ADB

Report and Recommendation of the President to the Board of Directors

INTERNAL

Project Number: 53221-003
March 2022

Proposed Policy-Based Loan for Subprogram 2 Islamic Republic of Pakistan: Third Capital Market Development Program

Asian Development Bank

CURRENCY EQUIVALENTS

(as of 1 February 2022)

Currency unit	–	Pakistan rupee/s (PRe/PRs)
PRe1.00	=	$0.0056
$1.00	=	PRs176.77

ABBREVIATIONS

ADB	–	Asian Development Bank
COVID-19	–	coronavirus disease
DMO	–	Debt Management Office
EFF	–	Extended Fund Facility
GDP	–	gross domestic product
IMF	–	International Monetary Fund
MOF	–	Ministry of Finance
P3F	–	post-program partnership framework
PBL	–	policy-based loan
PSX	–	Pakistan Stock Exchange
RISE	–	Resilient Institutions for Sustainable Economy
SECP	–	Securities and Exchange Commission of Pakistan
SMEs	–	small and medium-sized enterprises
SOE	–	state-owned enterprise
TA	–	technical assistance

NOTES

(i) The fiscal year (FY) of the Government of Pakistan ends on 30 June. “FY” before a calendar year denotes the year in which the fiscal year ends, e.g., FY2022 ends on 30 June 2022.

(ii) In this report, “$” refers to United States dollars.

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PROGRAM AT A GLANCE

1. Basic Data

Project Number: 53221-003

Project Name	Third Capital Market Development Program (Subprogram 2)	**Department/Division**	CWRD/CWPF
Country	Pakistan	**Executing Agency**	Ministry of Finance
Borrower	Islamic Republic of Pakistan		
Country Economic Indicators	https://www.adb.org/Documents/LinkedDocs/?id=53221-003-CEI		
Portfolio at a Glance	https://www.adb.org/Documents/LinkedDocs/?id=53221-003-PortAtaGlance		

2. Sector

Sector	**Subsector(s)**	**ADB Financing ($ million)**
✓ **Finance**	Finance sector development	300.000
	Total	**300.000**

3. Operational Priorities

✓ OP2: Accelerating progress in gender equality

✓ OP6: Strengthening governance and institutional capacity

Climate Change Information

GHG reductions (tons per annum)	0.000
Climate Change impact on the Project	Low
ADB Financing	
Adaptation ($ million)	0.000
Mitigation ($ million)	0.000
Cofinancing	
Adaptation ($ million)	0.000
Mitigation ($ million)	0.000

Sustainable Development Goals

SDG 5.c
SDG 17.3

Gender Equity and Mainstreaming

Effective gender mainstreaming (EGM) ✓

Poverty Targeting

General Intervention on Poverty ✓

4. Risk Categorization: Complex

5. Safeguard Categorization

Environment: C **Involuntary Resettlement:** C **Indigenous Peoples:** C

6. Financing

Modality and Sources	**Amount ($ million)**
ADB	**300.000**
Sovereign Programmatic Approach Policy-Based Lending (Concessional Loan): Ordinary capital resources	300.000
Cofinancing	**0.000**
None	0.000
Counterpart	**0.000**
None	0.000
Total	**300.000**

Currency of ADB Financing: US Dollar

I. THE PROPOSAL

1. I submit for your approval the following report and recommendation on a proposed policy-based loan (PBL) to the Islamic Republic of Pakistan for subprogram 2 of the Third Capital Market Development Program.[1]

2. The program supports the design and implementation of structural reforms necessary to create a competitive capital market and promote private investment in the country and is anchored in an overall government approved Capital Market Development Plan and Vision 2025 government agenda for Pakistan.[2] The program is in line with the Asian Development Bank (ADB) Strategy 2030 and the country partnership strategy for Pakistan, 2021–2025.[3] The program will (i) strengthen market stability, (ii) enhance market facilitation, (iii) enhance supply-based measures, and (iv) improve demand-based measures for capital market development. It also fits in the framework of the $6 billion International Monetary Fund (IMF) Extended Fund Facility (EFF) program approved on 3 July 2019 to facilitate improved macroeconomic management.[4] The EFF program includes recommendations for finance sector reforms that focus on deepening access to finance, implementing a sound debt management strategy, and supporting private sector development. The program also contributes to EFF implementation and sustainability since it develops alternative sources of access to finance (i.e., capital markets), supports sound debt management and government bond market development, and helps mobilize financial resources to private investment.

II. PROGRAM AND RATIONALE

A. Background and Development Constraints

3. The Pakistan economy has started to show signs of recovery, posting a gross domestic product (GDP) growth rate of 3.94% in fiscal year (FY) 2021.[5] The coronavirus disease (COVID-19) pandemic adversely impacted the economy in 2020, prompting a revision of the GDP forecast from a pre-pandemic growth projection of 2.6% to a contraction of 0.5% in FY2020. The government managed the pandemic response by enhancing the disease surveillance and response system, designating health facilities for COVID-19 patients, and initially imposing a partial lockdown in March 2020, which was gradually eased from May 2020 and replaced with localized lockdowns. The Ministry of National Health Services, Regulations, and Coordination also developed the National Deployment and Vaccination Plan with an implementation cost of $1,950 million.[6] As of 1 February 2022, 104.22 million persons had been vaccinated, of which 80.75 million have been fully vaccinated. On the back of this recovery, the government is targeting

[1] The programmatic approach and subprogram 1 were approved on 28 September 2020. ADB. 2020. *Report and Recommendation of the President to the Board of Directors: Proposed Programmatic Approach and Policy Based Loans for Subprogram 1 and Technical Assistance Grant to the Islamic Republic of Pakistan for the Third Capital Market Development Program*. Manila.

[2] Government of Pakistan. 2018. *Pakistan 2025: One Nation – One Vision*. Islamabad.

[3] ADB. 2018. *Strategy 2030: Achieving a Prosperous, Inclusive, Resilient, and Sustainable Asia and the Pacific*. Manila. The project is aligned with Strategy 2030's operational priority 6, strengthening governance and institutional capacity, operational priority 2, accelerating progress in gender equality, and operational priority 1, addressing remaining poverty and reducing inequalities. ADB. 2020. *Country Partnership Strategy: Pakistan, 2021–2025—Lifting Growth, Building Resilience, Increasing Competitiveness*. Manila.

[4] IMF. 2019. *Request for an Extended Arrangement Under the Extended Fund Facility-Press Release; Staff Report; and Statement by the Executive Director for Pakistan*. Washington, DC.

[5] The government has revised FY 2021 growth estimate to 5.6% after re-basing of GDP in January 2022. However, as of the date of this document, further details are yet to be published.

[6] Islamic Republic of Pakistan, Expanded Programme on Immunization (EPI). 2021. *National Deployment and Vaccination Plan (NDVP) for COVID-19 Vaccines (2021)*. Islamabad (24 June).

4.8% growth in FY2022. To support this, the federal budget for FY2022 includes measures to revive industrial growth and engage the private sector through fiscal and other incentives to support higher economic growth. The budget also introduces tax reforms rationalizing a series of withholding taxes and capital gains tax as well as promoting digital transactions. ADB is satisfied with the direction of macroeconomic conditions and policies, because the government continues to advance the reform agenda in key areas, including central bank autonomy and capital markets, taxation, management of state-owned enterprises (SOEs), and the power sector. Both the demand and supply sides have contributed to economic growth, and the debt outlook remains stable.[7] However, the economy remains vulnerable, and investment rates have remained very low (an estimated 15.2% of GDP in FY2021).[8] Underdeveloped capital markets have contributed to the ineffective mobilization of savings, leading to a wide saving–investment gap. The banks' own credit origination capacity was hampered by the ineffective role of Pakistan's capital markets, and the economy remained dependent on volatile foreign capital. The development of domestic capital markets can have the benefit of increasing the government's access to local currency financing by issuing debt through domestic open-market operations and thereby help manage foreign exchange risk and inflation better.

4. Global equity markets were severely impacted by COVID-19 but rebounded after governments injected big stimulus money into their economies. A steep decline on the Pakistan Stock Exchange (PSX) was also prevented by a series of State Bank of Pakistan policy rate cuts since mid-March 2020 that lowered the policy rate by 6.25% to 7.00%. However, to curb the inflationary pressure, SBP has revised the policy rate to 9.75% in December 2021.The COVID-19 pandemic situation and the recovery prospects illustrate that developing robust and competitive domestic capital markets is even more critical and is an indispensable tool for mobilizing private investment and minimizing future external shocks. The program will aid the COVID-19 recovery phase through reforms, such as enhanced access to finance for small and medium-sized enterprises (SMEs) and growth companies through a dedicated capital market platform. SMEs predominantly use short-term funding options from banks; however, as they mature, issuing equity and debt securities can provide SMEs with stable, long-term financing. SME-focused equity platforms can offer an alternative to main listing boards with lower listing requirements and costs, making it a viable solution for SMEs seeking finance. The program also supports onboarding new retail investors through online account opening, which will help develop a fully diversified investor base, deepen the markets, and enhance liquidity. The government has become increasingly aware that capital markets can play a strong role in economic growth in Pakistan, but certain constraints need to be addressed which are outlined in paras. 5–12.

5. **Pakistan significantly below peer countries on key capital market-related indicators.** At 15.2% of GDP, Pakistan's investment rate in FY2021 is almost half of the South Asian average of 31.0% of GDP.[9] For an economy at Pakistan's development stage, this low level of capital investment reflects low investor and business confidence and also constrains future growth. Nascent capital markets are part of the problem. Stock market capitalization, at 17.4% of GDP as of June 2021, has been declining and is below the figures for India (99%) in 2020. In Pakistan, assets managed by mutual funds and pension funds represent a fraction of those in regional peers. Pakistan has the lowest open-end fund asset base among its regional peers in Asia and the Pacific, totaling $6 billion or about 2% of its GDP (India's is 16% of GDP and the regional average is 32% of GDP).

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[7] Industry reversed the 3.8% contraction in FY2020 to expand by 3.6% in FY2021, while services expanded by 4.4% in FY2021, reversing the 0.6% decline in FY2020. Similarly, private consumption rebounded strongly in FY2021 to contribute 6.2 percentage points to GDP growth.

[8] Government of Pakistan. 2021. *Economic Survey of Pakistan 2020–2021*. Pakistan.

[9] World Bank. TCdata360 (accessed 9 August 2021).

6. **Bank-dominated finance sector.** Pakistan's finance sector is predominantly a bank-based system. As of December 2020, bank assets accounted for almost 75.5% of the country's total financial assets, whereas national saving instruments accounted for 12.7%, the insurance sector 5.5%, and nonbank financial institutions 5.0%. Such a bank-dominated finance sector reflects a lack of capacity in the non-banking sectors and capital markets. A non-diversified finance sector represents a risk because of the inability to deal with financial shocks and periods of uncertainty. It also fails to support the development of long-term finance and risk capital solutions. In addition, the lack of sufficient outstanding stocks of marketable and market-friendly government securities at crucial yield tenors impairs the formation of an effective pricing and risk management benchmark for financial deepening in local currency. This greatly impairs banks' maturity transformation. Banks in Pakistan mainly offer short maturity loans and offer very limited long-term financing for infrastructure projects.

7. **Underdeveloped capital markets with a limited role in financial intermediation and resource mobilization**. The PSX lacks depth in the number of investors and the number of companies raising capital. As of December 2021, about 255,000 individual investors (less than 0.1% of the population) have a stock investing account. The role of capital markets has regressed, with the number of companies listed in the PSX declining from 747 in 2001 to 533 by December 2021. Only 25 companies raised capital from the PSX between 2015 and 2019, while private equity and venture capital-raising activity was four times higher. Market capitalization of the PSX accounted for more than 17.4% of the country's GDP in June 2021, regressing from 30% of GDP in May 2017. With 533 listed companies and about $43.3 billion market capitalization as of 31 December 2021, the PSX is below most of its regional peers in market capitalization as a percentage of GDP (27.7% in Bangladesh, 99.0% in India, and 19.8% in Sri Lanka) in 2020.[10] The depth and breadth of the capital markets have also been restricted since many SOEs are not listed on the PSX because of a legacy of poor corporate governance and commercial performance of SOEs as well as excessive regulatory requirements for listings. SOEs also continue to rely on significant regular fiscal transfers and sovereign credit guarantees to maintain their operations. As a result, SOEs also miss out on the benefits from efficiency improvements through the discipline of stock market listing. Sophisticated products such as derivatives are not widely available in the capital markets.

8. **Constrained bond market development.** Pakistan's bond market (34% of GDP as of April 2020) is almost completely dominated by government borrowing. The government domestic bond market is primarily short dated with an average debt maturity of 3.6 years. Government debt management practices have limited capacity by international standards, although a professional Debt Management Office (DMO) has now been established. The DMO needs to be supplemented by a primary dealer system that actively supports the achievement of the government's debt management goals and continually seeks to develop deeper channels for distribution, thereby encouraging institutional investor participation. Auctioning of government securities is not based on market prices and hampers the formulation of a credible government yield curve and a liquid bond market. Although auctions follow a preannounced auction calendar, the government decides the cutoff yield for the debt rather than accepting a market-determined yield for the announced volume. This has restricted the volume and liquidity of longer-tenor government bonds, and yields do not then reflect true market conditions, which hinders the process of establishing a credible benchmark for medium- to long-term financing rates. This undermines the credibility of the primary market, as does the rejection of auction bids. The operating framework of the government bond market system does not promote competitive bidding. The government bond market offers limited

[10] CEIC. CEIC Data. https://www.ceicdata.com/en/indicator/pakistan/market-capitalization—nominal-gdp (accessed 10 August 2021).

sovereign *sukuks* (Islamic bonds) to cater to the liquidity management requirements of Islamic banks. Because of post-pandemic needs, a strong corporate and government bond market development will be critical to help a more sustainable and green recovery, including the issuance of social and sustainable development bonds, green bonds, and *sukuks*.

9. **Capacity-constrained Debt Management Office**. The DMO under the Ministry of Finance (MOF) faces capacity issues and does not function as a properly empowered treasury operation that develops and implements a consolidated administrative framework for debt management. The DMO's role has been to collate information and act as a conduit to government securities auctions. All decisions on terms, tenor, and structure of debt are made on a fragmented basis across the MOF. The DMO also does not possess a centralized database for effective cash management and planning. This exposes the government to the risk of default in case of any volatility in demand in the auctions for government bonds. A well-functioning DMO is not only imperative for the development of long-term government debt markets, but it also leads to (i) the development of institutional infrastructure for broader capital market development, and (ii) the provision of instruments to manage investors' financial risks. A strong DMO is also needed to monitor and manage risks from contingent liabilities more prudently and systematically and avoid defaults on non-guaranteed debts, including contractual obligations from public–private partnerships (including force majeure scenarios) and risks arising from catastrophes.

10. **Persistent weakness in regulatory capacity and governance structures.** The operational and financial efficiency of the Securities and Exchange Commission of Pakistan (SECP) has been constrained by the unclear appointment process, siloed operations where commissioners are responsible only for their designated areas rather than acting as a collegiate body, and limited clarity in the policy board's role. Its enforcement effectiveness is also challenged by the absence of a dedicated capital market tribunal. The court system does not have the competence to deliberate on securities cases, and the pace of resolving securities cases pending in the court system is also slow.

11. **Pakistan's financial inclusion for its population lagging to that of peer economies**. Pakistan ranked 135th out of 142 economies in the IMF's financial inclusion index in 2017. Lack of financial deepening is striking, with only about 40% of the adult population having access to formal bank accounts. In comparison of deposits with commercial banks to GDP, Pakistan lags behind regional peers like Bangladesh, India, and Thailand.[11] While the total assets and deposits of Pakistan's banking system have increased since 2008, private sector credit to GDP has declined from 22.7% in FY2009 to 17.2% in FY2020. This is because of a number of demand and supply side factors that have suppressed private sector credit in Pakistan. The hefty and growing demands for credit from government to fund ever larger fiscal deficits is the most important factor that weighs heavily on banks' incentive to extend credit to the private sector. Since large government borrowings also limit the supply of loanable funds to the private sector, only the blue-chip corporations get priority in banks' loaning decisions. The decline in credit provided to SMEs as a result has been particularly pronounced, falling from 16% of bank lending to the private sector in 2008 to just 7% in September 2019. Capital markets can create greater financial inclusion by introducing new products and services to suit investor risk and return, such as investment advisory and financial education. A strong capital market can also create a sustainable low-cost distribution mechanism for distributing debt and equity products across the country.

12. **Gender and inclusive capital markets.** As of 2021, Pakistan as a capital market is not gender inclusive. A mandatory female representation requirement on the boards of listed

[11] IMF. Financial Access Survey (accessed 10 October 2021).

companies, which attempted to break through the glass ceiling, has not delivered intended results. Given that there are only 255,000 accounts for stock trading, the participation of women as investors is minimal. Gender lens investing has not taken off because of women's limited access to capital, lower financial literacy, poor workplace equity, and limited products and services that are designed specifically to improve the lives of women. Major progress recently has been made in FY2021 by the central bank, which recently unveiled its Banking on Equality Policy.[12] There remains a lack of diversity and depth of products in the capital market such as gender bonds that would enable the access of women to capital markets. A further major constraint relates to the fact that employers in Pakistan's capital market are all heavily male-dominated, i.e., only 14% of staff at the PSX are female. Capital markets in Pakistan still require an effective, long-term strategy to attract, retain, and promote diverse talent.

13. ADB's Strategy 2030 prioritizes developing the finance sector and capital markets to support sustainable economic development by creating an enabling environment for private investment. The program will not only support private sector expansion but also contribute to the operational priorities of (i) strengthening governance and institutional capacity through specific institutional strengthening reforms, (ii) accelerating progress in gender equality through reforms that enhance the participation of female investors and decision-makers, and (iii) addressing poverty through general intervention for economic and private sector development.

B. Policy Reform, ADB's Value Addition, and Sustainability

14. ADB has been engaging with Pakistan since the 1990s and has been the lead development partner in supporting the evolution of the country's capital markets. Since 1997, ADB supported this development through four separate but interrelated programs. The first program, from 1997 to 2002, supported establishing the basic foundations for the market, including establishing the SECP and transitioning to a new regulatory regime through a $250 million PBL for the Capital Market Development Program.[13] From 2002 to 2007, a $260 million PBL for the Financial (Nonbank) Markets and Governance Program strengthened the institutional investor side around pension, insurance, and savings systems, as well as built up the nonbank finance subsector.[14] From 2007 to 2011, a $400 million PBL for the Second Generation of Capital Market Reform Program focused on developing an enabling environment for voluntary private pensions, adopting a professional certification regime, and implementing a self-regulatory organization model at the stock exchanges.[15]

15. This program builds on lessons from the previous programs, including (i) sustaining support across different authorities and ministries for a common strategy for capital market development, particularly in the state of the government bond market, institutional investor support, and the framework for securities; (ii) mobilizing domestic institutional investors who can mobilize savings across different asset classes and promote the buy side of capital markets; (iii) building retail investor capacity for participation in the capital markets; and (iv) leveraging technology to channel capital more effectively and manage risks.

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[12] SBP. 2020. *Draft Banking on Equality Policy: Reducing the Gender Gap in Financial Inclusion.* Pakistan.

[13] ADB. 1997. *Report and Recommendation of the President to the Board of Directors: Proposed Loan to the Islamic Republic of Pakistan for the Capital Market Development Program*. Manila.

[14] ADB. 2002. *Report and Recommendation of the President to the Board of Directors: Proposed Loans and Guarantees to the Islamic Republic of Pakistan for the Financial (Nonbank) Markets and Governance Program*. Manila.

[15] ADB. 2007. *Report and Recommendation of the President to the Board of Directors: Proposed Program Loan and Technical Assistance Grant to the Islamic Republic of Pakistan for the Second Generation of Capital Market Reform Program*. Manila.

16. The program builds on these lessons to introduce a holistic set of sequenced reform measures through a programmatic approach that deepens and broadens Pakistan's capital markets by (i) developing the government yield curve and promoting a more liquid government bond market; (ii) enhancing institutional investor demand by broadening, deepening, and diversifying the investor base; (iii) further strengthening of the institutional and regulatory capacity of the SECP, the DMO, and the Audit Oversight Board; (iv) developing important market infrastructure, such as new surveillance systems and a trading system for bonds; and (v) enhancing the supply of alternative financial instruments, such as derivatives and gender bonds. Importantly, to ensure all parties are brought into the reform process, the program is anchored in a long-term Capital Markets Development Plan and Roadmap, 2020–2027, approved by the finance minister as part of subprogram 1 reforms that helps ensure that the program is an integral part of a government-owned long-term development strategy.[16] The strategy's implementation across public and private sector stakeholders is being led by a high-level Capital Markets Implementation Council chaired by the finance minister as well as the regulators and independent advisors. The programmatic approach has been provided for the proposed reforms—grouped in four areas—to be chronologically sequenced in a multiyear framework, while allowing for flexibility to incorporate changes in an evolving environment.

17. **Reform area 1: Market stability strengthened.** These reforms are designed to promote more robust, resilient, and stable capital markets. Under subprogram 1, amendments were initiated to the SECP Act, 1997 to ensure structural changes in the appointment process of commissioners, and enhance operational efficiency by having commissioners operate as a collegiate body, while the National Finance Stability Council was established to deal with issues in cross regulatory domains. A new broker model was introduced to strengthen the brokerage industry by reducing the likelihood of broker defaults. The new model categorizes brokers according to their net worth and governance requirements, which will ascertain appropriate operational risks to be assumed by the brokers. These reforms continued with follow-up policy actions under subprogram 2, such as approval of the SECP Act amendments by the national assembly, exemption from income tax for the SECP, and notification of a customer custody regime for the brokerage industry. The post-program partnership framework (P3F) for the program will include notification of the SECP Act amendments after approval by Parliament, and issuance of secondary legislation for establishing a special tribunal for capital market-related cases after enactment of the amendment bill. Strong legal and institutional environment in governance and regulatory capacity is critical for the development of local capital markets as it forms the basis of attracting investor capital by ensuring stability by protecting investor rights.

18. **Reform area 2: Market facilitation enhanced.** These reforms will support more efficient resource mobilization and allocation in the economy by expediting the adjudication of enforcement actions, strengthening auditing standards, and enhancing market surveillance systems. Financial infrastructure including well-developed trading platforms and surveillance systems that facilitate efficient information exchange and disclosure, as well as stronger legal framework and resolution mechanisms are necessary to complement institutional environment for development of capital markets. Subprogram 1 actions included institutional strengthening of the Audit Oversight Board based on the adoption of international auditing standards, which will strengthen compliance, enhance market confidence, and allow for informed investment decisions. The formulation of a long-term national capital market master plan, developed with ADB's technical assistance (TA) for Supporting the Third Capital Market Development Program, helps ensure that the program is

[16] MOF. 2020. *Capital Markets Development Plan and Roadmap (2020–2027)*. Pakistan.

an integral part of a government-owned long-term development strategy.[17] The strategy lays down a detailed road map covering 76 actions under different strategic initiatives across four pillars: (i) develop demand, (ii) develop supply, (iii) reform legal and regulatory frameworks, and (iv) enhance market infrastructure. These reforms are being carried forward with follow-up policy actions under subprogram 2 and the P3F. Subprogram 2 actions include installing an upgraded electronic market surveillance system at the SECP, while P3F includes monitoring the progress of strategy implementation through the Capital Market Implementation Council.

19. **Reform area 3: Supply measures enhanced.** This area focuses on increasing the depth and breadth of the capital markets by promoting alternative financial instruments including derivatives and commodity futures, as well as providing an enabling framework to allow for increased access to financing by growth companies and SOEs. To promote listings, the PSX has launched a new Growth Enterprise Market for growth companies and/or SMEs to go public. The Growth Enterprise Market, besides facilitating listing of SMEs, greenfield projects, and start-ups, will also help them raise capital. Supply measures under subprogram 2 include (i) facilitate and expand the issuance of sovereign *sukuks*; (ii) facilitate listing of SOEs on the PSX to broaden and deepen the capital markets; (iii) promote the introduction of alternative asset classes, such as exchange-traded funds, options, futures, and sharia-compliant (compliant with Islamic principles) products; and (iv) issuing a framework for women entrepreneur bonds whose proceeds will help finance SMEs owned or led by women. The increased listing of SOEs will also help the government address other binding constraints in SOE management such as poor corporate governance and commercial performance.[18] The subprogram 2 also aims to increase the use of globally accepted derivatives to facilitate leverage in the market. Moreover, the federal government has approved a netting bill for passage by Parliament that will allow for enforcement of netting rights and collateral arrangements under financial contracts including for derivative instruments, thereby reducing counterparty risk, and promoting derivatives to develop a deeper and broader capital market. The P3F includes completion of offer for sale of at least one SOE on the PSX.

20. **Reform area 4: Demand measures enhanced.** These reform measures aim to enhance the scale of capital markets by not only encouraging investments by institutional and retail investors, but also by strengthening the government debt market. Local currency government bond markets can be a catalyst for the development of corporate bond markets by providing a yield curve benchmark against which to price bonds, market liquidity, and price revelation.[19] Demand measures in subprogram 1 included (i) onboarding new retail investors through simplified know-your-customer procedures with biometric verification; (ii) introducing volume-based auctions with variance limits to develop a credible government yield curve; (iii) approving a DMO staffing plan to strengthen debt management proficiency; and (iv) developing an SECP policy on gender mainstreaming that will raise demand for securities through the increased participation of female investors, since women's participation in Pakistan's capital markets is very low. Demand measures in subprogram 2 include (i) disallowing contractual savings institutions like provident, pension, gratuity, and superannuation funds from participating in the national savings schemes to expand demand in the capital markets;[20] (ii) introducing revisions to the primary dealer system

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[17] ADB. 2020. *Technical Assistance to the Islamic Republic of Pakistan for Supporting the Third Capital Market Development Program*. Manila.

[18] ADB has been the key development partner supporting the development of SOE (Governance and Operations) Bill in collaboration with the IMF and World Bank.

[19] Laeven, M.L., 2014. The Development of Local Capital Markets: Rationale and Challenges.

[20] National saving schemes are meant for individual investors lacking the resources and expertise to participate in the tradable securities markets. Restricting institutional participation in these schemes encourages participation in competitive auctions, which is important for primary market development.

to develop new and deeper channels for distribution of domestic government securities in developing an efficient primary government debt market; (iii) implementing buyback of fragmented issues and replacing them with liquid benchmark issues to create liquidity in the government bond market, keeping in view the cost risk trade off; and (iv) introducing online account opening to attract new retail investors. These measures saw a modest improvement in the number of the retail investor base, which stands at 255,000 as of 31 July 2021, but more importantly daily trading volumes on the PSX reached an all-time high of $404 million (2.21 billion shares) on 27 May 2021. Retail investors now account for 70% of the daily traded volumes and have invested more than $332 million during FY2021. Moreover, between January 2020 and December 2021, nine new companies have gone public on the PSX, and 12 new debt instruments were listed. The P3F will include notification of the amendments to the Fiscal Risk and Debt Limitation Act, 2005 after approval by the Parliament to strengthen the DMO, and completion of hiring of the DMO according to the approved organizational chart after the enactment of this amendment bill.

21. **Revisions in subprogram 2 indicative policy actions.** There are two types of revisions in the subprogram 2 policy matrix from the indicative policy matrix proposed during approval of subprogram 1.[21]

(i) A number of policy actions were strengthened for effective and speedy implementation of relevant reforms, including:
   (a) Approval of the National Assembly for amendments in the SECP Act and approval of the federal cabinet for enactment of the Netting Bill have been added to ensure continuity of subprogram 1 reforms.
   (b) Actions related to replacing the margin trading system and introducing derivatives were amended to better target the desired outcome of facilitating leverage at considerably less risk of drying out liquidity. The PSX will also expand product and asset class offerings by issuing regulations for options.
   (c) Other new actions include (1) revisions to the primary dealer system to develop an efficient primary government debt market that supplements the capacity building of the DMO, (2) allowing resident individuals for small investments in shares of listed companies abroad, and (3) fiscal incentives such as reduction of capital gains tax to 12.5% from 15% and removing anomalies for dividend taxation on different asset classes such as mutual funds and real estate investment trusts.

(ii) The following actions were deferred to P3F or replaced:
   (a) The establishment of the special tribunal for capital market cases relies upon the SECP (Amendment) Act being approved by the Parliament, and has been moved to P3F. The ADB TA is supporting to develop secondary legislation for establishment of the tribunal (footnote 17).
   (b) While the indicative matrix envisaged partial listing of at least three SOEs, approval for only one of the proposed three SOEs could be obtained by the government during the implementation period. The action was, however, strengthened by focusing on policy reform associated with SOE public offerings (rather than outcomes) and with approved Direct Listing Regulations that provide for relaxation of requirements for direct listing of SOEs.
   (c) The action relating to completion of DMO hiring to put staffing plans into operation has been deferred to P3F because of procedural delays on account of COVID-19.

[21] Revisions in the Policy Matrix (accessible from the list of linked documents in Appendix 2).

(d) The action relating to the appointment of at least two women representatives to the SECP policy board could not be completed during the implementation period. Therefore, this action has been replaced with a diversity action requiring institutionalization of SECP's gender policy (approved during subprogram 1 in 2020) where at least 50% of the SECP's fresh hires and 20% of the management team are women.

(e) Moreover, the indicative matrix envisaged approval of amendments to the insurance law as part of the legislative reforms for capital markets. However, after a detailed review of the proposed insurance amendment bill, given the considerable material reforms required in the insurance sector, it was concluded that this should form a separate sector development program.

22. Sequencing of reforms (such as the establishment of the special tribunal), as well as monitoring of reforms, necessitated the inclusion of P3F in the design of the programmatic approach and will be supported by ADB TA (footnote 17). The TA will support implementation of policy reforms, such as developing secondary legislation to establish the special tribunal, in the P3F period. The P3F will also help ADB design future programs in related areas.

23. **ADB's value addition.** The government, market participants, and development partners regard ADB as a credible party that will ensure a balanced and professional approach to guide and influence capital market reform not only in Pakistan but also in Central and West Asia (Uzbekistan) and other parts of South Asia (Bangladesh and Sri Lanka). In capital markets, ADB is uniquely qualified to play several roles, including issuer, investor, advisor, mobilizer of capital, standard setter, knowledge manager, and disseminator. In Pakistan, this is evidenced by ADB's leading role in supporting the long-term capital market master plan with the government, market participants, and regulators. ADB's value proposition includes (i) helping address the gaps in medium- to longer-term finance and financial stability, (ii) helping develop bond markets, (iii) supporting public management reforms by building strong institutional capacity and promoting good governance, and (iv) promoting private sector development. ADB's integrated approach combines professional and impartial policy advice with financial support, effective implementation support, and capacity development through TA to ensure sustainability.

24. **Development coordination.** Reforms under the program complement initiatives by other development partners such as the World Bank's Resilient Institutions for Sustainable Economy (RISE) development policy financing and the IMF's $6 billion EFF program. The second through fifth reviews of the IMF's EFF were approved on 24 March 2021, effecting a disbursement of $500 million.[22] The sixth review was concluded on 18 November 2021 and approved on 2 February 2022, making available for disbursement $1,053 million, bringing total disbursements under the EFF to about $3,027 million.[23] RISE aims to improve fiscal management and sustainability, enhance public debt management, and to support growth and competitiveness. RISE subprogram 1 for $500 million was approved in June 2020, while RISE subprogram 2 is scheduled for board consideration by June 2022, subject to compliance with policy actions. The EFF program includes recommendations on finance sector reforms that focus on deepening access to finance, implementing a sound debt management strategy, and supporting private sector development. Subprogram 2 supports these initiatives through developing alternative sources of access to

[22] IMF. 2021. *IMF Staff and Pakistan Reach Staff-Level Agreement on the Pending Reviews Under the Extended Fund Facility*. Press release. No. 21/41. 16 February. The EFF reviews were suspended during February–December 2020 and were consolidated in the 2nd–5th reviews in early 2021.

[23] IMF. 2021. *Pakistan: Staff Concluding Statement of the 2021 Article IV Mission and Staff-Level Agreement on the Sixth Review under the Extended Fund Facility*. The sixth review was completed on 18 November 2021.

finance (i.e., the capital markets), supporting solid debt management through bond market development, supporting debt management and transparency by strengthening the debt office, and facilitating private sector investment by mobilizing financial resources. ADB continues to hold regular consultations with the IMF and other development partners to ensure the alignment of development objectives and synergies, particularly in policy dialogue and reforms, fiscal regime and budgetary impacts, and broader macroeconomic debates that impact the ADB program.

25. In addition to the EFF, the IMF released a $1.4 billion Rapid Financing Instrument in FY2020 to meet pandemic response needs and allocated $2.7 billion in August 2021 as part of the global allocation to boost global liquidity and cope with the impact of the COVID-19 crisis.

C. Expected Outcome of the Reforms

26. The program is aligned with the overarching development objective under Pakistan Vision 2025: capital markets act as a major catalyst in transforming the economy into a more efficient, innovative, and competitive marketplace within the global arena (footnote 2). The program has the following reform effect—the capacity and size of capital markets augmented, which is structured around four reform areas: (i) market stability strengthened, (ii) market facilitation enhanced, (iii) supply measures enhanced, and (iv) demand measures enhanced. Subprogram 1 reforms focused on strengthening the institutional and regulatory capacity of the SECP, the DMO, and the Audit Oversight Board, while subprogram 2 will carry forward the reforms from subprogram 1 and catalyze institutional investor demand and increase the supply of alternative financial instruments, such as derivatives. The proposed reforms conform to best practices, including those promulgated by the International Organization of Securities Commissions.[24]

27. The program will help mobilize financial resources for productive investment, especially by the private sector, and help generate employment by supporting the development of bond and equity capital markets. This will help reduce the cost of financial intermediation and help stabilize systemic vulnerabilities in the bank-dominated finance system.[25] There are three specific transmission channels. First, by addressing policy and regulatory constraints on the issuance of corporate securities, the program will help increase the number of bond and equity issues, both primary and secondary. This will help mobilize scarce financial resources for long-term private sector investment. Second, by promoting the development of corporate securities markets and institutional investors, thereby diversifying financial instruments, and broadening the investor base, the program will reduce market volatility and improve the finance sector's resilience to external shocks. Third, by strengthening market governance in capital markets, the program will enhance market efficiency and transparency and improve investor protection.

D. Development Financing Needs and Budget Support

28. **Pakistan's development financing needs.** The government's foreign borrowing is expected to be $32.258 billion in FY2022 against foreign financing needs of $34.45 billion (Table 1). The surplus will be reflected as an increase in the reserve assets at the end of the fiscal year, after adjusting for any fluctuations in the gross financing requirement estimates.

[24] The policy design and monitoring framework is in Appendix 1.
[25] Program Economic Assessment (accessible from the list of linked documents in Appendix 2).

Table 1: External Financing Needs and Projected Support for Fiscal Year 2022
($ million)

Item	Amount
Gross foreign financing requirement	**32,258**
Available financing	**35,451**
Asian Development Bank's policy-based loans and results-based loan	
Third Capital Market Development Program, subprogram 2	300
Energy Sector Reform Program, subprogram 2	300
Integrated Social Protection Development Program (results-based loan)[a]	112
World Bank, others	1,838
International Monetary Fund	5,823
Bilateral	
People's Republic of China	4,063
Others	3,511
Commercial and bonds	10,682
Private sector creditors	8,784
Other net capital inflows	38

[a] The amount represents expected disbursement of $112.5 million in FY2022 from the loan amount of $600 million.
Source: Finance Division, Debt Management Office.

29. Based on the development financing requirements of the program, the government has requested a concessional loan of $300 million from ADB's ordinary capital resources to help finance subprogram 2.[26] The loan will have a 25-year term, including a grace period of 5 years; an interest rate of 2.0% per year during the grace period and thereafter; and such other terms and conditions set forth in the draft loan agreement. [27]

30. **Debt sustainability.** The debt sustainability analysis suggests that the public debt-to-GDP ratio is expected to decline gradually from 88.6% in FY2021 to 70.4% by FY2026.[28] While total public debt remains sustainable, during FY2021–FY2026 the public debt-to-GDP ratio remains higher than the debt threshold of 70.0%, declining to 70.4% in FY2026. Despite improvement in the maturity structure of the public debt, macro-fiscal shocks continue to pose a threat to debt sustainability in the medium term. The government has so far successfully secured external financing to meet the financing gap, yet delayed implementation of fiscal and structural reforms and continuation of low growth may undermine debt sustainability. Although financial assistance from ADB and other development partners will not impair debt sustainability, the government will need to monitor fiscal risks and remain committed to fiscal consolidation to maintain macroeconomic stability to ensure debt sustainability.

E. Implementation Arrangements

31. The MOF is the executing agency for the program. The MOF (including the DMO), the State Bank of Pakistan, SECP, and PSX are the implementing agencies. The Capital Markets Implementation Council has been established to oversee and coordinate program implementation. The proceeds of the PBL will be withdrawn following ADB's *Loan Disbursement Handbook* (2017, as amended from time to time). The programmatic approach was implemented from June 2019 to January 2022. Subprogram 2 implementation was covered from September

[26] The proposed loan is included in the latest commitment projection and reflected in the assessment of ADB's risk bearing capacity in the Quarterly Risk Management Report 2021 Q3.
[27] The development policy letter is in Appendix 3.
[28] Debt Sustainability Assessment (accessible from the list of linked documents in Appendix 2).

2020 to January 2022. The P3F is expected to be implemented from February 2022 to December 2023.

III. DUE DILIGENCE

32. **Governance**. A governance risk assessment was prepared by ADB staff while following the Guidelines for Implementing ADB's Second Governance and Anticorruption Action Plan.[29] The assessment reviewed areas of possible risk and vulnerability in public financial management, including (i) abrupt changes in administrative procedures and ministry leadership, with high staff turnover that may hinder smooth implementation of reforms; (ii) reduction in political support and government commitment to reforms; and (iii) weak institutional capacity and lack of coordination among the executing agency and implementing agencies. While no major risks of mismanagement of resources at the implementing level were highlighted, Pakistan has extensive centralized legislative and institutional public financial management structures, so budget execution remains an area of weakness. Institutional capacity development was targeted as a policy change under the program and under the transaction TA (footnote 17). ADB aims for continuous consultations and monitoring to mitigate any impact from the risks.

33. **Poverty and social**. Without the pandemic, the poverty incidence (below the poverty line of $3.20 a day) was estimated at 36.4% in 2020, but it is expected to increase to 39.1% under the pandemic scenario.[30] The capital market reforms will help lower financial intermediation costs and encourage private sector investment, leading to higher sustainable growth and job-creation opportunities. The program also mitigates the negative impact of capital market instability on the poor. It also helps Pakistan to diversify its financial system so the country can realize its broad-based economic growth and socioeconomic development objectives, including poverty reduction.

34. **Gender.** The program seeks to address gender disparities, particularly women's limited access to capital markets. Subprogram 2 was categorized *effective gender mainstreaming*. The program has three specific gender-related actions to reinforce the importance of gender and capital markets. Under this program, the SECP approved a framework for issuing gender bonds to support women entrepreneurs and their financial inclusion. Moreover, the SECP institutionalized its gender mainstreaming policy to promote greater regulator-driven diversity and inclusion behaviors by having (i) 51% of fresh employees were women during FY2020, and (ii) female officers were heading 22% of departments within the SECP. The PSX also approved a gender policy that includes (i) a minimum percentage of female staff within the management cadre, (ii) a minimum number of female candidates interviewed when hiring for an open position, and (iii) a consistent rewards and remuneration package across genders.

35. **Safeguards**. The policy actions supported by the program are not expected to have adverse impacts on the environment and indigenous peoples, nor lead to involuntary resettlement. Given the nature of the program, all three safeguard categories (environment, involuntary resettlement, and indigenous peoples) are categorized C under the PBL.

36. **Risks and mitigating measures**. The program's risk assessment is rated *moderate* since (i) ADB has solid experience in the sector in Pakistan; (ii) the MOF, being the executing agency, has a good performance record in the implementation of externally financed projects; and (iii) the program is unlikely to have any adverse impacts on safeguards. Major risks and mitigating

[29] Public Financial Management and Governance Risk Assessment (accessible from the list of linked documents in Appendix 2).

[30] J. Bulan et al. 2020. COVID-19 and Poverty: Some Scenarios. Unpublished (note prepared for ADB's Economic Research and Regional Cooperation Department).

measures are summarized in Table 2 and described in detail in the risk assessment and risk management plan.[31] Other risks include delay in implementation because of weak institutional capacity and lack of coordination between the executing and implementing agencies, which are expected to be mitigated through the provision of TA to improve the capacity of the implementing agencies (footnote 17), and continuous engagement by ADB with the government for regular consultations and monitoring.

Table 2: Summary of Risks and Mitigating Measures

Risk	Mitigation Measure
Weak internal controls and audit functions leading to fiduciary risks.	ADB will make provisions for financial management and audit, including capacity development, in ADB projects.

ADB = Asian Development Bank.
Source: Asian Development Bank.

37. ADB's Anticorruption Policy (1998, as amended to date) was explained to and discussed with the government and the MOF.

IV. ASSURANCES

38. The government has assured ADB that implementation of the program shall conform to all applicable ADB policies, including those concerning anticorruption measures, safeguards, gender, procurement, consulting services, and disbursement, as described in detail in the draft loan agreement.

V. RECOMMENDATION

39. I am satisfied that the proposed policy-based loan would comply with the Articles of Agreement of the Asian Development Bank (ADB) and recommend that the Board approve the loan of $300,000,000 to the Islamic Republic of Pakistan for subprogram 2 of the Third Capital Market Development Program, from ADB's ordinary capital resources, in concessional terms, with an interest charge at the rate of 2% per year during the grace period and thereafter; for a term of 25 years, including a grace period of 5 years; and such other terms and conditions as are substantially in accordance with those set forth in the draft loan agreement presented to the Board.

Masatsugu Asakawa
President

1 March 2022

[31] Risk Assessment and Risk Management Plan (accessible from the list of linked documents in Appendix 2).

POLICY DESIGN AND MONITORING FRAMEWORK

Country's Overarching Development Objective Capital markets act as a major catalyst in transforming the economy into a more efficient, innovative, and competitive marketplace within the global arena. (Pakistan Vision 2025)[a]

Outcome	**Risks and Critical Assumptions**
Capacity and size of capital markets augmented.	R: Lack of inter-ministerial coordination hinders the implementation of reform measures envisaged under the program. Sudden changes in administrative procedures, political and ministerial leadership, major staff turnover, and COVID-19's impact on the economy cause delays, including for legislative process.

Prior Actions: Subprogram 1 (Completed: June 2019–August 2020)	**Prior Actions: Subprogram 2** (Completed: September 2020–January 2022)	**Outcome Indicators**	**Post-Program Partnership Framework** February 2022–December 2023
Reform Area 1: Market stability strengthened			
1.1. Federal Cabinet approved the amendments in SECP Act, 1997 (Act) to enhance SECP's operational efficiency that includes the following key elements: (i) enhancing SECP's governance by providing a transparent appointment process and code of conduct for statutory posts and strengthening of provisions pertaining to eligibility criteria, dismissal and conflict of interest; (ii) ensuring operations of commission as a collegiate body; and (iii) clarifying role of the policy board. (Document Required: Federal Cabinet approval for amendment in Act) 1.2. SECP introduced new broker model to strengthen brokerage industry that included approval of the roadmap for	2.1 The National Assembly has approved the SECP (Amendment) Bill 2021 to enhance SECP's operational efficiency. (Document Required: Approval of National Assembly of the SECP [Amendment] Bill, 2021) 2.2 Government of Pakistan approved exemption from income tax for SECP, effective 30 June 2021, through amendment in Income Tax Ordinance, 2001, to create a consistent tax environment for financial sector regulators. (Document Required: Government of Pakistan [the government] notification for amendment in Income Tax Ordinance, 2001) 2.3 SECP has issued notification for implementation of customer custody	a. By June 2022: The government has notified the SECP (Amendment) Bill 2021 for implementation, after approval by the Parliament. (Baseline 2020: The federal cabinet has approved the SECP [Amendment] Bill 2021)	• The government has notified the amended SECP Act, 1997 after approval of Parliament. • The government has notified the road map for establishment of a special tribunal for capital market-related cases and issued regulations.

Prior Actions: Subprogram 1 (Completed: June 2019–August 2020)	**Prior Actions: Subprogram 2** (Completed: September 2020–January 2022)	**Outcome Indicators**	**Post-Program Partnership Framework** February 2022–December 2023
custody consolidation and amendments to the securities brokers regulations for (i) licensing of brokers, (ii) categorization of brokers, (iii) additional requirements for trading and clearing brokers, and (iv) relaxation of requirements for zero custody brokers. (Document Required: SECP SRO for amendments in the regulations) 1.3. MOF established the National Finance Stability Council comprised of SBP, SECP, and MOF to improve inter-agency policy coordination and play an instrumental role in dealing with systematic issues that cut across regulatory domains. (Document Required: Signed Memorandum of Understanding by SBP, SECP and MOF)	regime for brokerage industry to (i) prescribe minimum threshold for liquid capital, (ii) discontinue net capital balance regime, and (iii) prescribe different slabs of paid up capital and net worth requirement for broker, in order to strengthen the brokerage industry.[b] (Documents Required: [i] SECP notification on Implementation of Liquid Capital Requirements on Securities Brokers [including any required extension in cut-off date]; and [ii] SECP notification of Professional Clearing Members Regulations)		• Finance Division continues to monitor the progress of National Finance Stability Council.
Reform Area 2: Market facilitation enhanced			
1.4. Government (i) approved long-term capital market master plan to guide direction and implementation of capital market development reforms, and (ii) established a Capital Market Implementation Council comprising of MOF, SBP and SECP at the strategic level to spearhead and implement the master plan (5–7 years). (Document Required: Finance Advisor approval of master plan and the	2.4 SECP has completed testing on the pilot phase of the new market surveillance system installed at PSX to maintain market integrity.[c] (Document Required: Letter from SECP confirming that testing on the surveillance terminal of the market surveillance system has been successfully completed).	b. By December 2022: At least 30 of the 76 recommendations of the Capital Market Development Plan (2020–2027) have been fully implemented, and at least 20 recommendations are in process.	• The new market surveillance system at PSX, with terminal at SECP, will go-live by June 2022. • Finance Division continues to monitor the progress of Capital Market Implementation Council.

Prior Actions: Subprogram 1 (Completed: June 2019–August 2020)	**Prior Actions: Subprogram 2** (Completed: September 2020–January 2022)	**Outcome Indicators**	**Post-Program Partnership Framework** February 2022–December 2023
government issuance of a notification of capital market advisory council) 1.5. Federal Cabinet approved amendments in SECP Act, 1997 to strengthen AOB's independence, financial resources, and regulatory powers. (Document Required: Federal Cabinet approval for amendments to SECP Act, 1997) 1.6. Federal Cabinet approved amendment in the SECP Act, 1997 (Act) to replace section 33 and section 34 of Act with a new section "Capital Markets Tribunal" to establish a special tribunal for capital market-related cases. (Document Required: Federal Cabinet approval for amendment in SECP Act, 1997) 1.7. PSX installed an upgraded electronic market surveillance system to maintain market integrity. (Document Required: PSX signed agreement and evidence of payment to vendor for establishment of a market surveillance system)		(2021 baseline: 22 recommendations have been implemented)	
Reform Area 3: Supply measures enhanced			
1.8. PSX established GEM to encourage SME listing that includes the following elements: (i) reduce the regulatory requirements for eligible companies, including SMEs; and	2.5 To promote supply measures to deepen the capital markets: (i) PSX has rolled out Direct Listing Regulations that allow for an alternative way of listing on the PSX without mandatory appointment of	c. By December 2022: Number of listed companies in the equity market increased to 550. (2021	• The government has completed partial listing through offer for sale of at least one state-owned entity on the PSX.

Prior Actions: Subprogram 1 (Completed: June 2019–August 2020)	**Prior Actions: Subprogram 2** (Completed: September 2020–January 2022)	**Outcome Indicators**	**Post-Program Partnership Framework** February 2022–December 2023
(ii) issuance of regulatory framework for GEM. (Document Required: PSX Notification for regulatory amendments) 1.9. Federal Cabinet approved proposal to streamline taxation regime for non-resident companies investing in debt securities to enhance institutional investor demand. (Document Required: ECC decision dated 4 September 2019 and SBP Notification) 1.10. Federal Cabinet approved Netting Bill, in-principle, to promote issuance of derivatives through reduction in counterparty risk. (Document Required: Federal Cabinet in-principle approval of the Netting Bill)	intermediary(ies) and provision of relaxation of requirements for direct listing of state-owned entities. (Document Required: Amended PSX rule book with inclusion of chapter on Direct Listing Regulations). (ii) Cabinet committee on privatization has approved partial listing of at least one state-owned entity on the PSX either through offer for sale and divestment of government holdings or secondary public offerings of listed companies.[d] (Document Required: cabinet committee approval secondary offering of Pakistan Reinsurance Company Limited) 2.6 MOF has issued framework for issuance of asset light *sukuk* structures to facilitate development of shariah compliant *sukuk* market, and set a target to increase the share of Shariah compliant instruments in domestic securities should be at least 10% by the end of FY2023 (Document Required: MOF Notification).[e] 2.7 To promote derivatives and to facilitate leverage in the capital market and reduce market risk: (i) SECP has allowed 90-day deliverable futures contracts (DFCs), and removed mandatory	baseline: 531 listed companies). d. By December 2022: At least 2 companies have been listed on the GEM board. (2020 baseline: No listings on GEM board) e. By December 2022: Trading volume in PSX futures market is enhanced to average daily turnover of 175 million shares. (2019 baseline: 46 million shares).	

Prior Actions: Subprogram 1 (Completed: June 2019–August 2020)	**Prior Actions: Subprogram 2** (Completed: September 2020–January 2022)	**Outcome Indicators**	**Post-Program Partnership Framework** February 2022–December 2023
	roll-over week requirements with effect from June 2021; (ii) PSX has issued regulations for implementation for options and exchange-traded funds to expand product and asset class offerings; (iii) SECP has introduced futures contracts based on e-warehouse receipts for trading on PMEX; (iv) The government has approved amendment in the Income Tax Ordinance, 2001 to exempt commodity futures contracts listed on PMEX from withholding tax under section 153 of the ordinance; and (v) The Cabinet Committee on Disposal of Legislative Cases has approved Netting of Financial Arrangements Bill for submission to the parliament after ratification by the cabinet, for promotion of derivatives by reduction in counterpart risk. (Document Required: SECP, PSX, and PMEX Notifications, cabinet committee approval of Netting of Financial Contracts Bill, 2021) 2.8 The SECP has approved framework for issuing Gender Bonds for implementation by potential financiers to facilitate the issuers of debt securities to diversify their source of financing and provide an additional		• The government has submitted the netting of financial arrangements act to the parliament.

Prior Actions: Subprogram 1 (Completed: June 2019–August 2020)	**Prior Actions: Subprogram 2** (Completed: September 2020–January 2022)	**Outcome Indicators**	**Post-Program Partnership Framework** February 2022–December 2023
	financial instrument to increase visibility of women entrepreneurship and facilitate its access to finance. (Document Requirement: SECP Guidelines for issuance of gender bonds, effective May 2021) 2.9 To improve and streamline the regulatory environment, the Cabinet Committee on Disposal of Legislative Cases has approved for submission to the parliament after ratification by the cabinet: (i) non-banking finance companies (NBFC) Bill, (ii) consolidation of Securities and Future Acts approved, and, (iii) removal of regulatory restrictions from voluntary pension system (VPS) Rules 2005, with effect from 29 June 2021. (Document Required: cabinet committee approvals for the above)		• The government has submitted the NBFC Bill and the amalgamated Securities and Futures Bill to the parliament.
Reform Area 4: Demand measures enhanced			
1.11. MOF strengthened DMO's operational and technical proficiency to entrench sound debt management practices that includes the following elements: (i) the government approved the organizational chart and staffing plan for DMO; and (ii) the government allowed DMO involvement in sequencing and structuring Annual Borrowing Plan.	2.10 The government has improved debt management practices by: (i) The cabinet has submitted amendment to FRDLA, 2005 to the parliament, to make DMO responsible for debt raising and proposing policy guidelines regarding raising of external debt;[f] and (ii) The government has provided access to the DMO for utilization of	f. By December 2022: DMO has prepared and published debt strategy, debt review, policy guidelines, and quarterly borrowing plan. (2020 Baseline: DMO is publishing	• The government has completed recruitment of 6 additional positions in the DMO according to the approved organizational chart, and notified the FRDLA amendment act after approval of parliament.[g]

Prior Actions: Subprogram 1 (Completed: June 2019–August 2020)	**Prior Actions: Subprogram 2** (Completed: September 2020–January 2022)	**Outcome Indicators**	**Post-Program Partnership Framework** February 2022–December 2023
1.12. MOF established a committee comprising CDNS, DMO, and SBP to finalize a plan for the elimination of institutional investors from NSS products. (Document Required: MOF Office Order of the committee to develop a plan with clear timelines for implementation of actions) 1.13. MOF implemented auctions of Government securities through adherence to target volumes (with maximum variance of 25%) to enhance determination of market-based yield. (Document Required: Government of Pakistan and MOF Office Order) 1.14. PSX amended procedure for onboarding new retail investors through simplified know your customer involving biometric verification to enhance retail investor demand. (Document Required: NCCPL Notification) 1.15. SECP approved a gender policy document entitled "Gender Mainstreaming" for promotion of female participation in the governance of capital markets and increased access to capital markets by females. (Document Required: SECP approved policy)	an integrated debt recording and information system to provide for the enhanced role regarding repository of debt data to maintain consistent and authenticated record of public debt and government guarantees. (Documents Required: [i] MOF Office Memorandum; [ii] Cabinet approval of FRDLA Amendment Act 2021; [iii] MOF Office Order ensuring DMO access to DMFAS) 2.11 To establish a more active debt market, SBP has completed the architectural design and system specification of a new centralized trading platform to be used for primary, secondary government debt market. (Document Required: SBP agreement with vendor) 2.12 To improve overall institutional investor involvement in capital markets, MOF has: (i) restricted participation of institutional investors from NSS products, and (ii) made DMO responsible for pricing and selection of NSS debt instruments. (Document Required: [i] MOF Office Order; [ii] MOF Office Order)	debt strategy, debt bulletin, and debt policy statement) g. By December 2022: Individual investor accounts at PSX increased to at least 300,000. (2021 baseline: 255,000) h. By December 2022: At least 275 listed companies have at least one female director on their boards. (2020 baseline: 265 listed companies have female representation on the board)	• The implementation of centralized trading platform for primary and secondary debt market is completed by June 2022.

Prior Actions: Subprogram 1 (Completed: June 2019–August 2020)	**Prior Actions: Subprogram 2** (Completed: September 2020–January 2022)	**Outcome Indicators**	**Post-Program Partnership Framework** February 2022–December 2023
1.16. SECP mandated female representation on the board of directors of all listed companies by: (i) making it mandatory to have at least one female director on the board, effective after the expiry of the current board terms, reinforcing the requirement of section 154 of the Companies Act, 2017; (ii) ensuring mandatory disclosure of female directors as part of the board composition in the annual Statement of Compliance with Listed Companies (Code of Corporate Governance) Regulations, 2019, as well as in the directors' report accompanying quarterly financial statements; and (iii) encouraging listed companies to arrange directors' training for at least one female executive from July 2020 onwards, to increase the number of female leaders and directors. (Document required: SRO 1163 for Listed Companies [Code of Corporate Governance] Regulations, 2019).	2.13 To promote a more liquid government debt market, (i) SBP has introduced reopening mechanism of Government *Ijara Sukuks* to raise additional funds for the government from capital markets; and (ii) MOF has introduced a mechanism to create liquid benchmark bond issues through buy back of fragmented issues and replacing them with liquid benchmark issues. (Document Required: [i] SBP Circular No DMMD Circular No. 19 of 2020, and [ii] MOF notification of approved mechanism) 2.14 The government has approved amendments in Income Tax Ordinance, 2001 to: (i) reduce capital gains tax to 12.5% from 15.0% to promote capital market investment by retail and institutional investors; and (ii) remove anomalies for dividend taxation on different asset classes such as mutual funds and real estate investment trusts to promote a level tax playing field. (Document Required: SRO confirming approved amendments) 2.15 SECP has introduced online account opening system to allow online onboarding for improving access for		

Prior Actions: Subprogram 1 (Completed: June 2019–August 2020)	Prior Actions: Subprogram 2 (Completed: September 2020–January 2022)	Outcome Indicators	Post-Program Partnership Framework February 2022–December 2023
	retail customers and grow the retail investor base. (Document Required: SECP and NCCPL notifications) 2.16 To facilitate cross-border investment flows, and enhance efficiency: (i) SBP has introduced a new mechanism to enable companies in Pakistan to easily remit disinvestment proceeds to its foreign shareholders through delegation to banks, to facilitate foreign direct investment; and (ii) SBP has allowed resident individuals to remit funds through authorized dealers for small investments in shares of listed companies abroad. (Document Required: SBP Notification or Circular) 2.17 The SBP has revised and implemented the rules governing the primary dealer system to develop new and deeper channels for distribution of domestic government securities to develop an efficient primary government debt market. (Required Document: Master Circular - Rules Governing Primary Dealer System dated 12 April 2021) 2.18 SECP has institutionalized its gender mainstreaming policy to promote		

Prior Actions: Subprogram 1 (Completed: June 2019–August 2020)	**Prior Actions: Subprogram 2** (Completed: September 2020–January 2022)	**Outcome Indicators**	**Post-Program Partnership Framework** February 2022–December 2023
	greater regulator-driven diversity and inclusion behaviors; evidenced by having (i) 50% of females as fresh employees during latest financial year, and (ii) female officers heading 20% of departments within the Commission. (Document required: SECP latest annual report).[h] 2.19 PSX has approved diversity and inclusion policy for implementation that includes the following elements: (i) a minimum percentage of female staff within the management cadre, (ii) a minimum number of female candidates interviewed when hiring for an open position, and (iii) a consistent rewards and remuneration package across genders.[i] (Document Required: PSX letter confirming approval of policy)		
Budget Support ADB: $600 million (ordinary capital resources loan), over two subprograms of $300 million each			

ADB = Asian Development Bank; AOB = Audit Oversight Board; CDNS = Central Directorate of National Savings; COVID-19 = coronavirus disease; DMFAS = Debt Management and Financial Analysis System; DMO = Debt Management Office; ETF = exchange-traded funds; FRDLA = Fiscal Responsibility and Debt Limitation Act, 2005; GDP = gross domestic product; GEM = Growth Enterprise Market; MOF = Ministry of Finance; MOU = memorandum of understanding; NSS = National Savings Scheme; PDMF = policy design and monitoring framework; PMEX = Pakistan Mercantile Exchange; PSX = Pakistan Stock Exchange; R = risk, SBP = State Bank of Pakistan; SECP = Securities and Exchange Commission of Pakistan; SMEs = small and medium-sized enterprises.

[a] Government of Pakistan. 2018. *Pakistan 2025: One Nation – One Vision.* Islamabad.

[b] A new broker model was introduced by the SECP to strengthen the brokerage industry for categorization of brokers. The liquid capital requirements for different categories of brokers have been announced by SECP and PSX for compliance by the brokers. An independent professional clearing member has been established and is fully functional to provide services to different categories of brokers.

[c] A memorandum of understanding has been signed between SECP and PSX for provision of surveillance terminal to SECP. The testing for the pilot version of the surveillance system has been completed. The production version of the surveillance system is expected to go live by June 2022.
[d] Due to COVID-19 impact, the capital market situation did not permit the listing of three SOEs as envisaged at the time of subprogram 1 approval. However, the approval from the cabinet committee of privatization for the offer for sale of Pakistan Reinsurance Company is in place.
[e] Asset light *sukuk* structures can be instrumental in increasing access to finance for the government. The framework for issuance of asset light *sukuk* will allow the government to issue *sukuks* based on modalities other than the *ijarah sukuk*, when needed. The share of shariah compliant instruments in government securities was at 2% in FY2020, which is being targeted to 10% for FY2023.
[f] Fiscal Responsibility and Debt Limitation (FRDLA) Act, 2005 amendments to make DMO responsible for: (a) raise domestic debt through domestic government securities, bank loans or any other domestic borrowing instruments other than those issued by the CDNS; (b) raise external debt through commercial sources including debt securities such as bonds, sukuks, bank loans or any other commercial borrowing instruments; (c) propose policy guidelines to Finance Division and Economic Affairs Division regarding raising of external debt through multilateral and bilateral sources; and (d) prepare and finalize medium-term debt management strategy with approval of Minister of Finance, in line with the medium-term budgetary framework.
[g] Three deputy director positions have been added for public borrowing, risk management, and data management and analytics.
[h] SECP gender mainstreaming policy encourages women representation and decision-making positions and recruitment of women at all levels
[i] Under the policy, PSX will ensure that a nondiscriminatory salary and benefits allocation is always awarded to all employees irrespective of gender.

Contribution to Strategy 2030 Operational Priorities: Operational priority indicators to which this operation will contribute results are detailed in Contribution to Strategy 2030 Operational Priorities (accessible from the list of linked documents in Appendix 2).

Source: Asian Development Bank.

LIST OF LINKED DOCUMENTS

http://www.adb.org/Documents/RRPs/?id=53221-003-3

1. Loan Agreement
2. Sector Assessment (Summary): Finance (Money and Capital Markets)
3. Contribution to Strategy 2030 Operational Priorities
4. Development Coordination
5. International Monetary Fund Assessment Letter
6. Summary Poverty Reduction and Social Strategy
7. Program Economic Assessment
8. Risk Assessment and Risk Management Plan
9. List of Ineligible Items
10. Management-Approved Concept Paper: Proposed Programmatic Approach and Policy-Based Loan for Subprogram 1 to the Islamic Republic of Pakistan for the Financial Markets Development Program
11. Approved Report and Recommendation of the President to the Board of Directors: Proposed Programmatic Approach and Policy-Based Loans for Subprogram 1 and Technical Assistance Grant to the Islamic Republic of Pakistan for the Third Capital Market Development Program

Supplementary Documents

12. Key Revisions in the Policy Matrix
13. Public Financial Management and Governance Risk Assessment
14. Debt Sustainability Analysis

DEVELOPMENT POLICY LETTER

Shaukat Tarin
Minister for Finance and Revenue

F. No. 1(11)ADB/2019

ISLAMABAD

February 8, 2022

SUBJECT: **DEVELOPMENT POLICY LETTER FOR THE THIRD CAPITAL MARKET DEVELOPMENT PROGRAM – SUBPROGRAM 2**

Dear President Asakawa,

As part of its overall macroeconomic development agenda, the Government of the Islamic Republic of Pakistan (GOP) has been undertaking reform measures under the Third Capital Market Development Program – Subprogram 2 (the Program), through support by the Asian Development Bank (ADB). The development of domestic capital market is critical for the uplift of country's economy and for putting it on a path to greater and sustainable growth.

Despite a robust infrastructure foundation, our capital market lacks the sophistication, diversity, and depth to effectively channel savings into much needed investment and sustainable growth. Several factors have contributed towards curtailed growth of the capital market including supply and demand constraints, weak coordination among financial regulators, absence of level playing field among the regulators, inconsistencies in policies, and limited access to the market.

First and foremost, support under the Program has been vital for the Government to embark on several legislative reforms including strengthening the operational capacity of Securities & Exchange Commission of Pakistan (SECP) and providing consistent tax environment to financial sector regulators through amendments to the SECP Act 1997 and Income Tax Ordinance 2001, respectively. Other measures included introduction of new legislations like Netting of Financial Arrangements Bill to promote derivatives in the capital market, Non-Banking Finance Companies Bill for the development of non-banking finance companies, and Securities and Futures Bill to streamline the regulatory environment. While the legislative reforms have been approved by the cabinet, the Government is committed to fully complete the reforms as part of ADB's post program partnership framework (P3F).

Furthermore, to deliberate on issues and trends in the financial system affecting financial stability, and suggest a coordinated policy response, the Government had established a National Finance Stability Council with representations from the Ministry of Finance, SBP and SECP. The Government also continues to implement recommendations under the 7-year Capital Market Development Roadmap, as approved under the subprogram 1. Similarly, through support of ADB, SECP and Pakistan Stock Exchange (PSX) continue to work towards gender diversity and inclusion through promotion of institutionalized gender mainstreaming policies.

In order to enhance market integrity and investors' confidence, SECP has implemented measures to strengthen the brokerage industry, while enhancing its oversight and enforceability capacity through installation of market surveillance system. Other measures such as reduction of capital gains tax and promoting a level playing field, through amendments to Income Tax Ordinance, 2001, will further boost investor's confidence to channel their investments to the capital market. Digital onboarding of retail investors has also been launched to improve access to the capital market and to diversify the investor base.

To improve the supply of securities in the capital market, the Program has supported SECP in relaxing requirements for listing of state-owned entities (SOEs) through issuance of Direct Listing Regulations. The Government remains committed to continuing its privatization program through divestment of SOE's shareholdings through the PSX in a phased manner. In this regard, divestment of 20% shares of Pakistan Reinsurance Company (PakRe) is expected to be completed in FY 2022, under the P3F. Other measures include introduction of framework for asset light sukuk structures. A framework of issuance of gender bonds has also been approved by SECP to support women entrepreneurship and to improve financial inclusion.

Under the Program, the capacity of Debt Management Office has been enhanced to improve debt management practices, through assigning it greater responsibility in debt management and policy making, while maintaining record of government debt and guarantees. To this effect, amendment to Fiscal Responsibility and Debt Limitation Act, 2005 (FRDLA) has been submitted to the Parliament, the approval of which will be reported under P3F, alongwith the staffing of the debt office. The Government has also endeavored to develop debt capital markets allowing it to raise required funding from the capital market and encouraging institutional investors to channel their investment into debt capital market. Additional measures by SBP aim to enhance cross border trades by facilitating the domestic and foreign investors in remitting small investments and disinvestment proceeds, respectively.

As the Government continues to work towards development of domestic capital market for the overall objective of country's economic growth, it appreciates ADB's continued commitment in supporting its efforts. The Government will continue to strive for successful completion and monitoring of reforms during P3F, such as the program legislative actions, roadmap for establishment of a special tribunal for capital market related cases, and monitoring of reforms through the Capital Market Implementation Council.

In light of the above and in continuation of subprogram 1, the Government would like to request ADB for provision of loan of $300 million in consideration of the policy reform measures under the subprogram 2. Successful implementation of the reforms is integral in supporting other ongoing structural, legal, and fiscal reforms and would put the country on track for sustainable growth.

We welcome and look forward to ADB's continued support in reform efforts.

With regards,

Yours sincerely,

(SHAUKAT TARIN)

Mr. Masatsugu Asakawa
President,
Asian Development Bank,
Manila,
Philippines.