeveloped industrial countries, the stock market plays a pivotal role in mobilizing national savings for economic growth and improving the quality of capital formation by enhancing efficiency in the allocation of financial resources. A healthy and broad-based stock market not only helps in the mobilization of domestic resources and its diversion to productive investment but also promotes a more equitable distribution of wealth. An unhealthy and inefficient stock exchange, however, can lead to worsening of in-equality in income and wealth and sub-optimal allocation of resources.

At present there are three stock exchanges in Pakistan, one each in Karachi, Lahore and Islamabad. The Karachi Stock Exchange (KSE) was opened in 1948, the Lahore in 1970 and the Islamabad in 1992. The stock market in Pakistan has played only a limited role in mobilizing and allocating financial resources. The slow growth of equity market has been due to a variety of factors of which the following are significant:

- Public sector enterprises were not encouraged to list on the stock exchange because prior to early 1990s government interest rate and credit allocation policies distorted the price structure of equity finance relative to loans from financial institutions and other resources. This stimulated excessive reliance on debt financing and led to high debt-equity ratios.
- Many public enterprises received funding directly from the government either through appropriations from the national budget or at relatively low interest rates from state controlled institutions.
- The majority of private sector firms tended to be small and consequently their needs have tended to be modest, mainly confined to working capital requirements. The firms have been able to generate the required finances from personal loans or their own contributions and retained earnings as well as short-term facilities from commercial banks.
- There is a strong concern among private company owners regarding the dilution of ownership and control of their firms. Most owners wished to keep the benefits of their entrepreneur-ship and control over their enterprises within a limited circle of relatives and friends. Even when a company is listed on the stock exchange, quite often the shares are unavailable for public trading.
- A number of companies are reluctant to disclose information about their financial status.
- As a result of these factors such as after tax returns, risk and liquidity other instruments offered higher yields and less risk than equity shares.
• Investors have felt that the market can be rigged against any but except the largest investors. There is trading on the basis of privileged information involving considerable unacceptable risk for the small investor.
• Institutional investors such as investment companies pension funds and insurance companies have played a limited role in the development of the stock market.

However extensive reforms have been carried out to strengthen the system and bring the stock market at par with the leading stock exchanges of the Asia. Some important initiatives in the corporation sector were taken in Pakistan during the year 1995-96. Through the Finance Act, 1995, the Capital Issue (Continuance of Control) Act, 1947, was repealed. It was a major push towards liberalization of the capital market. (Economic Survey of Pakistan-1995-96)

Literature Review:

After the stock markets crash in October 1987 in USA and other developed world, the stock markets started to think over the improvement in structural changes and improvements in the automated trade executions (GAO 1991) The stable macroeconomic policies are necessary for development of stock markets, which help to boost up and venture a high growth of real sector, business environment and higher investment (Greenwood & Smith 1997). Similarly stock market development stimulates economic growth through its impact on various macroeconomic variables including saving, productivity of capital and investment (McKinnon & Shaw 1973, Pagano 1993, Levine & Zarvos 1996).

Liberalizing the financial markets and letting the markets allocating the capital achieve the most efficient of capitalization in an economy. Thus the development of stock exchange is necessary to achieve full efficiency in allocation of capital through it (Coporale & Pittis 1997). For development of the trust of investor in the stock exchange, the transparency in the trading process is inevitable. Pagano & Roell (1996) observe that great transparency in trading process enhances market liquidity by reducing the opportunity for taking undue advantage on the cost of less informed investors. The structural changes and institutional developments may ensure that transparency. Most of the researchers are engaged in analyzing the relationship between stock market and macro economic variables such as inflation, exchange rate, GNP, Unemployment and other real economic activities. Meanwhile some studies look at the response of the stock market to market changes (Fama 1981 Kual 1987, Marshall 1992, Hess & Lee 1999).

Levine and Zarvos (1996) attempt to study the role of stock market development in economic growth by examining whether stock market is linked to long run economic growth. However the October 1987 crash was considered a mistrust of investors on the automated trading systems in major stock exchanges of USA and other developed world (GAO). The Karachi stock exchange is an important emerging market of the region among the developing countries which is termed as high-risk, high-return market where investor seek high risk premium(Nishat 1999).

The study of institutional development and liberalization is a descriptive analysis of market after the institutional development, changes in infrastructure and liberalization of policies. Institution development and liberalization of policies may involve easing restrictions on capital inflows or reducing impediments to repatriating dividends or capital. In this study these development has been analyzed and discussed. It is also an important analysis that the important factors have been studied in the Pakistani context after the introduction of reforms. These institutional development are mostly consists of two components viz; the technological advancement and changes in the rules and regulations.

Pre-Reform Structure of KSE:

During 1980s, KSE made some progress in terms of listed companies. However, this progress could not be considered significant, as only 150 companies were listed during the decade. This highlights certain structural issues that constrained the market progress. For example, foreign nationals were not allowed to make investment without prior approval from government and were also barred from owing 100 percent shares of a company. Moreover, restrictions on foreign exchange movement in and out of the country kept the foreign investors away from Pakistani markets. These policies put capital market on a slow pace development and such was the Karachi Stock Exchange which is first and a major stock exchange of the Pakistan. The average value of daily turnover of the shares the period from 1986 to 1990, which period is considered as Pre-reform period, and the period from 1990 and onward is considered as; the post-reform period which is given in the table-1.

The table-1 shows us three periods as pre-reforms, post-reforms and Karachi Automated Trading (KATs) period and the Average Value of Daily Turnover of shares traded at Karachi stock exchange during the study period. There is a significant growth in the trading and in the value of traded shares in these three periods. In 1985-86 there was only Rs. 2.583 billion average value of daily turnover at KSE which shows a slow increase in total turnover and its value which is also depicted in the graph-1. The average value of daily turnover was Rs. 2.583 billion in the year 1985-86 which went up to Rs.2.813 billion in the year 1986-87, Rs. 3.181 billion, in 1987-88 Rs. 3.91 billion and at the end of pre-reforms period it became Rs. 4.979 billion simultaneously.
Graph 1: Average value of daily turnover (Rs. Billion).

It is amazing to see here that with the implementation of the new policies and reforms in the economy and by the supervisory body Corporate Law Agencies (CLA) of stock exchanges, the average value of daily turnover went with a record growth as it is witnessed in table-1 and graph-2 (see graph-2).

Table 1: Average Value of Daily Turnover at KSE.

<table>
<thead>
<tr>
<th>Year</th>
<th>Average Value of Daily Turnover Shares Traded (Rs. Billion)</th>
<th>Pre-reform/post-reform/Karachi Automated Trading (KATs) period</th>
</tr>
</thead>
<tbody>
<tr>
<td>1985-86</td>
<td>2.583</td>
<td>Pre-reforms period</td>
</tr>
<tr>
<td>1986-87</td>
<td>2.813</td>
<td></td>
</tr>
<tr>
<td>1987-88</td>
<td>3.181</td>
<td></td>
</tr>
<tr>
<td>1988-89</td>
<td>3.91</td>
<td></td>
</tr>
<tr>
<td>1989-90</td>
<td>4.979</td>
<td></td>
</tr>
<tr>
<td>1990-91</td>
<td>15.232</td>
<td></td>
</tr>
<tr>
<td>1991-92</td>
<td>24.435</td>
<td></td>
</tr>
<tr>
<td>1992-93</td>
<td>51.579</td>
<td>Post-reforms period Before KATs</td>
</tr>
<tr>
<td>1993-94</td>
<td>97.472</td>
<td></td>
</tr>
<tr>
<td>1994-95</td>
<td>101.446</td>
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</tr>
<tr>
<td>1995-96</td>
<td>218.21</td>
<td></td>
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<tr>
<td>1996-97</td>
<td>461.611</td>
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<tr>
<td>1997-98</td>
<td>424.675</td>
<td></td>
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<tr>
<td>1998-99</td>
<td>1081.143</td>
<td></td>
</tr>
<tr>
<td>1999-00</td>
<td>605.6</td>
<td></td>
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<tr>
<td>2000-01</td>
<td>1877.8</td>
<td></td>
</tr>
<tr>
<td>2001-02</td>
<td>805.6</td>
<td></td>
</tr>
<tr>
<td>2002-03</td>
<td>3844</td>
<td></td>
</tr>
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<td>2003-04</td>
<td>4862</td>
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<tr>
<td>2004-05</td>
<td>7167.58</td>
<td></td>
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<tr>
<td>2005-06</td>
<td>8707.46</td>
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<td>2006-07</td>
<td>25262.97</td>
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<td>2007-08</td>
<td>14228.35</td>
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<td>2008-09</td>
<td>7450.75</td>
<td></td>
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<tr>
<td>2009-10</td>
<td>4405.2</td>
<td></td>
</tr>
</tbody>
</table>

Data Source: Government of Pakistan, Finance Division, Economic Adviser’s Wing, Islamabad, Economic survey (Various Issues), Annual Reports of SBP (Various Issues)

It is worthwhile to mention here that due to many difficulties and constraints the Karachi stock exchange shows a takeoff from its debris. The KSE witnessed its all the time high after the introduction of KATS. The Karachi stock exchange introduced a state-of-the-art computerized trading system to provide a fair, transparent, an efficient and cost effective market to the investor and abolished the outcry system and switched over to the automated system of trading w.e.f., May 26, 1998.

Before this on the supervisory front, the Corporate Law Agencies (CLA) was the primary regulator; its control over capital market was compromised due to lack of autonomy and overlapping of some functions with Monopoly Control Authority and Controller of Capital Issue. On the other side, stock exchange lacked the proper infrastructure for trading and settlement. In particular, trading was carried out through open outcry system (See figure-1). Due to lack of automation, turnover remained very low and in the absence of a depository company, investors had to take physical delivery of shares.
Who Were The Investors?:

Almost all financial institutions in Pakistan were involved in the securities business. National Commercial Banks (NCB), Investment Corporation of Pakistan (ICP), National Investment Trust (NIT) and Development Financial Institutions were among the major players active in underwriting business. Despite the active participation of these institutions, the equity market in Pakistan remained small. Since the corporate sector was relying more on DFIs for their financing needs, this did not allow equity market to develop significantly. This was a policy-induced outcome as most of the DFIs were in the public sector and these were ready in providing the long-term finance at concessionary rates.

The activity in the capital market was further restricted due to liquidity constraints; narrow trading base and limited use of technology. This limited the number of listed companies and their market capitalization. Consequently, the market was characterized by the limited equity of established, reputed and well-managed companies. Closely held companies were unwilling to go public for a variety of reasons. First, cost of equity was significantly higher than the debt. And dividends were paid out of after tax profits while interest on loans, invariably subsidized, was tax deductible. Also sponsors (DFIs) were generally able to finance projects with very low equity shares. Second, fearing consequent dilution of shareholding and loss of control, family controlled companies were reluctant to go public and enlarge their capital base. Finally, listing involved obligation to disclose information, which these companies preferred to avoid. The institutional and structural changes from 1985 to 2000 have been shown in the figure 1.

Graph 2: Average value of daily turnover (Rs. Billion).

Graph 3: Average value of daily turnover (Rs. Billion).

Fig. 1: Institutional Developments at KSE.
And after 1990 the Karachi Stock Markets have seen a continuous development in its infrastructure and advancement in framing the policies and implementation after 1990. The introduction of the KSE-100 index was a big breakthrough as the structural change as post-reform policies.

Post-Reform Policies at KSE:
During 1991-92 capital market in Pakistan was very active, witnessing expansion in the number of financial institutions as well as an unprecedented increase in the capitalized value of shares quoted on stock exchange (see Table-1 and graph-2). The expansion of the capital market activity resulted from a broad-based liberalization of the economy including in particular the opening up of foreign sector, specially the direct foreign investment policy. The Karachi Stock Exchange was characterized by bullish trends during the years 1991-92. The major factors contributing among others were:

- News of higher earnings by most of the leading companies
- Announcement of package of incentives in the new export policy and
- Setting up of $22.6 million Pak- fund for investment in shares
- Corporate Law Authority (CLA) granted permission for the establishment of a number of brokerage houses in the private sector. Consequently many private brokerage houses were opened in collaboration of some foreign banks in country during the years 1992-93 and 1993-94.
- During this period a number of other government policies in bringing the reforms in financial sector were introduced viz. devaluation of rupee, tax cut policy, integration of National Investment Council (NIC), Pakistan Investment Board (PIB) and Investment Promotion Bureau (IPB) into a single Board of Investment.

Following are silent features of KSE post-reform policies and implementations:

a. The Karachi Stock Exchange introduced the KSE-100 Index in November 1991 and was recomposed in November 1994.
b. The KSE All share index was introduced in September, 1995.

Technology and KSE:
Technology is going to play a pivotal role in shaping the future of the Karachi Stock Exchange. KSE was to grow from a city exchange in Pakistan to a significant player in the Regional, Asian and World market. In this regard some bold steps were taken. This includes the areas of Automated Trading, Clearinghouse, Office Automation, and Market Information System and with other facilities for the investors.

Hardware & Network:
The Automated Trading System which is based on a strong and sturdy hardware platform. These include IBM RISC servers, which serves as trading engines for the system. The data based servers maintains the historical data of all transactions and some of the servers are engaged in communication and traffic controllers while others facilitates the primary servers and used by member users.

In start there was the LAN having a 100 Base-T network using Cisco equipment. The entire building was cabled with Switches on each floor. The 800 points for work stations with specific IP addresses were allocated. The network also started to serves as the traffic controller between members and the CDC through a fiber optic connection. In this way the Karachi Stock Exchange has introduced a state-of-the-art computerized trading system, KATS (Karachi Automated Trading System) to provide a fair, transparent, efficient and cost effective market for the investors. This has been possible due to a number of policy decisions taken by the Exchange during the period of study. The main features of the policies include complete scrapping of the Outcry System and switching over to automated trading through KATS. In this regard the out cry system of trading was abolished w.e.f., May 26, 1998. The KATS has helped achieving all transactions being electronically settled through these both systems viz: KATS and CDS. After these developments the stock market shows a steady increase in the all indicators but here the study is only focused to see the daily business which is given in the table-1 and the graph-2 and graph-3 are evident in this respect. The average value of daily turn increased hundred times when we compare it historically.

Conclusion:
The Institutional Development at Karachi Stock Exchange during the study period includes the technological advancement and changes in the rules and regulations at Karachi Stock Exchange. This study is divided into two parts: Pre-Reform structure in 1990 and Post- Reform Policies at Karachi Stock Exchange. Before reforms the Karachi Stock Exchange lacked the proper infrastructure for trading and settlement. The study reveals that in particular, trading was carried out through open out cry system. Due to lack of automation, turnover remained very low and in the absence of a depository company, investors had to take physical delivery of shares and moreover all financial institutions in Pakistan were involved in the securities business. Despite the active participation of these institutions, the equity market in Pakistan remained small. Since the corporate
sector was relying more on Development Financial Institutions and commercial banks (DFI &CBs) for their financial needs, this did not allow equity market to develop significantly. The cost of equity was significantly higher than the debt as dividends were paid out of after tax profits while interest on loans, invariably subsidized, was tax deductible. The sponsors (DFI &CBs) were generally able to finance projects with very low equity shares.

But after the infrastructure and institutional reforms, the capital market in Pakistan has been very active. The expansion of the capital market activity resulted from a broad-based liberalization of the economy including in particular the opening up of foreign sector, specially the direct foreign investment policy. The Karachi Stock Exchange institutional development after the reforms is very good and at par with world markets but when we compare it with the other regional market its performances are as it is a low size of market, low liquidity, low turnover ratio, high volatility, and high concentration has kept away this market form success. An international comparing show that Pakistan’s stock market capitalization was merely 3% of the South Asian markets which was dominated by India as its share stands 94% (IFC 1997).

It is therefore concluded that Pakistan’s equity market is underdeveloped meanwhile the above study of Karachi stock exchange indicates that over time, the size and liquidity of this stock market have increased specially after liberalization of economy and removal of restriction on repatriation of capital and dividends.

REFERENCES