FINANCIAL MARKET RECOMMENDATIONS TO A.I.D./MOROCCO

Bureau for Private Enterprise
U.S. Agency for International Development

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Arthur Young
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MOROCCO FINANCIAL MARKETS REPORT

December 17, 1986

Dr. James Smith
Chief Economist
USAID - Rabat
Morocco

Dear Jay:

Attached is the draft report on Financial Markets in Morocco. Steve and I are continuing our work on the document and as discussed will round out our visits with World Bank people here. We look forward to receiving your comments on the draft and can put greater emphasis on any areas you may wish to highlight. We hope this material will be helpful to the Mission in planning for future activities.

At present, I will be in Morocco on about January 15, 1987. We could make a formal presentation January 16th or probably any day you wish to pick in the following week. Just let us know how your schedule looks.

We also would like to be able to provide the Moroccans who so generously gave of their time and ideas a copy of the report. Please keep your eyes open for any material in the draft which might be sensitive so we can delete it or prepare a separate version, if necessary.

Both of us thank you for your support on this project. Warm wishes for a Happy New Year to our friends in Morocco.

Sincerely,

Cathryn Goddard
Vice President

CG/CG2/sdk

enclosure

EXECUTIVE SUMMARY

Morocco stands at a turning point. The political will exists to encourage private initiative and management across several sectors of the economy. The human capital needed to execute these tasks is essentially alive and well and, for the most part, already living in Morocco. A consensus is emerging among key players in government, parastatal and private financial institutions that practical adaptations of Morocco's financial and capital markets can play a critical role in the country's economic development. This report reflects that consensus and is a tribute to the growing cadre of Moroccans with an impressive combination of technical skills, business judgement and political acumen.

Our focus is on practical, achievable steps which do not require major changes in the financial system. Such significant changes as privatization, whether in the United Kingdom or in the Kingdom of Morocco, represent a complicated process that does not usually proceed quickly. Financial market development, on the other hand, can make evolutionary progress in the near-term with the catalytic assistance of USAID.

USAID therefore faces a unique opportunity to direct its efforts toward financial markets with confidence that progress can be made that will affect Morocco's ability to invest in its future development. Many of the suggestions in this report will also contribute directly to successful privatization; all of the recommendations help utilize resources more effectively in the development process. Broadening and strengthening the role of the indigenous private sector financial institutions can more effectively channel investment resources for economic progress.

The report presents:

- A profile of financial markets,

  including medium- and long-term financing as well as equity markets.

- Practical suggestions to strengthen the private sector and improve financial markets in Morocco,

  including new capital market instruments, an investment banking initiative, and mechanisms for using Section 108 funds.

MOROCCO FINANCIAL MARKETS REPORT

Introduction:

This report looks at the opportunities for constructive USAID action in strengthening the private financial sector in Morocco and in enhancing the financing options available to the private sector in general. We focus on the three basic segments of the Morocco financial system: banking and credit, capital markets, and equity markets.

I. A PROFILE OF FINANCIAL MARKETS IN MOROCCO

- The System

1. The banking and credit system, reported by the Central Bank of Morocco.
2. The capital market for debt instruments (bonds), reported by the Finance Ministry, and the Treasury.
3. The equity markets, characterized by extensive state ownership in much of industry and closely-held private ownership in the rest of the economy.

- Key institutions contacted during this assignment that operate in these markets are the following:

1. GOM:

   Central Bank of Morocco
   Treasury

2. Private commercial banks:

   - WAFABANK
   - SMDC
   - BCM
   - BMCI
   - BMCE
   - CITIBANK

3. Specialized banking institutions:

   - BNDE
   - CIH
   - BMCE

4. Non-bank institutional investors:

   - CDG
   - Insurance companies (SNA, AA)
   - Retirement funds (CIMR)

5. State investment holding companies:

   - ODI
   - SNI
   - Tresor

6. Non-bank private financial institution:

   - CFI

7. Stock market-related:

   - Stock market
   - Somacovam

o Basic financing instruments within the system are:

   1. In credit markets

      a. Bank credit

         1. Under credit ceiling (encadre)
            Not under credit ceiling (nonencadre)

         2. Medium-term rediscountable
            Medium-term non-rediscountable

      b. Deposits in banks; regulated interest rates

   2. In capital markets

      a. Bonds

      b. Equity instruments

o The key features of Morocco's financial system overall are:

1. The strength and variety of financial institutions (including private sector): quite advanced compared to other developing countries. Private banks typically are relatively sound, well-managed and profitable.

2. Very ample availability of local currency (dirhams) private sector savings and liquidity in the system, constituting a potential pool of investable funds. The artificially high (regulated) deposit interest rate of 12% p.a. attracts such funds to commercial banks, that cannot lend more for productive economic uses because of the credit ceiling (encadrement) system. These funds are therefore "frozen" in the bank, in effect, and must be invested in government treasury bonds. Strengthening alternative channels of investment for these funds is therefore a key element in our inquiry.

3. The Moroccan financial system is closely modeled after the French banking system as it existed from the 1950s into the 1970s, namely:

   a. Narrowness of available credit instruments, oriented mainly toward short-term credit.

   b. Highly regulated environment in which the banks accept deposits and extend loans (category by category).

   c. Weakness of capital market (both primary and secondary).

   d. Monopolization of key functions by public sector specialized banks who also compete with private banks in important respects.

4. There is a high potential for "opening up" the Moroccan financial system (as the French system has recently opened up). New instruments, new institutions, a stronger capital market, more efficient channeling of investable funds to productive investment needs: all this can be accomplished <u>without</u> making radical changes in the system itself. All the recommendations made below are of practical application since

they can be made within the existing system and through existing institutions. Also, all the innovations discussed herein are already under active discussion within the Moroccan financial community (public as well as private sector).

A. Credit (Banking) Markets for Medium-Term Projects

Since the availability of short-term credit was outside the scope of this project, our focus here is on the supply and demand for medium-term credit to productive private-sector enterprises.

There are two forms of medium-term bank credit available in Morocco:

1. Through the BNDE

   -- subject to credit ceilings

   -- subject to detailed BNDE approval

   -- amounts limited

2. Outside-ceiling medium-term lending

   -- more attractive to banks

   -- attractive to those borrowers who need rapid replies or who wish to avoid the BNDE approval process (offsetting the higher interest rates)

   -- this form of lending is increasing as a proportion of total medium-term lending in the banking system

The BNDE monopoly on providing rediscountable (outside ceiling) medium-term credit and its approval process is a sore point with banks and a bottleneck in the system. The BNDE is now being authorized to enter commercial banking, take deposits, etc. This is a positive development only if the BNDE's monopoly on medium-term rediscountable credit is ended, which is unlikely in the present context. However, the BNDE could form the core of some new banking institutions which would be most attractive if: (1) private sector institutions are allowed to compete with the BNDE for all its activities; and/or (2) the BNDE itself is privatized.

The demand for medium-term lending is a function of the investment projects that require medium-term funds. There are many voices on this subject: private-sector bankers complain about the rigidities of the government-imposed system, whereas government people claim the private banks are not aggressive enough in identifying projects requiring such financing. A further point made is the overall regulatory environment which discourages investors in the first place. All these views appear to have some truth. However, there is a fairly wide consensus that the right kind of financial institutions, with the proper incentives and reasonable flexibility to operate, could overcome these obstacles, at least for the best projects (see Section II.A., on domestic investment and investment banking).

One very practical way for USAID to contribute to "opening up" the Moroccan medium-term lending system would be to make use of "Section 108" local currency funds to provide the risks incentives to finance new projects, and to introduce a new instrument (floating rate medium-term syndicated lending) to the Moroccan scene (see Section II.C. below).

B. Long-Term Financing (Bond Market)

The market for long-term financing instruments (bonds) in Morocco is of reasonably significant size but extremely narrow in terms of type of issue, identity of issuers, identity of investors, and secondary markets.

All issuers of bonds in Morocco are government entities, including the Treasury itself and such institutions as BNDE under State guarantee. The annual volume of bonds issued annually has grown steadily and is now running at about 5 billion Dh (of which about 2/3 are issued by the State, and 1/3 by public enterprises under State guarantees). Terms vary from 5 years ("bons de caisse" paying 12% p.a.) to 15 years ("bons de tresor" paying 13% p.a.). "Emprunts obligatiares" vary from 10 years (12.5% p.a.) to 15 years (13% p.a.).

Virtually all bonds are subscribed to at issuance by three sets of entities with significant funds to place: (1) the Caisse de Depots et de Gestion (State-owned); (2) the large insurance companies; and (3) commercial banks (as part of their reserve requirements). All these subscribers normally buy bonds at issue to hold to maturity, so that there is little or no secondary trading in these instruments (they are nonetheless quoted on the stock market). The bond market at present is therefore little more than a mechanism to channel funds from these three sets of "liquid" institutions to finance the State's treasury needs. The only major exception has been the "Sahara Bonds," which were specifically targeted to the individual investor.

In the Moroccan context of very narrow sources of medium-term funds though the credit markets, plus an excess of liquidity in private bonds which is "frozen" in the banking system representing a pool of investable funds, it is clear that the possible use of bonds in a broader context than at present has considerable appeal. The typical reaction encountered when this subject is raised with officers of investing institutions is revealing:

Q. "Could bonds ever be issued by a private sector borrower?"

A. "Only the State issues bonds."

Q. "But in other countries like France and the U.S., private companies also issue bonds."

A. "In Morocco the investor wants a safe investment. Private companies would not be acceptable."

Q. "What if one of the strongest private banks guaranteed 5-year bonds issued by one of the strongest private companies?"

A. "Interesting -- but we wouldn't invest if the return wasn't attractive enough."

Q. "What if the interest rate on the bonds was 14% versus 12% for a State bond?"

A. "Very interesting -- but the Finance Ministry would not permit it. If they would, we would certainly consider investing in such an instrument."

Q. At Finance Ministry (Tresor); "Are such bonds acceptable to you as an instrument in the market?"

A. "They are a good idea which we can approve (provided they do not crowd out the State's own borrowing, which is highly unlikely given the current liquidity situation). But we have never seen any proposals for such bonds. Why don't the banks bring proposals to us?"

<u>Conclusion</u>: An investment bank in Morocco (see Section II. A. and B. below) could do some good business by pioneering this instrument, for which conditions are now very favorable. The task would be: (1) find a private sector borrower with a legitimate need for such funds; (2) find a private bank willing to add its name; (3) secure Finance Ministry approval; (4) price the issue properly to ensure investor interest; (5) underwrite and place the issue (through a

syndicate if large enough) with private investors outside the current "club" of institutional subscribers; and (6) ensure an active secondary market in the issue through the stock market.

The opportunity exists, therefore, to introduce three new debt instruments to the Moroccan capital markets:

1. Bonds issued by private companies (probably requiring the guarantee of top private banks to be attractive to investors).

2. Bonds issued by the strongest state-owed enterprises (including financial institutions) without State guarantees.

3. Bonds convertible to shares, issued by state-owned enterprises targeted for privatization (see Section I.C. below).

Developing these instruments can have several benefits:

1. Provide a new source of medium-term credit to the Moroccan private sector.

2. Absorb excess private sector savings now placed with banks but which the banks are unable to lend out to productive businesses.

3. Revitalize the stock market.

4. Stimulate the development of a private Moroccan investment banking sector.

5. Smooth the way to privatization (in the case of convertible bonds).

C. Share (Equity) Markets

The private sector in Morocco is heavily oriented toward control of an enterprise by a single shareholding group. The concept of minority, or widespread, shareholding is discouraged by a combination of factors such as:

-- psychological/cultural bias in favor of tightly-held enterprises run by and for a dominant group, opposed to (or unfamiliar with) the concept of professional management of the business to the equal benefit of all shareholders,

-- lack of safeguards for minority shareholders such as financial reporting and accounting standards, and

-- lack of ready marketability of minority shares on the stock market.

Much is said in Morocco about the weakness of the stock market, such weakness being attributed to various factors including past problems, personalities, unwillingness and/or inability of private holders of liquid funds to invest in shares when regulated bank deposit rates are so high, etc. However, it is also obvious to all knowledgeable parties that on the rare occasions when shares in an established company have been available (such as the recent offering through the SNI of minority shares in Cosumar) the interest on the part of potential investors has been such that there is clearly considerable pent-up demand for share offerings.

Morocco has the advantage of possessing a stock market which (whatever its weaknesses) exists and operates. Reforms to revitalize the stock market are possible, and some are already in the works (such as the "Plan Comptable" relating to accounting standards and financial disclosure). Others, such as an appropriate regulatory mechanism, are still in the early stages. What is truly lacking as of today in Morocco's equity markets are: (1) a supply of equity issues in which the investing public can have confidence; and (2) investment banking institutions (see II.A. below) to manage the process of identifying appropriate share issue opportunities and matching them with pools of investable funds.

The probable trend toward privatization provides the best opportunity today to develop and revitalize the equity markets in Morocco. Conversely, a functioning equity market can best serve the Government's objectives in privatization, which include: (1) maximizing the return to the GOM as it divests, and (2) democratization of share ownership. The three government entities which hold the State's participation in "droit commercial" parastatal companies are the Tresor, the ODI and SNI. The heads of all three of these government units expressed support -- indeed eagerness -- for the concept of offering to the private investor shares in the company they hold (either new issues for fresh capital, or sales of existing equity).

This gradualist view of privatization (which involves offering minority shareholding to private investors while retaining State control -- at least initially) is likely to be the most practical approach in the Moroccan context today, rather than outright sales of parastatals to large private-sector groups. There are three instruments which (all parties seem to agree) can be used for this purpose:

1. Convertible bonds issued by the State-owned companies. These would appeal to the investors' presumed conservatism, since (until converted to shares) they would be debt instruments guaranteed by the government. (This would be especially important for parastatals of less-than-unquestioned financial strength). These instruments would be sold through, and quoted on, the stock market. No new legislation is required (according to studies done by the Tresor).

2. Sale to private investors of shares representing a minority portion of the existing ownership of a State-owned company; quotation of such shares on the stock market. Proceeds of the sale would go to the seller (Tresor, SNI).

3. New issue of shares sold to private investors to raise funds for a state-owned company. Proceeds go to the company. Quotation of shares on the stock market.

Given the GOM's potential interest in maximizing its return from the proceeds of the sale of such instruments (with benefits to the government budget in so doing) a gradual approach could be done as follows:

1. Issue shares or convertible bonds as above, quoted on the stock market.

2. As confidence rises in the business outlook and management of the quoted company, the stock market price of the share or bond can be expected to rise.

3. Additional shares or convertible bonds are sold at that point, taking advantage of the higher quoted price to improve the seller's (the government's) return. In this way, privatization proceeds at a gradual, steady pace with benefits for all concerned.

Planning a share-sale strategy described above, and carrying it out skillfully, will require professional assistance from investment banking institutions -- ideally domestic ones (see Section II.A. below). The intricacies of setting the right price (not too high to discourage sales, not too low to make it appear a "giveaway"), of setting the right convertible bond interest rate, and of monitoring stock market quotation development to plan the next issue, are jobs for professionals.

As we will see in Section II. A. and B., the BNDE and SNI themselves could become institutions capable of providing such expertise to the GOM. It is important for Morocco to avoid falling into the trap of paying high professional fees to major U.S., British or French institutions (be they investment banks, consulting or accounting firms) who look good on paper but lack the specific skills to help the GOM carry out the practical task at hand in the local Moroccan markets. Home-grown Moroccan investment banking institutions (who can retain help from foreign advisors if necessary) will be the best-equipped to carry out this task.

In conclusion, the privatization process (gradual sale or issue of equity in parastatals to private investors) offers the best near-term opportunity to Morocco to develop an active equity share market. The companies issuing the shares will be established and known entities, and the major shareholder at the outset will be the Government, thereby ensuring investor confidence in purchasing shares as minority shareholders. Because of the new political will to move in this direction, and the availability of private liquid funds and mechanisms, this process can proceed even before other reforms (stock market, legal, accounting) are in place.

Once the investing public has become comfortable with equity and convertible bonds issues; once the stock market operates in a proper framework and an active secondary market has developed; and once the necessary legal, accounting and financial disclosure rules are in place to protect minority shareholders -- at that time it will become possible to expect private sector companies to begin to raise funds on the equity markets and investors to purchase such issues. At that point also, venture capital becomes a real possibility (today venture capital is limited to State institutions such as ODI which places equity in new ventures and later sells it back to the principal owners, rather than to outside parties through the equity markets).

II. PRACTICAL SUGGESTIONS TO STRENGTHEN THE PRIVATE SECTOR AND IMPROVE FINANCIAL MARKETS IN MOROCCO

A. Domestic Private Investment and the Need for Investment Banking Institutions

It is generally acknowledged that domestic private investment in productive industries remains sluggish despite perceived opportunities and the availability of investable capital funds in domestic private hands.

Some obstacles to such investment are cited by local business people as follows:

-- severe administrative bottlenecks in securing necessary approvals and permits, and a sense that many government officials do not look favorably on private entrepreneurship generally and do not see helping such activity proceed as part of their proper role;

-- overly-active state-owned industrial firms which dominate certain desirable sectors and enjoy special treatment not available to private-sector firms;

-- insufficient information and assistance available with regard to export opportunities (Europe, Africa, U.S.), coupled with a strong bias toward already-established businesses in the government-assisted export finance programs; and

-- insufficient medium-term credit available for newly-established or newly-expanding industrial enterprises.

All these factors appear valid, but do not tell the whole story. The missing piece is the institutional gap in the capital market. Discussions with knowledgeable individuals in the private and government sectors reveal a common belief that there are no necessary or insuperable obstacles to increase domestic private sector investment, but that someone else's obstacles are in the way ("the private sector is too conservative and inert to come forward with projects;" "the government won't give the necessary approvals;" "the right financing isn't available"). What is in fact being expressed here is a need for capital market intermediaries (investment banks, in our terminology) which are today lacking in Morocco. The need for such institutions is acknowledged by the most far-sighted members of the local financial community.

The role of investment banks in this context would be to cause new private sector investments to happen by bringing to bear the following skills and capabilities:

1. Project Identification: Identify profitable new (or expanded) projects for investment; also identify the business group or individuals most likely to make that project succeed.

2. Advisory: Serve as financial advisor to the potential investors, preparing a sound business plan and financial forecasts and thereby identifying the amount and type of outside financing required for the project to succeed.

3. Fund Raising (intermediation): Raise the necessary financing for the project on the credit and capital markets: tapping outside sources of credit; underwriting the issuance debt or equity instruments and pricing same appropriately; and on occasion providing some of its own venture capital funds to the project.

4. Project Completion: Helping the project complete all the requirements necessary to proceed, which may range from building permits to import/export permits to recruiting qualified senior managers.

The driving force behind the successful, investment-stimulating activity of an investment bank is profit, i.e., the shareholders of such an investment bank, and its hired professionals, need to view this activity as highly profitable for themselves, with the greatest benefits linked to the successful completion of major new transactions. This is standard practice in all successful capital markets where investable funds are channeled to productive investments by dynamic capital market intermediaries. The attempts by governments and international agencies to place such activities in the hands of public sector development banks has only led to inefficiencies and bottlenecks such as Morocco displays today. Governments can -- and should -- use a well-constructed regulatory framework to channel the energies of the private-sector capital market intermediaries and ensure that rules are abided by.

The public sector itself, as it moves down its recently-announced path toward gradual privatization of certain parastatal industrial entities, would benefit greatly from the existence of such investment banks. The act of issuing new equity -- or selling some current equity -- to the private sector requires skill in assessing the marketability of such transactions and in pricing them accordingly. In the government's own interest this activity is best done by the non-political, arms-length criteria of investment banking professionals (the ills thereby avoided are: charges of favoritism; charges of "giveaways;" or a "no-sale").

It would therefore seem to be a top priority in the context of privatization (which is already occurring in small doses) for the government to concur in the activities of private-sector investment banks (which it would need to in the Moroccan context). The signals from the Finance Ministry and Treasury Department are positive (it is also felt that the Palace would not be opposed to such activity). The fact that an institution like Price Waterhouse is now undertaking valuations of "privatizable" parastatals, at the Government's request, is a very favorable sign; a CPA firm like Price Waterhouse is critical in two respects: (1) assessment of a company's books and forecasts, and valuation thereupon; and (2) helping establish agreed-upon accounting and disclosure rules for the capital markets generally. (No CPA firm, however, by the rules governing that profession, can itself serve in an investment banking capacity, the latter being transaction-driven and compensated accordingly.)

Morocco -- unlike most other developing societies -- is blessed with a reasonably large number of skilled and profit-oriented individuals and institutions which are the prerequisite to successful investment banking. Therefore, unlike some other countries where USAID has experience in this area (e.g., Costa Rica), it is not necessary in Morocco to create a "de novo" institution staffed at the top by non-locals. In sum, in Morocco the human and institutional ingredients for rapid establishment of potentially successful investment banking institutions are already present and do not need to be "imported." The most constructive role for an outside institution like USAID is to serve as a catalyst in its precise sense -- adding a small dose of the right ingredient to permit the coalescing into new combinations of ingredients already present. The challenge -- and our recommendation -- for USAID will be to find the right formula for this "catalytic" process to be most effective.

The key prerequisites to any Moroccan group seeking to operate successfully as an investment bank are:

1. <u>Support from the Moroccan Government</u>: (Intangible - no cost in resources; no new laws required):

-- at the highest levels in terms of broad support of the principle of what the investment bank (or banks) are seeking to do to stimulate investment in the Moroccan economy;

-- at the technical level, in terms of approvals and open-mindedness on activities which are permitted even today but which the authorities can stop, i.e., bond issues by entities other than the government;

-- as a parallel effort, the invigoration of the stock market, and the establishment of clear regulatory guidelines for stock market activity (debt and equity issues) should proceed under Government auspices; and

-- in particular, the concept in Government circles that private-sector holders of investable funds are not capable of making investment decisions through the capital markets based on market criteria needs to be modified; this attitude is at the core of the current perceived obstacles to enhanced capital market activity.

2. Adequate Capitalization: Any institution seeking to become a reliable intermediary between sources of funds and their use should be prepared to commit its own funds either potentially (as an underwriter of a new debt, convertible or equity issue), or in fact (as a minority venture capital investor). Therefore, any such institution should ideally have ties to one or several existing private financial institutions with a strong capital base, in addition to being adequately capitalized in its own right.

3. High Quality Professional Skills in at least the following key areas:

a. Project planning: scrutiny of new project proposals, and preparation of business and financial plans for such proposals.

b. Financial engineering: structuring of the most appropriate and practical financing package for the project in the Moroccan context.

c. Regulatory approval: an ability to negotiate through the Moroccan regulatory environment.

d. Capital market skills: for major institutions (including the government itself) the ability to plan, structure and price the institution's anticipated capital market issues and activities.

Most of these skills can probably be found in Morocco; at the outset there may be some need for experienced outside assistance (either consultants or expatriate staff), especially for (d). capital market skills.

4. Excellent personal connections with senior people in Morocco's government, business and financial milieux. This is vital both for business development and to ensure continued support where it counts.

The following groups operating in Morocco today have the potential ability to be involved in local investment banking in Morocco in some form or other:

1. Wafabank
2. SMDC
3. BCM
4. Citibank Maghreb
   (now a majority Moroccan-owned entity)
5. BMCI
6. BNDI
7. SNI
8. ODI

It is desirable, for competitive purposes, to envision the establishment of two or more investment banking institutions. The most obvious players would be:

1. SMDC and/or

2. Wafabank (possibly through its new CFI venture with BCM). (Nos. 1 and 2 are identified because of the ability and interest of their shareholders and top managers in moving in this direction).

3. Citibank (key decisions are made in their regional Capital Markets Group based in London; they would become active once it is clear that new instruments, i.e., bond underwriting is possible in Morocco).

4. A practical cluster of previously state-controlled entities; the combination of BNDE and SNI would seem most appropriate (since BNDE is knowledgeable about new investment projects, and SNI has already launched in the stock market some share issues of parastatals private investors; SNI own shares in numerous parastatals.)

Conclusion: The time is ripe for the creation of investment banking intermediaries in Morocco, and USAID can play a very constructive role in this development (see Section II. A. and B. below).

B. Investment Banking in Morocco: Possible USAID Initiatives

For the reasons : ted in Sections I.C. and II. A. and B. above, a major institutional breakthrough is both possible and necessary in order to provide the support (which knowledgeable parties agree will be required) to domestic investment and to privatization. There is an active process of fermentation of ideas in Morocco's financial world today as to how best to achieve this breakthrough, and who will do so. In the best private sector tradition, the more dynamic institutions such as SMDC, Wafabank, and BCM have already taken steps to enter new forms of financial intermediation. However, to begin investment banking as defined in Section II. A. and B. (which is the most needed step to spur domestic investment), certain steps or decisions need to be taken by the government. In this context, the most constructive steps would be for the government to:

1. Agree that straight bond issues with "blue-chip" names and private bank guarantees can and should make their first appearance in Morocco and be offered to the public.

2. Agree that convertible bonds are an attractive instrument for parastatals to issue to the private investor in the context of privatization.

3. Agree that entities such as the Tresor, SNI, and ODI should sell some of their holdings of "droit commercial" parastatals to private investors through the stock market.

4. Most significantly, agree to the full privatization of BNDE and SNI, who (ideally) would merge and form Morocco's first investment bank, authorized to conduct activities 1, 2 and 3 above, plus all the investment banking activities cited in Section II. A. and B., namely:

   -- project planning and advisory,
   -- financial engineering,
   -- fund raising/intermediation,
   -- assistance in project completion,

   plus exporting assistance and financing as appropriate.

   BNDE/SNI would continue their current activities in the new framework, but without their existing state monopoly.

5. A necessary companion to 4. above would be to signal to other groups in Morocco that all qualified private groups (SMDC, Wafabank, Citibank, etc.) capable of conducting the activities cited in 4. above are able to do so.

The result of all this will be the creation of a new private financial services business sector (a worthy goal in its own right); a set of new capital markets instruments; and therefore a set of profit-driven institutions with the necessary tools to seek out and finance new private sector projects in Morocco, thereby contributing strongly to the country's economic development. These steps would also set the stage for a revitalization of the stock market (whose reform would parallel the steps described herein) and for a successful privatization process (as in I.C. above).

USAID can help this process along in several ways, but the most powerful would be to provide the financial catalyst, in the form of U.S. dollar loan financing in some form, to point to 4. above -- the privatization of BNDE/SNI and their constitution in a local investment bank. The heads of these institutions (not to mention other key government players like the Finance Ministry, the Tresor and the Central Bank) would appear to be potentially quite supportive of this move.

To ensure a positive response, USAID could stipulate that if BNDE/SNI were unable to accept USAID's offer by a given date, the USAID funds would then become available to existing private sector financial institutions as backing to an investing banking institution (for example on a consortium basis).

There is precedent for USAID providing dollar financing to a new investment banking institution. In Costa Rica, the "Private Investment Corporation" (PIC) was formed with USAID as a catalyst and several million dollars in long-term loans to support this entity whose shareholders consist entirely of local private sector financial institutions. While the PIC is now up and running, it started slowly due to the fact that it was a "de novo" organization with a variety of growing pains, including staffing at senior levels (some problems developed at Board level and with the expatriates brought in to head the operation, who have since left). It speaks well for the basic concept, however that, despite these problems, the PIC's business is now advancing and it is now prepared to play a key role in identifying and financing projects (focusing on non-traditional exports, both agricultural and manufactured).

In the case of Morocco, the ready availability of existing institutions would enable USAID catalyst funds to be effective quickly, with known local organizations and people, and avoid the startup pains of the Costa Rican experience.

It is therefore recommended that USAID-Rabat (if possible under the auspices and with the assistance of the PRE-Financial Markets project) consider in detail the possibility of offering technical assistance along with dollar loan funds in exchange for a Moroccan government commitment to (a) privatize BNDE/SNI, (b) permit this institution and others to engage in "investment banking", and (c) authorize the use of new capital markets instruments as cited above.

C. Mechanisms for Using Section 108 Funds in Morocco

This section provides a summary of the findings of the PRE-Financial Markets Project regarding use of Section 108 funds in Morocco.

After detailed discussions of the potential use of Section 108 funds with the Moroccan entities most likely to be willing and able to serve as "intermediate financial institutions" (IFIs) for purposes of Section 108, the following mechanisms can be recommended. These mechanisms are apparently entirely consistent with the U.S. legislation and Interagency Group directives. The agreement of the Government of Morocco will of course be needed for any proposed usage of Section 108 funds in the Moroccan financial system.

Lender: U.S. Government (represented by the In-Country Policy Group (IPG) and administered by USAID-Rabat).

Amounts and Currency of Lending: 95% of Section 108 funds held in Moroccan dirhams by the U.S. Government. According to Section 108, the remaining 5% must be employed for agricultural technical assistance to the maximum extent practicable.

Borrowers: IFIs deemed eligible based on the following criteria specifically:

- o Control by local private sector (stated U.S. executive branch policy only requires IFIs, to be eligible, to be privately-owned, with no public-sector ownership.
- o Authorized locally to accept U.S.G. funds and to relend to private sector borrowers.
- o Financial strength, capable management, history of stability, experience.

Such eligible IFIs would include: leading local private-sector banks such as Wafabank, BCM, Citibank (which is a majority Moroccan-owned entity), and other financial institutions such as Compagnie Financiere d'Investissement and SMDC's investment company. The IPG has the authority for final selection of eligible IFIs; AID is responsible for negotiations with IFIs.

Basic Concepts:

1. A credit facility would be established, which may be

drawn upon by any eligible IFI on the following proposed basis:

- An eligible IFI presents a sub-lending transaction which meets all the Section 108 criteria (100% private sector borrower; non-competition with U.S. products if agriculture, etc.).

- The sub-loan will be medium-term in duration (one to ten years).

- It is proposed that the IFI fund 50% of the total transaction from its own funding sources, and 50% by drawing on the U.S.G. Section 108 facility.

- The IFI will assume 100% of the credit risk (non-payment by borrower) for the entire transaction. (The U.S.G. assumes credit risk only for the IFI itself, not for the sub-borrower for which the IFI assumes the entire risk).

- Funds are disbursed from the Section 108 facility to the IFI for such transactions once a loan agreement document is signed between the US Government and the IFI (both U.S. and Moroccan law documents will be necessary to ensure full local enforceability).

- The applicable interest rate should be equal to a local posted market rate such as the local treasury bill rate (currently 8 1/2% p.a.), which fluctuates moderately and infrequently, or the local export lending rate (currently 9% p.a.). There are no other posted market rates in Morocco. This rate concept will introduce floating-rate medium-term lending to Morocco. It is recommended that fixed rates to maturity not be applied by the U.S.G. to IFI's funding. It is further recommended that IFIs be free to apply any reasonable lending rate formula to their sub-borrower to ensure that all eligible sub-borrowers are given the opportunity to take advantage of the Section 108 facility.

- It is possible for more than one IFI to participate as lender in a given transaction; i.e., this will encourage multi-bank loan syndication for large projects.

- It is appropriate to put caps on the total participation of any single IFI (not more than 25% of the total 108 facility) and on any single transaction (not more than 15% of the total facility).

2. An administrative management process will need to be put in place locally since this facility in effect puts the U.S.G.-Rabat in the local lending business. Any administrative process has the following five key elements:

a. Initial evaluation of potential eligible IFIs: their financial strength (balance sheet ratios, capitalization, portfolio composition); profitability indicators; management capability; direct and contingent liabilities; customer base; etc.

b. Verification of the completeness of each facility drawdown application from the IFIs: compliance of the application with required Section 108 criteria; completion of necessary loan documentation; appropriateness of loan term to project payout; etc. Presentation of the application to the IPG-Rabat for final approval and loan disbursement.

c. Ongoing evaluation of the IFI after a disbursement is made to the IFI; periodic review of the IFI's financial strength and performance; "early warning" of any deterioration in the IFI which could affect its ability to repay its obligation to the U.S.G.; etc.

d. Monitoring of promptness of IFI's payments of interest and principal to the U.S.G.; monitoring of the sub-loan to ensure Section 108 purposes are being fulfilled.

e. In event of IFI's financial deterioration, or default by IFI on its payment to the U.S.G., remedial action will need to be contemplated and carried out.

Such administrative procedures, which would be highly burdensome for USAID-Rabat to perform, can readily be carried out by any financial institution experienced in extending medium-term loans to IFIs in Morocco. It is therefore strongly recommended that an administrative management agreement be entered into with such an institution. This can be done at no direct cost to the U.S.G.; since the administrative manager's fee for providing such services would be paid by the IFIs (as a fixed percentage of all initial loan disbursements) and thus would come from the IFI's loan spreads and not from U.S.G. funds.

The selection of an administrative manager must be made on the basis of competence only, since USAID and IPG-Rabat will be entrusting this entity to perform important services on the U.S.G.'s behalf and since no U.S.G. funds are being committed. Since the initial and ongoing evaluation of the potentially eligible IFIs is the key element to ensure that the U.S.G. ultimately is repaid the funds it has lent to the IFIs, it is important to note that only U.S. banks have sufficient experience with lending to Moroccan IFIs and sufficiently stringent criteria to be acceptable as administrative managers. Citibank is the only U.S. bank with local operations in Morocco, and has an extensive information base on the other potentially-eligible IFIs which can be made available to the IPG-Rabat. (In similar circumstances elsewhere, such as Costa Rica, USAID has used the administrative services of other U.S.-owned banks in this manner.) Using a Moroccan-owned bank is not recommended because they do not have the practical experience of the major U.S. banks in making medium-term loans (and evaluating the risks involved in so doing) to other banks and IFIs.

The core of the procedural relationship between the administrative manager and the IPG-Rabat will be in the following two areas, each of which would be the subject of detailed guidelines to be mutually agreed upon in advance:

1. Selection of eligible IFIs: the administrative

manager performs evaluation, makes specific recommendations for IPG-Rabat's decision.

2. Procedures for accepting and approving loan applications from IFIs: the administrative manager examines application thoroughly to ensure compliance with all criteria. If USDA approval is required (for sub-loans involving agricultural products), the administrative manager will so indicate to USAID and IPG-Rabat, who will take appropriate steps to secure USDA approval or disapproval). Once all information, loan documentation, etc., has been assembled by the administrative manager, the latter presents the proposal to the IPG-Rabat for its approval and, if approved, for drawdown of loan (such drawdown can most efficiently occur by having U.S.G. dirham funds destined for Section 108 loans held on deposit, if U.S.G.'s name, on the books of the administrative manager, who would pay the U.S.G. a rate of interest of, say, 5% per annum for such funds.)

Conclusion:

The mechanism proposed above is designed to meet all the requirements for Section 108 lending. In addition, it fills a real gap in local lending practices (medium-term project loans, up to 10 years, to small-to-medium private sector firms); and expands the range of financial market instruments by introducing for the first time in Morocco the possibility of a fluctuating rate loan based on local money market indicator. Approval by local central banking authorities is considered likely. These authorities may well require such lending to be done within established credit ceilings (this should not hamper those IFIs subject to credit ceiling since their loan spreads offer a reasonable return equivalent to their other local lending). These authorities may wish to target certain economic sectors which can readily be done by establishing percentages of the total facility to be used to finance designated industrial or agriculture sectors, small to medium businesses, or any other target sub-borrowing sector (privately-owned) which the local authorities and USAID-Rabat may agree should be the beneficiaries of such loans. However, some portion of the total facility should in all cases be left to the discretion of IFIs (as long as the other criteria are met) as regards the identity of the sub-borrowers, to ensure the rapid and successful implementation of this program.

ATTACHMENT

MEETINGS ON MOROCCO FINANCIAL MARKETS
October 17-31, 1986

October 17, 1986

USAID

Abdelhak Bennani, Directeur General
WAFABANK

USAID

October 20, 1986

Simon D. Riggall, Directeur General
Citibank - Maghreb

Mr. Guerraoui, President
Compagnie Financiere d'Investissement (CFI)

Abdellatif Benjelloun, Directeur Central Adjoint
WAFABANK

Omar Akalay, Administrateur Directeur General
Societe Marocaine de Depot et Credit (SMDC)

M. Brahim Elamiri, International Division Manager
(SMDC)

October 21, 1986

Abdellah Belkeziz, Administrateur Directeur General
Societe Nationale d'Investissement (SNI)

Abdelaziz Alami, President Directeur General
Banque Commerciale du Maroc (BCM)

October 22, 1986

USAID

Farid Dellero, Administrateur Directeur General
Banque Nationale Pour le Developpement Economique (BNDE)

Doghmi Chakih
(BNDE)

Hassan Rhourbi, Secretaire General
Caisse Interprofessionnelle Marocaine de Retraites (CIMR)

Ouissal Laraqui, Fondee de Pouvoirs
(CIMR)

Mr. Arafati
(CIMR)

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Bourse des Valeurs

Abdelaziz Belkasmi, Associe (Partner)
Price Waterhouse

Citibank

October 23, 1986

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Caisse de Depot et de Gestion (CDG)

USAID

Mohammed Alj, Directeur
Banque du Maroc

Mohamed Belkhayat, Directeur General
Office pour le Developpement Industrial (ODI)

October 24, 1986

Mr. Tazi
Tresor

Othmane Slimani, President Directeur General
Credit Immobilier et Hotelier (CIH)

Abdellatif Jouahri, President Directeur General
Banque Marocaine du Commerce Exterieur (BMCE)

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Omar Akalay
SMDC

M. Brahim Elamiri
SMDC

October 28, 1986

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SNI
Directeur, SOMACOVAM

Abdellah Belkeziz
(SNI)

Jaouad Kettani, Administrateur Directeur General
Societe Nouvelle d'Assurances (SNA)

Abdelfettah Rahmani, Chef du Departement Financier
Banque Marocaine pour le Commerce et L'Industrie (BMCI)

Robert Annibale
Citibank - London

October 29, 1986

Driss El Hilal, Directeur
L' Alliance Africaine
Societe Marocaine d'Assurances et de Reassurances

CIMR

BMCE

Abdellah Belkeziz
SNI

October 30, 1986

Abdellatif Ghissassi, President Directeur General
Societe Maroc Emirats Arabes Unis de Developpement (SOMED)

USAID

October 31, 1986

USAID
