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AID/PRE - Financial Sector Development Project

USAID/PAKISTAN CAPITAL MARKETS STUDY

FINAL REPORT

November 15, 1990

Office of Government Services
1801 K Street, N.W.
Washington, DC 20006
Telephone 202 296 0800

Price Waterhouse

November 15, 1990

Mr. Richard Goldman
Private Sector Office
USAID/Pakistan
18, Sixth Ave., Ramna 5
Islamabad, Pakistan

Dear Mr. Goldman:

Re: AID/PRE Financial Sector Development Project
Contract No. PDC-2206-Z-00-8191-00
USAID/Pakistan - Capital Markets
PIO/T No. 664-0328-3-00033

Enclosed please find twenty copies of our Final Report on the Pakistan Capital Markets conducted by the Price Waterhouse Capital Markets team. Two copies have been forwarded to Sandra Frydman, AID/PRE/PD and an additional eighty copies are being sent to you by surface mail at your request.

It has been a pleasure working with USAID/Pakistan on this important assignment. We look forward to working with you in the future as your plans for new projects in the financial sector develop.

Very truly yours,

J. Richard Breen
Director, FSDP

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EXECUTIVE SUMMARY

The Government of Pakistan (GOP) and the U.S. Agency for International Development (USAID) are preparing to launch a joint program aimed at promoting private sector investment and capital market development in Pakistan. The 180 million dollar Private Investment Expansion (PIE) Program seeks to increase the volume and efficiency of private investment through three mechanisms: (1) sector grants; (2) private investment support; and (3) special projects, technical cooperation and training.

Sector grants provide the opportunity to set an agenda with the GOP for policy reforms targeting decreased government intervention; greater ease in obtaining investment approvals, licenses and sanctions; expanded investment, employment and income; and the increased efficiency of the commercial sector. The private investment support component consists of a private sector commodity import program (PSCIP). This program is designed to assist private sector importers in developing new industry, modernizing existing industry, transferring technology and stimulating increased trade between Pakistan and the U.S.

The Special Projects, Technical Cooperation and Training (STT) ties together and supports the sector grant and investment support components of the PIE Program by establishing close working relationships with local businesses, chambers of commerce, industry and trade associations and others, and providing feedback through the appropriate channels on the need for policy reform, deregulation, credit facilities and further improvements in the investment environment. STT activities include a PIE Investment Fund; grants to the International Executive Service Corps, the Federation of Pakistani Chambers of Commerce and Industry, the American Business Council, the World Environmental Council and various women's business organizations; a resident technical assistance team supported by short-term consultants; support for privatization; and training.

Objective and Scope

Price Waterhouse was given the mission of conducting a study of the Pakistani capital markets in order to identify those areas in need of policy reform or technical assistance which might be supported by USAID over the next several years. The Price Waterhouse team consisted of a Macroeconomist, a Development Finance Specialist, an Investment Specialist, a Stock Market/Regulatory Specialist, and a Technical Support/Finance Specialist who spent approximately seven weeks in Pakistan during the months of June, July and August, 1990. The team analyzed the strengths and weaknesses of the financial sector with particular emphasis on the constraints to long-term capital formation, and evaluated the macroeconomic and microeconomic constraints to the development of a more efficient banking system and capital market. The team also prepared a study of the legal and institutional barriers to the development of capital markets and ways of overcoming them, and the potential for increasing participation in the financial sector of private sector organizations, with a view to encouraging U.S. and Pakistani investors in setting up companies or joint ventures in Pakistan. In particular, the team was told to develop a set of policy reform and technical assistance recommendations relating to the strengthening of the capital markets. In addition, the team was to solicit suggestions during their interviews for the Investment Packaging program. The following is a summary of the team's recommendations for policy reform, technical assistance and investment packaging. A list of the recommendations, ranked according to their priority, appears after page 47 of the report.

Capital Markets Policy Recommendations

A. Liberalization of the Interest Rate Structure

As in many developing countries, attempts to modify the allocation of resources in Pakistan through government-controlled interest rates adversely affect the development and functioning of the capital market. No major improvement in the capital market can be expected unless corrective measures regarding the interest rate structure are adopted.

Ideally, interest rates on government debt serve as the reference rates for all other types of short and long-term obligations. In Pakistan, all rates on government debt are administratively determined, resulting in distortions in the interest rate structure. A government program of Islamization, begun in 1979, has had a decidedly positive impact in terms of deregulating financial rates of return. However, Islamic financial instruments constitute only a small segment of the credit market. Because of the large GOP borrowing requirements resulting from the budget deficit, government debt instruments continue to pay interest at tax-free rates up to 12.5 percent on long-term savings certificates.

The National Credit Consultative Council (NCCC) and the State Bank of Pakistan (or central bank) administer quantitative control over the allocation of financial resources through credit ceilings. High mandatory reserve requirements are imposed on banks at low interest rates, substantially increasing the cost of the remaining funds to the private sector. The Government has taken several steps toward the development of a mechanism for auctioning treasury bills on a weekly basis. At the present time, however, the system is such that the Government targets the interest rate for each auction and refrains from selling if its targets are not met. In conjunction with a recent structural adjustment loan, the World Bank has provided a long-term consultant to the central bank to study the GOP's policies for debt management and to assist in developing the auction mechanism.

In order to achieve a more efficient mobilization and allocation of financial resources, several policy changes are recommended. The Government should: (a) reduce its budget deficit, hence reducing its need for debt financing; (b) reduce its reliance on the State Bank of Pakistan for financing its budget requirements and, instead, gradually increase its funding through the securities market; and (c) conduct true auctions of treasury bills and bonds, thereby establishing a reference rate for other debt instruments, absorbing excess liquidity and keeping inflation in check. In addition, given the risks of mismanaging Pakistan's complex credit allocation schemes, especially in a world of increasingly sophisticated and intermingled financial markets, the GOP should adopt measures that will reduce the number of directed credit programs and the proportion of total credit affected by such programs, and should gradually reduce the degree of interest rate subsidization.

B. Financial Sector Institutional Reform

While there has been some liberalization of the financial sector in recent years, and the Government has stated its intention to do more, the financial sector remains dominated by the Government through the broad ownership and control of financial institutions. This contributes to rigidity and a lack of innovation in the financial system, to poor performance reflecting entrenched bureaucratic personnel, corruption, excessive costs, high interest rates and redundant personnel. The nationalized commercial banks (NCBs) account for approximately 90 percent of the banking system's deposits and 85 percent of advances. Government-owned specialized banks exist for financing agriculture, industry and cooperatives. Although chartered as deposit-taking institutions, these banks rely on central bank support for the majority of their funding. In addition, there are a number of non-bank financial institutions, the most important being the National Development Finance Corporation, the House Building Finance Corporation and the Pakistan Industrial Credit and Investment Corporation (PICIC). The National Investment Trust (NIT) and the Investment Corporation of Pakistan (ICP) are collective investment institutions, managing a range of mutual funds.

During the past decade, the GOP has adopted numerous corrective measures to increase the scope of private sector activity in the financial sector. These measures include (a) Islamization of the financial sector, which has culminated in the creation of numerous types of financial institutions and instruments in the private sector; (b) licensing of investment finance companies; and (c) provision for the establishment of an offshore fund. Although there are 19 foreign private commercial banks in the system, statutory restrictions on their activities limit competition in the banking sector. Presently, the banking system faces numerous difficulties, including poor quality loans, a large number of willful defaults, ineffective recovery mechanisms and restrictive, uniform rules and regulations.

In our view, the policy framework should be reformed to promote increased competition among financial institutions, within a framework of prudential government regulation. In particular, the GOP should: (a) proceed with increased deregulation of the financial sector, encouraging interbank lending, the development of a money market and increased competition with the foreign banks, (b) allow greater autonomy of the NCBs in their day-to-day operations, (c) consolidate the activities of certain overlapping state-owned credit institutions (for example, in the area of agricultural credits), (d) begin the process of privatizing several of the NCBs, and (e) assure greater autonomy of the central bank in pursuing monetary policy, independent of powerful social and political pressures.

C. The Insurance Industry

While there are approximately 50 private insurance companies in Pakistan providing accident, household and general insurance, the life insurance business is monopolized by the government-owned State Life Insurance Corporation (SLIC). The SLIC was established in 1972 as the result of the nationalization of all private life insurance companies. Recently, the GOP passed a law allowing private insurance companies to enter the life insurance business in Pakistan. With this new law in place, the team's recommendation related to the insurance industry focuses on technical assistance to support the development of a private life insurance industry. The team's recommendation is accordingly presented in the section on Technical Assistance.

D. Privatization

The first and foremost requirement for a successful privatization program is a strong commitment on the part of the Government. In Pakistan, Government officials hold conflicting views on the meaning of privatization and appropriate strategies for divestiture. Some believe that the majority of shares and the management of each enterprise should remain with the Government, and that divestiture should begin with sick or loss making units. Others suggest that privatization should commence with the sale of public companies with good track records, and that the Government should guarantee dividend payments during the first five years to generate broad public interest in the shares. The issue of labor and how to redeploy workers is often cited as a major obstacle to privatization.

At this time, especially given the recent change in government, we recommend that USAID's policy dialogue focus on encouraging a strong commitment by the GOP to privatization and on establishing a clear understanding of the meaning of and potential strategies for privatization. Additional support in the form of technical assistance might also be provided once the Government is strongly committed to privatization.

E. Tax Policy

The failure to operate an effective tax collection system distorts capital markets primarily by encouraging companies to underreport income and thus provide inadequate disclosure. The principal problem in Pakistan is that, due to the ineffective tax collection system, hardly anyone pays taxes. Incentives were introduced to encourage companies to list on the stock exchange by lowering the statutory tax rate for listed companies from 45 to 40 percent. This policy has been generally ineffective since most Pakistani companies, with the exception of the multinationals, reportedly pay little or no tax.

It is anticipated that the Internal Revenue Service will be assisting the GOP in efforts to improve the tax system. In addition to supporting these efforts, USAID might support a study of the impact on the capital markets of varying tax rates on dividends and interest.

F. Securities Market Enhancement

1. Problems Affecting Corporate Participation in the Markets

To address the problem of the concentration of Pakistan's wealth in the hands of a small number of families, the GOP introduced a number of measures to effect a wider distribution of shares: (a) companies over a certain size (Rs 50 million in paid-up capital) are required to go public, selling 50% of their shares through the stock exchange; (b) the National Investment Trust, an open-end mutual fund accessible to small investors, is provided an option to acquire 20% of all issuances of securities; and (c) the amount that companies can charge for their shares is limited through a pricing formula designed by the Government.

While these measures are intended to address important social issues, they distort a free market. A better approach would be for the GOP to: (a) encourage companies to list by addressing the macroeconomic issues that distort interest rates so that companies find it advantageous to list, (b) encourage the formation of private mutual funds to compete with the NIT, while gradually removing the benefits and restrictions imposed on the NIT, (c) provide tax and other incentives to encourage the creation of ESOPs and stock option plans, and (d) allow companies to issue their securities at fair market value. In addition, companies should be allowed to determine the types of securities they will issue provided the securities comply with Islamic principles. Changes in the legal system should also be introduced to encourage an increase in mortgage loans and the development of a mortgage loan market.

2. Problems with Investor Confidence

Central to an efficient stock market is a perception that an investor will have a fair opportunity to participate in the potential for profit. As in many developing country markets, the common perception of the Karachi Stock Exchange is that it does not provide a level playing field.

Several factors contribute to the generally weak state of investor confidence. With respect to the quality and availability of financial information, disclosure rules are sufficient but there is no enforcement. International accounting principles are technically required to be applied to the financial statements of listed companies, but due to apparent corruption, significant deviations occur. Many persons interviewed suggested the system is rampant with insider trading and advantages. The Corporate Law Authority (CLA), which is charged with enforcing the securities laws (including disclosure and insider trading) has historically served a bureaucratic rather than an enforcement function. These difficulties are compounded by the grip on companies of family interests, the inadequate protection of minority shareholders and the lack of company takeover provisions.

The principal focus of the GOP and the PIE Program to improve investor confidence should be on strengthening the enforcement capabilities of the CLA and the application of disclosure requirements. The focus of the CLA should be on enforcement as compared to a bureaucratic review of disclosure documents. Broker regulation, including introduction of professional standards for licensed brokers and a review of brokers' transactions should be a function of this agency. In conjunction with this effort, adoption of uniform accounting principles and the development of effective disciplinary programs for members of the accounting profession should be encouraged.

3. Institutions that would Encourage Investor Participation

There are no entities in Pakistan that perform the function of analyzing investments on behalf of investors either lacking sufficient time, resources or knowledge to assess the merits of a particular investment. In more developed markets, credit rating agencies and investment advisory firms are among the organizations serving this role. These types of entities would be beneficial in improving the integrity of the markets, provided they are independent from brokers and issuers and that the quality of financial reporting is improved. The Karachi Stock Exchange and brokers are self-regulated and have not inspired investor confidence. Historically, brokers in Pakistan have not been held to any standards of education, competence or net worth, and their ability to act both as agents and for their own account clearly creates a conflict of interest.

The GOP should encourage the development of private investment advisory organizations and credit rating agencies as described above. According to government officials, the establishment of the Islamabad Stock Exchange (awaiting a ruling by the High Court) as an independent body would create healthy competition with the Karachi Stock Exchange. USAID could support both of these efforts through its program of Technical Assistance (see below).

4. Problems Affecting Liquidity in the Market

Market depth, in the form of an active secondary trading market, is one of the most important functions of a stock exchange. Without an active secondary market to assure investors of liquidity, it is difficult to effect primary distributions. In U.S. markets, this function is generally performed by specialists or market makers who are always available to purchase and sell securities at quoted bid and asked prices. Historically, the Karachi Stock Exchange has not provided a good secondary market. There are several factors affecting the liquidity of the exchange, including the lack of specialists and market makers, the significant portion of the market float held by the NIT and the ICP, restrictions on the ability of pension funds to invest in the market, fixed commissions on underwriting, and the existence of a large unofficial market in bearer bonds.

While the primary focus of the GOP's efforts to enhance market liquidity should be on the macroeconomic issues described under "Interest Rate Structure", additional reform measures would be to: (a) encourage institutions such as pension funds to invest a portion of their funds in securities, (b) allow underwriting commissions to increase to provide an incentive for increased offerings, (c) encourage underwriting by the newly-formed investment banks, and (d) increase efforts to attract the unofficial market into the formal market.

Technical Assistance Recommendations

In identifying areas where USAID might provide technical assistance to the GOP, the Capital Markets team targeted activities where USAID assistance would complement proposed policy reforms, where it would be welcomed by the GOP and where it would produce the greatest rewards or benefits in terms of strengthening the capital markets in the near to medium-term. These recommendations are presented below.

In order to overcome the reportedly ambivalent and sometimes negative attitude of a significant proportion of the Pakistani population toward private enterprise, the team concluded that one of the most important steps needed in improving the environment for private sector investment is a campaign, in coordination with a local media consultant, to educate the public on the benefits of private enterprise, private investment and a free market to Pakistan's economic and social development. Through a public education campaign, Pakistanis could be encouraged to take pride in their work and to contribute to the development of their country. Programs to educate the people on the meaning of share ownership, the role of mutual funds, the purpose of levying an income tax and the duty of workers and businesses to contribute to the cost of public services could be another important element of this campaign.

The development of an efficient securities market is necessary to enable Pakistan to mobilize the long-term capital required to sustain economic growth and expanded private sector investment. In our discussions with public and private sector officials and other donor agencies, it was suggested USAID could play an important role in the development of the securities market by offering technical assistance in the following areas: (a) assist in strengthening the institutional capacity of the Corporate Law Authority to regulate the securities market, (b) assist in strengthening the capacity of the Institute of Chartered Accountants of Pakistan to promote improved accounting practices, (c) support the establishment of a chartered financial analyst's program, (d) support improvements at the Karachi Stock Exchange, and communications linkages and increased competition with other exchanges, (e) provide seminars and training programs to securities markets participants, and (f) assist in the development of a credit rating agency. While the IFC has been approached by the Karachi Stock Exchange with a proposal to support an automation and capital spending program, none of the other donor agencies indicated plans to provide technical assistance in these areas.

In its capacity as the central bank, the State Bank of Pakistan is responsible for ensuring the soundness and liquidity of the banking system. During the interviews, we learned that the

Bank of France is already providing technical assistance to the State Bank of Pakistan in setting up a credit bureau to collect and report loan information. In addition, a consultant from the IMF is assisting the GOP (in particular, the Ministry of Finance) in developing an active government bond market. Given the importance of both of these initiatives, we recommend that USAID monitor them and hold discussions with the Bank of France and the IMF to determine what role USAID might play to assist in these programs.

To support increased competition in the government-dominated financial sector, USAID might support the development of private non-bank financial institutions, such as investment finance companies, modarabas (a type of investment fund company), leasing companies and venture capital companies. In particular, USAID could (a) support the IESC in matching Pakistani companies with retired U.S. business executives with investment banking, financial management or entrepreneurial backgrounds; (b) encourage the development of local consulting firms offering business development or financial advisory expertise; or (c) provide direct, short-term technical assistance to selected financial institutions for which local expertise is not available.

In the insurance arena, Adamjee Insurance expressed an interest in taking advantage of the new law allowing private companies to enter the life insurance business and in establishing a joint venture with a foreign insurance company. At the present time, Adamjee is the only insurance company able to meet the minimum capital requirements of approximately US $1.4 million to enter the life insurance business. USAID could assist in the development of the private life insurance business by identifying and encouraging a US insurance company to conduct a feasibility study for investment, and by providing technical and/or financial assistance for such a feasibility study. In addition to promoting increased business for U.S. insurance companies in Pakistan, such a joint venture would provide the Pakistanis with access to managerial and technical skills in the new field of underwriting life insurance policies.

With respect to privatization, recent divestitures, such as Pakistan International Airlines, have targeted only partial sales of shares and no change in the management or control of these organizations. Once assured of a high level of commitment of the new government to a substantial program of privatization, USAID might provide technical assistance in the following areas: (a) determining the appropriate method of privatization for each enterprise, (b) preparing candidates for privatization, (c) valuations, (d) designing a labor deployment strategy, and (e) monitoring the privatization process.

In the team's opinion, the greatest problem affecting the banking sector and bank lending practices is a lack of competition. Until some form of privatization is introduced, banks are unlikely to accept the higher risk associated with cash flow-based lending and will continue to rely on heavy collateral and political connections. As a result, we do not recommend offering technical assistance or training to the commercial banks at this time.

Finally, in our meetings with foreign business representatives, we were told that much could be done to improve the quality of promotional materials on investing in Pakistan and the services provided to potential foreign investors. USAID could support the development of superior promotional materials, a comprehensive guide to doing business in Pakistan, and a one-stop investment information shop dedicated to attracting foreign investment.

Investment Packaging

The Capital Markets team discussed with market participants possibilities for a USAID role in the creation of new investment packages and financing methods that would assist in the process of improving the capital markets. The principal areas in which opportunities were identified concern financial instruments that may be created by the new investment banks, the creation of private mutual funds, venture capital companies, employee stock ownership plans, and mortgage banking and the development of mortgage-backed securities. USAID should establish a set of criteria against which the investment packages designed by the new investment banks, venture capital companies and other private financial institutions can be evaluated for possible USAID participation.

I. INTRODUCTION

A. Background and Origins of Project

With a need to restrain its own spending in the face of mounting budget deficits, the Government of Pakistan (GOP) has had to look increasingly to the private sector to provide the necessary investment to sustain economic growth. At the January 1990 meetings of the U.S.-Pakistan Economic Subcommission, the GOP welcomed a proposal by the U.S. Agency for International Development (USAID) to develop a joint program aimed at expanding private investment. As a result of these discussions, USAID is preparing a Project Assistance Approval Document for the Private Investment Expansion (PIE) Program. This document will lay the groundwork for a bilateral agreement between the GOP and USAID for the PIE Program.

1. Private Investment Expansion Program

The PIE Program is a $180 million program to promote private sector investment and capital market development in Pakistan. The Program seeks to increase the volume and efficiency of private investment through three mechanisms: (1) sector grants; (2) private investment support; and (3) special projects, technical cooperation and training.

Sector grants provide the opportunity to set an agenda with the GOP for policy reform and deregulation, after consultations with the private sector. Agenda topics will include those which decrease GOP intervention; decrease the problems associated with obtaining approvals, licenses and sanctions; increase the efficiency of business operations and commercial activity; and promote increased investment, employment and income.

The private **Investment Support** component consists of a private sector commodity import program (PSCIP). This program is designed to assist private sector importers in developing new industry, modernizing existing industry, transferring technology, and stimulating trade between Pakistan and the U.S. An important benefit of the PSCIP is that it will provide balance of payments support to Pakistan by making available scarce foreign exchange for private sector imports.

Special Projects, Technical Cooperation and Training (STT) ties together and supports the sector grant and investment support components of the PIE Program by establishing close working relationships with local businesses, chambers of commerce, industry and trade associations and others, and providing feedback through the appropriate channels on the need for policy reform, deregulation, credit facilities and further improvements in the investment environment. STT activities include a PIE Investment Fund (explained below); grants to the International Executive Service Corps, the Federation of Pakistani Chambers of Commerce and Industry, the American Business Council, the World Environmental

Council and various women's business organizations; a resident technical assistance team supported by short-term consultants; support for privatization; and training.

The PIE Investment Fund will support the newly formed private investment finance banks (IFBs) by providing them with loans at market interest rates for onlending to approved projects. These projects are to be ones in which the IFBs have made an equity investment and which might not otherwise be undertaken, such as loans to small and medium-sized businesses, women-owned businesses or projects from disadvantaged areas.

The resident technical assistance team, consisting of Pakistani and U.S. experts in capital markets development, financial instruments, financial institutions, investment expansion and entrepreneurship, will conduct research on policy issues, arrange workshops and seminars and arrange visitation programs for both public sector and private sector representatives. In addition, direct technical assistance will be provided to stock exchanges, government agencies, banks and other institutions related to the capital markets. Such technical assistance may consist of seminars and training, feasibility studies, institutional strengthening, promotion and other activities.

B. Objective and Scope

Price Waterhouse was given the mission of conducting a study of the Pakistan capital markets in order to identify those areas in need of policy reform or technical assistance which might be supported by USAID over the next several years. The study was to be conducted with the goal of improving the domestic and foreign investment climate in Pakistan and, in particular, creating a more efficient and competitive financial sector.

The Capital Markets team consisted of five people: an Investment Specialist, Mr. Jalil Shoraka; a Stock Market/Regulatory Specialist, Ms. Jan Aalbregtse; a Macroeconomist, Mr. Haris Jafri; a Development Finance Specialist, Mr. Don Green; and a Technical Support/Finance Specialist, Ms. Julia Philipp. The assignment was conducted in Pakistan over approximately seven weeks during the months of June, July and August 1990.

The team analyzed the strengths and weaknesses of the financial sector with particular emphasis on the constraints to the development of long-term capital formation, and evaluated the macroeconomic and microeconomic constraints to the development of a more efficient banking system and capital market. In addition, the team prepared a study of the institutional and legal barriers to the development of capital markets and ways of overcoming them; and the potential for increasing participation in the financial sector of private sector organizations with a view to encouraging U.S. and Pakistani investors in setting up companies or joint ventures in Pakistan. In particular, the team was told to develop a set of policy reform and technical assistance recommendations relating to the strengthening of the capital markets, taking into account the activities of other donor agencies. In addition, the team was asked to solicit suggestions during the interviews for the Investment Packaging program. A list of persons interviewed is presented in Appendix A.

With the outstanding support of the Private Sector Office, our team believes it has developed a set of recommendations for policy reform and technical assistance that should fulfill the objectives of the PIE Program with respect to the capital markets. Our recommendations, however, should be put in a proper context. Our visit to Pakistan coincided with a change in the government of Pakistan. It also coincided with a change in the local representatives of the World Bank, International Finance Corporation and the Asian Development Bank. USAID will need to follow up with additional discussions to determine which of the team's recommendations should be pursued and how they should be implemented.

C. Organization of the Report

The Capital Markets team has prepared this report based on a collective assessment of the Pakistan capital markets and those areas in which USAID might make the greatest contribution to capital market development during the implementation of the PIE Program. The report is divided into three major sections, in keeping with the major components of our assignment. Section II presents the team's analysis and recommendations regarding policy reforms intended to increase the efficiency of the financial sector and promote increased breadth and liquidity in the capital markets. Section III presents a series of recommended technical assistance activities designed to complement and support the policy reform agenda. Section IV presents a summary of discussions with financial sector representatives regarding the Investment Packaging program.

The team had access to and benefitted from a large collection of reports that had been written by previous teams, other donor agencies and Pakistani research groups on the capital markets and the financial sector. A bibliography of these reports is included in Appendix C. Since most readers will have come into contact with at least a sampling of these reports, we have avoided presenting the reader with a lengthy repetition of some of the basic information contained in these reports. Necessarily, we introduce each policy issue and technical assistance recommendation with a brief description of the relevant historical, macroeconomic, financial, institutional, legal and regulatory context.

II. CAPITAL MARKETS POLICY RECOMMENDATIONS

A. Liberalization of the Interest Rate Structure

1. Discussion

A securities market, functioning in a market-oriented business environment, is the most efficient vehicle for mobilizing financial resources and allocating them to the most efficient and productive economic sectors. An appropriate interest rate structure is the fundamental ingredient of capital market development. Distortion of interest rates adversely affects the development and operation of the capital market. The experience in most developing countries has been that attempts to modify the allocation of resources through manipulation of interest rates and against the call of market forces, frequently do not get the desired results. Instead, they tend to increase the intermediation cost, lower the efficiency of investment funds, and lead to the growth of the informal segment of the financial sector.

Usually, interest rates on government debt establish the reference rates for all other types of short and long-term obligations. In Pakistan, all rates on government debts are administratively determined and the interest rate structure is somewhat distorted. The Government finances its deficit mainly through four types of debt instruments:

- Adhoc T-bills which resemble an automatic overdraft facility at 0.5% and are held by the State Bank; they are usually short term with maturity of one year or less.

- Regular or eligible T-bills at 6%, which are held by commercial banks to meet their asset reserve requirement. At present, the asset reserve requirement of the banking system stands at 30 percent of total deposits; this is in addition to a 5-percent cash liquid asset requirement.

- Government Term Deposit Receipts (GTDRs) which bear an interest rate of 9-10.5 percent and are held by the general public.

- Special Deposit Certificates, such as Defence Saving Certificates, bearing tax-free interest rate of 12-16 percent, which can be purchased only by the general public.

The first three categories of debt instruments account for 43 percent of the Government's domestic debt, while the last category accounts for 44 percent.

The Government in 1979 commenced a program of financial Islamization, the primary goal of which has been to eliminate the use of interest (Riba). A variety of organizations and financial instruments have been devised to make possible the substitution of profit-and-loss sharing mechanisms for interest-bearing instruments, providing rates of return which are more responsive to market conditions. The impact of Islamization on the financial system and industrial finance has thus far been positive. By not imposing restrictions on the terms and conditions which can be negotiated between lenders and borrowers, the Government has effectively deregulated financial rates of return. However, these instruments constitute only a small segment of the credit market and these conditions do not apply to the government debt instruments. Furthermore, return on these instruments are distorted by the Government's long-term, tax-exempt, saving certificates presently paying 12.5 percent interest.

Because of excessive financing requirements resulting from the government deficit, and a desire to maintain nominal low interest rates, the National Credit Consultative Council (NCCC), which is responsible for the national monetary policies, and the State Bank of Pakistan, which is responsible for administration of those policies, administer quantitative control over the allocation of financial resources. Quantitative control is maintained through a "credit ceiling" mechanism which, at present, constitutes the key instrument of monetary policy. Credit targets are prescribed for individual banks indicating the public and private sector ceilings. Mandatory targets are also established for small loans to agriculture, business, industry, and low cost housing.

Credit allocation for the private sector is principally based on past performance, reducing the chances of new entries into the credit market. High mandatory reserve requirements are imposed on the banks (35% of total deposits) at low interest rates, averaging about 6 percent. As noted, the banks are also required to allocate subsidized loans to priority sectors; these requirements increase substantially the cost of the remaining funds allocated to the private sector.

Government T-bills are auctioned on weekly intervals. The Government, however, sells only when the bidding prices are close to the predetermined yield of around 6 percent; banks are required to buy the T-bills that are auctioned in order to meet their reserve requirements. There is no open market operation; hence, there is no market-oriented reference rate for the debt market. In conjunction with the recent financial adjustment loan, the World Bank has provided a long-term consultant who is assigned to the State Bank and is studying the issued of the GOP's debt finance management.

In 1987 a new law was adopted authorizing the creation of investment finance companies (IFCs) in the private sector with broad powers similar to those of investment banks in other countries. Although financial institutions and instruments established under the above measures will no doubt enhance participation of the private sector in the development of the capital and securities market and will encourage market rates of return on investment, no major improvement in the financial sector can be expected unless corrective measures regarding the interest rate structure are adopted.

2. Areas in Need of Reform

Several conditions are required in order to develop a more competitive financial system and to achieve a more efficient mobilization and allocation of resources:

- Returns offered to savers on financial instruments should be competitive with alternative forms of savings. Otherwise, there will be diminishing incentive for saving, and there will be a tendency for savings to be kept in non-financial form, such as real estate.

- Financial institutions should be able to obtain an adequate return on their loans and/or investments so that they (1) remain financially viable and (2) can offer savers competitive rates.

- Users of financial resources, both public and private, should pay rates that reflect market conditions. Government borrowing for financing its budget deficit, therefore, should be made under the terms of prevailing market conditions.

- Credit schemes, directing credits to priority sectors at concessionary terms, should be gradually reduced -- both in type and in volume-- and should be viewed as seed money to be complemented by a more extensive use of equity.

- Statutory reserve requirements should be gradually reduced to the minimum required by law, and the mopping-up operation of excess liquidity should be conducted through open market operations at prevailing market terms.

Considering that the present interest rate structure and credit schemes in Pakistan have been in operation, in various degree of intensity, for the past two decades, it may not be feasible to undertake the necessary corrective measures all at once. Financial liberalization has often proved difficult and needs to be undertaken alongside macroeconomic reform. Furthermore, financial liberalization cannot succeed unless it is accompanied by the restructuring of insolvent banks and firms, and by adequate prudential regulations and supervision. It is therefore recommended that the corrective measures be adopted gradually and alongside other macroeconomic reforms.

3. Policy Reform Recommendations

With regard to the interest rate structure, the Government should:

(a) reduce its budget deficit, hence reducing its need for debt financing;

(b) reduce its reliance on the State Bank for financing its fiscal deficit and, instead, gradually shift to the securities market for its financing requirements, and;

(c) conduct true auctions of treasury bills for raising its needed fund , thereby establishing reference rates for other debt instruments.

The fiscal deficit rose steadily through the 1980s, reaching 8.6 percent of GDP in fiscal year 1988/89; it was reduced to 7.3 percent in 1989/90, though the budgetary target had been set at 6.3 percent. The target for fiscal year 1990/91 is set at 5.7 percent, while preliminary figures indicate a ratio of over 7 percent.

During the past few years, in line with the GOP's policy of liberalizing and increasing the efficiency of the financial system, the ceiling on long-term interest rates was abolished and the permissible rate on short-term credits was set at 10-20 percent. However, there is currently no market-determined interest rate for term lending.

The sale of treasury bills for the establishment of reference rates and for liquidity absorption is the most effective method available to the monetary authorities for keeping inflationary forces in check. Even though interest rates will tend to go up, they will go up by less than if inflation takes hold. While it is true that there will be a crowding out effect on the private sector, resources that remain available will be allocated more efficiently. Furthermore treasury bills are considered the ideal instrument for development of the money market because they carry the lowest risk and can easily achieve the largest market depth due to the size of the Government financing needs.

It is also not possible to totally eliminate the existing credit allocation schemes. It should be recognized that, in a world of a rapidly changing relative prices, complex economic structures, and increasingly sophisticated financial markets, the risk of mismanaging such controls has greatly increased. Therefore, the Government should adopt measures which would keep the program in a manageable size, and would reduce its potential adverse impact on the financial markets. The following measures could assist in maintaining control over the existing credit allocation schemes:

o Reduce the number of directed credit programs.

o Reduce the proportion of total credit affected.

o Gradually reduce the degree of interest rate subsidization

o Specify and define priority sectors narrowly.

B. Financial Sector Institutional Reform

1. Recent Developments: Emerging Private Sector Involvement

The financial sector is dominated by five state-owned commercial banks, which control 80 to 90 percent of the nation's financial resources, leaving little room for the private sector's involvement in financial sector activities. Before discussing the problems of the state-owned banks, however, it is important to note that, during the past decade, the Government of Pakistan has adopted numerous corrective measures for encouraging private sector participation in the financial sector. These measures include (1) islamization of the financial sector which has culminated in the creation of numerous types of financial institutions and instruments in the private sector, (2) provision for establishment of investment finance companies, which has encouraged participation of domestic and foreign financial institutions to take part in the Pakistan financial sector, and (3) provision for establishment of an off-shore fund, which would attract global attention to Pakistan's securities market.

Islamization. Islamization reform, which began in 1979, essentially shifts transactions from an interest bearing basis, for both deposits and loans, to a profit and loss sharing basis (PLS); it advocates equity participation in place of deposits and loans. The operations of certain non-bank financial institutions (NBFIs) were the first to be reoriented and, subsequently, new financial instruments were introduced and PLS was extended to the nationalized commercial banks (NCBs). There are a variety of lending mechanisms, including term finance certificates (TFCs); modarabas (conceptually an invesment fund for which resources are obtained through sale of certificates); musharikas (temporary partnerships for providing working capital requirements); leasing and hire purchase (also for financing fixed industrial investment); lending with a service charge; and mark-up lending. In view of the difficulty of establishing non-interest based instruments for financing deficits, government borrowing continues on a interest-based approach. However, the provision of SBP finance to banks is on a PLS or mark-up basis.

As a result of the Islamization reform, the Investment Corporation of Pakistan (ICP) and the National Investment Trust (NIT) began to reorient their financial activities toward non-interest bearing operations. Bankers Equity Limited (BEL), the first company in Pakistan, was established to finance private industrial investment through the provision of new islamic financing modes. In 1980, legal changes were introduced to permit the issue of participation term certificates (PTCs) to replace debentures and to establish companies,which issue transferable certificates. In 1980, the Small Business Finance Corporation (SBFC) was converted to non-interest operations. In 1981, commercial banks were directed to begin accepting profit and loss sharing (PLS) savings and terms deposit accounts.

Although till now, Islamization, in terms of the existing volume of transactions, has simply changed the term "interest" for "PLS", it has succeeded in introducing various private sector-oriented institutions and instruments, and has provided a vehicle for private sector participation in the development of the financial sector. This is important because at the time when Islamization laws were enacted, the entire financial sector was owned and operated by the Government.

Private Investment Finance Companies. The second important measure adopted by the Government was the recent decision to issue licenses for new financial institutions, investment banks. In 1987 a new law was adopted authorizing the creation of investment finance companies (IFCs) in the private sector with broad powers similar to investment banks in other countries. IFCs can undertake all merchant bank activities (as known in the UK) or investment bank activities (as know in the U.S.A). The objectives of investment finance companies as outlined by the authorities are to:

- Conduct money market activities
- Issue short-term paper with a maturity of not less than 30 days (no checking accounts)
- Trade in commercial paper and assist in the issue of same
- Act a as broker in the call money market
- Engage in capital market activities
- Trade in listed securities, both equity and non-equity, either as a broker or for their own account
- Provide professional analysis of securities to both institutions and individual investors
- Underwrite and distribute stocks and shares or long-term certificates of deposit
- Float and manage mutual funds both open and closed
- Manage funds of personal or institutional investors
- Provide margin loans to both types of investors
- Undertake project finance activities

- o Guarantee loans
- o Provide corporate finance services including venture capital but no banking or insurance business.

Until the time of this study eleven licenses had been issued and two of the banks, Cresbank (in Karachi) and Interbank (in Lahore) are about to begin operations. The remaining nine licensees are required to complete their registration process and begin operation by the end of December 1990, but most financial executives interviewed do not find the existing economic and business environment conducive to the promotion of investment banking activities. They list numerous uncertainties which remain with regard to (1) the future distribution of their equity shares, as the Controller of Capital issues is now requiring that "shareholding of the general public shall be increased to 50% of the total paid up capital within a period of three years"; (2) participation in the money market, as they are prohibited in dealing in the inter-bank money market; (3) supervision, as it is not yet clear whether SBP or CLA would be the supervisory agent for the IFCs (although the Deputy Governor of the State Bank indicated that the supervision of the IFCs will ultimately be with the State Bank); and (4) the types of permissible operation, as the Government has stated that it is reviewing the law and that it will issue directives regarding the IFCs' future activities. Once these issues are resolved, however, investment finance companies, with appropriate expertise and technical assistance, could address many institutional deficiencies which at present exist in the capital market.

Offshore Fund. The third important measure undertaken by the GOP, which would lead to the improvement of the securities market activities, is the recent approval of an offshore fund, initiated by the Asian Development Bank and Morgan Stanley International, a U. S. investment bank. The Fund will be listed on the London stock exchange and will raise US $50 million to be invested in Pakistani securities. The Fund will demand improvement in the quality of corporate and market information and should culminate in a transfer of portfolio management technology.

2. Problems: The Issue of State-Owned Financial Institutions

While there has been some liberalization in the past few years, and the Government has stated its intention to do more, the financial sector remains dominated by the Government through broad ownership and control of financial institutions. This contributes to rigidity or lack of innovation and flexibility in the system, to poor performance reflecting entrenched bureaucratic personnel, and to economic waste due to inefficiency, corruption, redundant personnel, high costs, and excessive interest rates.

Pakistan's financial sector is a centrally controlled system of directed credit, dominated by government ownership of the commercial banks and the specialized development institutions. At its apex is the State Bank of Pakistan which, along with considerable direct

involvement of the Ministry of Finance, regulates the financial institutions. The nationalized commercial
banks, especially the three largest (Habib, National, and United) have the great majority of the deposit business. Together, the NCBs account for approximately 90 per cent of banking system deposits and 85 per cent of the advances.

Government-owned specialized banks exist for financing agriculture, industry, and cooperatives. Although these banks are treated as deposit-taking institutions, they rely on central bank support for the majority of their funding. These and a number of development finance institutions (DFIs) are classified as non-bank financial intermediaries. The most important of the NBFIs are the National Development Finance Corporation (NDFC), which is wholly government owned, and lends to public and private manufacturing enterprises; the House Building Finance Corporation (HBFC), which specializes in financing for home purchase and is funded almost entirely from the central bank; and the Pakistan Industrial Credit and Investment Corporation (PICIC), which provides long-term foreign currency financing to the private manufacturing sector. National Investment Trust (NIT) and Investment Corporation of Pakistan (ICP) are collective investment institutions, the former being an open-end mutual fund or unit trust. ICP manages a series of 18 closed-end mutual funds.

Over the past few years, the financial institutions have been confronted with numerous difficulties. The most important problem is the status of their loan portfolios; presently the banking system faces a big problem of arrears which appears to be endemic throughout the system. There have been a large number of willful defaults in the absence of efficient recovery mechanisms; while in existence, banking tribunals are ineffective and the litigation process is lengthy and tedious. There is inadequate competition among the banks, as they are all owned by the Government, and are managed under a set of uniform rules and regulations which are established by the bureaucrats and cover all aspects of the banking operations. Unavailability of credit information has caused concentration of credits in relatively few established enterprises and individuals, making it quite difficult for new entries to the credit market.

Although there are 19 foreign private commercial banks in the system, they do not provide competition due to the limited size of their financial resources and the statutory limitations on their activities (banking authorities claim that there is no restriction on foreign bank activities; this issue should be studied further.) The newly licensed investment finance companies are in no hurry to begin operation due to the lack of equitable conditions in the financial market.

3. Policy Reform Recommendations

(a) The Government should proceed with complete deregulation of the financial sector. Foreign banks and the newly licensed investment finance companies should be able to compete with the state-owned commercial banks in all aspects of banking, except in taking short-term (30 days or less) deposits. Interbank lending and the development of a money market should be encouraged in order to provide funds for private banks' lending activities. It is through this competition that state-owned commercial banks would be encouraged to improve their efficiency and the quality of their services, as well as the quality of their portfolios.

(b) Government intervention in the day-to-day affairs of the state-owned commercial banks should be curtailed. Many financial executives believe that, in Pakistan, political considerations often override feasibility factors in granting loans and credits. The Government should change its focus from "operating" to regulating and supervising the financial institutions, and should strengthen the regulatory framework and the supervisory authority and capability of the State Bank. The management of the banks should have, on the one hand, the necessary authority over the administration of the bank, and on the other hand, accountability for the performance of their respective financial institutions. Accountability for performance should be gauged by the following: (1) economic efficiency; (2) the ability to mobilize savings; (3) the ability to maintain financial stability; (4) the ability and willingness to promote entrepreneurship; and (5) the ability to avoid conflict of interest.

(c) State-owned credit institutions that overlap one another should be consolidated. For example, agricultural credits, sourced originally from the central bank at concessionary terms, are channelled through the Agricultural Development Bank of Pakistan, the Federal Bank for Cooperatives, provincial cooperative banks, and the five NCBs. In order to bring the directed credit schemes under a manageable program and allow commercial banks to attend to their commercial banking operation, it is suggested that agricultural credits which are of concessionary nature be handled by the Federal Bank for Cooperatives through the provincial cooperative banks. It is also recommended that a study be conducted to determine the overlapping activities of the specialized financial institutions, review their present status, and identify appropriate measures to improve, consolidate and expand their activities.

(d) Privatization of state-owned commercial banks, which has been on the agenda of the Government for some time, should begin. There are two schools of thought among the government officials; some are of the opinion that privatization should begin with the sale of 10 to 20 percent of the equity shares of all five commercial banks to the public, and the Government should continue to hold the remaining 80 to 90 percent, as well as the management of the banks; others believe that, instead, the Government should proceed to sell a majority share in one or two banks. Selling off to the private sector only a minority position of an NCB, as originally planned, is not sufficient. Such a half-hearted move would not achieve the objectives of privatization. Also, this type of disinvestment is not likely to draw strong private interests, and consequently the Government will not obtain favorable market prices of the shares being offered to the public. If return on the publicly held shares is guaranteed by the Government, as some suggest, then the whole idea of risk capital and equity investment is misrepresented. More damaging is that the failure of this program would be perceived as the failure of privatization, which would make it more difficult for the private sector to participate in the future government divestiture programs.

It is understood, however, that the Government is now considering the latter type of privatization, and intends to sell 60 percent of the shares of the two state-commercial banks, Muslim Commercial Bank Ltd. and Allied Bank Ltd. According to the Chairman of the Pakistan Banking Council, who is also a member of the Privatization Committee, the previous government was committed to the privatization of these two banks and the Minister of Finance was in the process of negotiating settlement with the labor union which we are told is the only remaining stumbling block. Whether these negotiations will be tabled for the time being remains to be seen.

(e) Government and the legislative bodies should assure autonomy of the State Bank. Monetary and banking decisions of the central bank should be principally based on domestic and international market conditions without any government or political influence. In Pakistan, as in other developing countries, there are powerful social and political pressures for popular programs, implementation of which would often require excessive monetary expansion leading to economic instability. An independent central bank could assist in maintaining economic stability. Furthermore, proper alignment of rates of interest and foreign exchange, which can be best achieved through an independent central bank, is particularly important in the present world economic environment that is rapidly moving toward the globalization of capital markets. This situation has left the developing countries with a great degree of vulnerability to economic instability including capital outflows, unless corrective market-oriented measures are adopted.

C. Insurance Industry: A Source of Equity Financing

1. Discussion

A strong capital market requires the existence of viable institutional investors who can take a long-term view of securities investments and who possess professional expertise in portfolio management. In Pakistan the two most active institutional participants in the stock market are the ICP and the NIT, which were discussed earlier. In addition, there are many insurance companies, both public and private, which hold substantial amounts of investment primarily in government and quasi-government securities. A brief discussion of the insurance industry follows.

While there are approximately 50 private insurance companies providing accident, household and general insurance, the life insurance business is monopolized by the government-owned State Life Insurance Corporation (SLIC). The SLIC was established in 1972 as the result of the nationalization of all private life insurance companies. The SLIC is now the only life insurance company in Pakistan and is controlled by a board of directors, the members of which are appointed by the Government.

In terms of asset allocation, the SLIC has to operate within investment guidelines which require that: (1) a minimum of 30 percent of net liabilities be in Government securities; (2) a minimum of 10 percent be in Government approved securities; and (3) a maximum of 60 percent be in shares, TFCs, PTCs, etc. The book value of the SLIC's investment portfolio has increased at an average rate of 14.8 percent per annum since 1973 and at end-September 1989 exceeded Rs 12,700 million (approximately US $590 million). At the end of 1989, government securities constituted approximately 80 per cent of the SLIC's investment portfolio.

The SLIC is at present concentrating on the promotion of life insurance both to individuals and to union councils in small towns and villages. The Government has provided tax relief on life insurance premiums through the provision of an investment allowance, available up to a maximum of 10 percent of the capital sum assured. This initiative on the part of the Government should help to expand life insurance coverage as a source of savings and capital formation.

Recently the GOP passed a law allowing private insurance companies to enter the life insurance business in Pakistan. The capital requirement for the life insurance business, however, is set at Rs 30 million (about US $1.4 million). At the current time only one insurance company, Adamjee Insurance, is able to meet the capital requirement. Adamjee Insurance is the largest of the approximately 50 private non-life insurance companies, with total assets of Rs 681 million (about US $32 million) and total premium income of Rs 822 million (about US $38 million) at the end of 1989. Its assets and annual premium income are almost three times larger than those of its nearest competitor. At the end of 1989, about 45 per cent of Adamjee's total assets were invested in stocks. Since private insurance companies still have to pay capital gains tax upon liquidation of their stock portfolios, they tend to buy and hold stocks, except for offsetting occasional capital losses from liquidation of bad stocks with sales of some good stocks. Thus, the capital gains tax tends to reduce secondary market trading in shares by private insurance companies.

2. Recommendation

Until recently, there was an urgent need for the GOP to allow the establishment of private life insurance companies in Pakistan. With the new law allowing private companies to offer life insurance, the team's recommendation related to the insurance industry focuses on technical assistance to support the development of a private life insurance industry. The team's recommendation is accordingly presented in the section on Technical Assistance.

D. Privatization

1. Discussion

Privatization of state-owned enterprises (SOEs) is one of the most effective ways to rapidly expand the capital market, in general, and the securities market, in particular. Privatization of SOEs reduces the Government's borrowing requirements on two fronts: (1) it eliminates the need for government funding of the capital expenditure requirements of SOEs and, if they are money-losing enterprises, their losses, and (2) it is a source of one-time revenue for the Treasury, with great potential for reducing the nation's long-term debt service cost. As often noted, privatization is also a major source of supply of shares for the securities market, along with other benefits such as promoting economic efficiency, increased competition and private sector growth.

The first and foremost requirement for a successful privatization program is the commitment of the Government. Although there have been numerous statements made in favor of a privatization program and a limited amount of divestiture, there is a great deal of skepticism about the previous government's commitment to privatization and public support appears to be lacking. As part of the 1985-86 budget, the GOP announced a divestiture program amounting to Rs 2 billion and proposed handing over the management of 12 SOEs to the private sector. In January 1986, the Government announced that a portfolio of companies with a reduced value of Rs 1.04 billion would be divested to the public. Toward year-end 1988, the Government retained a British merchant bank, N.M. Rothschild, to study the viability of an extensive privatization program in Pakistan. In June 1989, following the completion of the Rothschild study, five public sector companies were shortlisted for privatization. The companies are: Pakistan International Airlines, Habib Bank Limited, Pakistan State Oil, Sui Northern Gas Company and Southern Gas Company.

Of the five companies discussed in the Rothschild report, PIA might appear to be a likely first candidate for privatization. It has the highest paid-up capital of any company in the country (approximately Rs 2.5 billion) with the Government holding over 90 percent of the equity. PIA's management, however, has indicated the Government's intention to retain majority ownership and control over the management of the airline. Habib Bank Limited has the second largest paid-up capital of under Rs 2 billion. Given the extremely low rates of return of NCBs (below 5 percent), finding interested buyers will be very difficult.

Pakistan State Oil, with just under Rs 190 million in paid-up capital, is believed to be the most liquid of the five candidates. Ownership is divided between the private sector (23 percent), the Government (25 percent), and the government-owned and managed National Investment Trust and Investment Corporation of Pakistan (the remaining 52 percent). Sui Northern and Southern Gas, the two natural gas marketing companies, which enjoy good dividend track records, are good privatization candidates, but their small paid-up capital, at Rs 383 million and Rs 146 million respectively, would not enable the Government to raise revenue in an amount anywhere close to the target indicated in the budget as "revenue from divestitures". Once again, the Government is anticipating the sale of less than 50 percent of equity and retaining the control of the management of these companies.

The major finding of the Rothschild report is that Pakistani SOEs can be successfully privatized provided the program is handled properly, in a step-by-step approach. The report suggests a five-year timetable for the privatization of the five short-listed companies. Rothschild has cautioned the Government about the lack of depth of the capital market, the extremely low domestic savings rate and the preference of Pakistani investors to put their money in real estate on account of the unstable political situation. The report, however, does not foresee any problem in addressing the issue of labor, often cited during our interviews as the major constraint to privatization.

Government officials have conflicting views on the meaning of privatization and appropriate strategies. Some insist that the majority of the shares and the management of the SOEs should remain with the Government and that divestiture should begin with the sick or loss making units. Others suggest that privatization should commence with the sale of public sector companies with good track records and excellent reputations, and encourage guaranteeing a dividend payment of 20 percent for the first five years to encourage the public interest in shares. While the sale of state-owned enterprises is a complex matter requiring consideration of numerous delicate national issues, these issues can be resolved providing the Government is convinced of the benefits of the privatization program and is willing to commit to proceed with such a program. Before making this commitment, however, the Government, needs to generate public and political support which is evidently missing in Pakistan at this time.

2. Recommendation

At this stage, especially given the recent change in government, USAID's assistance should focus on a policy reform dialogue to (1) establish a clear understanding of the meaning of and potential strategies for privatization, and (2) encourage a strong commitment by the GOP to privatization, resulting in concrete action. Recommendations for technical assistance to support these policy reform objectives are presented in Section III.

E. Tax Policy

1. Discussion

The failure to operate an effective tax collection system distorts capital markets primarily by encouraging companies to underreport income and thus provide inadequate disclosure. Companies that are free from tax (such as modarabas) and multinationals that pay their taxes generally disclose more accurate information and their securities have developed active trading markets. Where tax systems are relatively effective, more companies go public.

Other developing countries that have ineffective tax systems have provided incentives for listing by significantly reducing the rate of tax applicable to listed companies (sometimes in proportion to the percentage of shares listed). These programs have had mixed results. In Pakistan, incentives were introduced to stimulate the development of the securities market; corporate income tax for listed companies was reduced to 40 percent, while that on unlisted companies was reduced to 45 percent. The reason these policies are generally ineffective is that companies in developing countries often pay very little tax in any event and, therefore, a lower tax rate is meaningless. It is our understanding that most Pakistani corporations pay little or no tax.

The tax rate on receipt of dividends compared to that on interest also affects an investor's decision regarding the placement of his or her funds. Currently, interest paid to individuals on GOP securities is tax free, while dividends are exempt only to the extent of Rs 10,000 per year.

2. Recommendations

- The PIE Program should support efforts to improve the tax collection system, particularly with respect to private companies. As part of the PIE Program, it is anticipated that the U.S. Internal Revenue Service will be assisting the GOP in efforts to improve the system. No other agencies have indicated an intention to take action in this area. USAID should support these efforts, not only because they should contribute to a reduction of the GOP's deficit, but also because improvements in the tax system will assist in expansion of the capital markets.

- A study should be conducted of the impact on the capital markets of varying tax rates on dividends, and interest earned on savings, government bonds, NIT certificates and other Islamic instruments. In general, (i) interest earned on government securities, if tax free, must bear a low enough rate to reflect the tax benefit component, and (ii) there should be parity of treatment for dividends and interest, or favorable treatment for dividends over interest.

F. Securities Market Enhancement

1. Problems with Corporate Participation in the Markets: Social Goals

a. Discussion

Pakistan has a problem with its securities market that many developing countries would love to have--there is an excess of funds to be invested and no place to invest. The National Investment Trust ("NIT"), a government-controlled open-end mutual fund, has US $4 billion in assets and insufficient companies in which to invest. For example, a Pakistani insurance company has indicated an interest in forming a joint venture with a multinational life insurance company, but plans to seek permission to invest the funds in foreign securities because the Karachi Stock Exchange does not provide sufficient opportunities. Surely it would be preferable to invest these excess funds in Pakistan.

There are a number of reasons why more companies have not listed their securities, including the following: (1) as discussed above, the interest rate and financial structure makes it less expensive to obtain debt financing than equity financing, (2) family-owned companies do not wish to sacrifice their privileged position, and (3) the price permitted to be obtained from the sale of shares to the public does not represent a fair market price. Companies have also indicated a desire to issue other types of securities, such as commercial paper and convertible securities, to provide them with an alternative to bank loans. While permission is apparently granted for the issuance of other securities on an ad hoc basis, a policy favoring other instruments would encourage their use.

To address the problem of concentration of Pakistan's wealth in the hands of a small number of families, the GOP has introduced a number of measures to effect a wider distribution of shares:

(1) Companies with over Rs 50 million paid up capital are required to become public limited companies and to sell 50% of their shares through the stock exchange.

(2) The NIT was created as an open-end mutual fund to encourage indirect investment in the market by small investors. NIT is provided an option to acquire 20% of all issuances of securities. Since many new issuances are at a price that does not reflect market, this provides a significant benefit to NIT. NIT is required, however, to hold securities for 2 years (unless the GOP provides an exception) and has a general mandate to exercise its option (thus resulting in acquisitions of poorly performing companies, as well as blue chip companies).

(3) The price that can be charged by companies for their shares in the primary market is controlled by the Government in order to effect a redistribution of wealth.

While these measures are intended to address important social issues, they distort a free market. A compromise between social goals and free market principles is required.

i. Forced Listing and the NIT Advantage

A requirement that a company list its securities is inimical to a free market. Many developing countries have required listings, however, in order to break up family holdings, an important democratic objective that should also eventually expand the private capital base.

A better approach is to address macroeconomic issues that distort interest rates so that it becomes advantageous for companies to become public, but these changes will be accomplished only gradually. Social goals to achieve a wider distribution of securities may also be better achieved in the long run through the creation of private mutual funds, employee stock ownership plans and stock option plans, and the investment of pension funds in securities, as discussed below.

Mutual funds, such as NIT, provide a vehicle for small investors to enter the market; little knowledge is required on the part of the investor as the fund is professionally managed. In NIT, for example, as little as Rs 61 ($3) is required to purchase a unit. The advantage provided to NIT has been effective in attracting smaller investors in this manner. NIT, however, now controls a major portion of the market with little competition from the private sector.

Employee stock ownership plans are used in the United States as incentives for employees and have resulted in significant shareholdings by employees. These plans generally allow a portion of an employee's wages to be withheld from each paycheck and invested in the company's stock without brokerage commissions. The employer often matches the amount contributed for purchases by the employee.

Stock option plans permit employees (often limited to executives) to purchase stock at advantageous (and sometimes tax favorable) rates if the price of the stock increases, presumably as a result of the employees' efforts.

ii. Pricing of Equities

In any free market system if a company wishes to go public, the company will attempt to obtain the best price available for its shares and will only sell that portion of the company required to obtain funds which can be employed to achieve a higher return than the cost of the capital obtained. Generally, an underwriter will determine the appropriate price range by gauging the market and will negotiate the price with the company.

In Pakistan, the price to be obtained for securities offered publicly is established by the Controller of Capital Issues ("CCI"). The CCI was formerly a division of the Ministry of Finance, but now has been consolidated as a part of the Corporate Law Authority, thereby eliminating one bureaucratic layer and the potential for conflict between agencies.

The price is presently calculated based on book value. Thus, the fair market value of a company's assets, and any goodwill of the company that may have been established, are not taken into account. Apparently, exceptions may be made to the pricing formula depending on one's bargaining power. Due to the significant undervaluation of the company's shares, most offerings are overwhelmingly oversubscribed. A "grey" market develops immediately for the shares (before they are listed), because they are undervalued, and there is now a separate section of the Karachi Stock Exchange (the "KSE") where this trading takes place. This practice encourages speculative trading. Brokers and others who abuse the system through multiple subscription applications, as well as NIT, which is provided a preference, may be expected to oppose any change in pricing methodology.

The CCI has indicated that they realize this pricing mechanism distorts the market and discourages equity financing. They agree that fair market pricing would be preferable. They advocate a change to permit free market pricing in firm commitment underwritings, provided mechanisms are in place to prevent sham underwritings. For example, they are concerned that there may be under the table buy back arrangements between the issuer and the underwriter.

iii. Additional Types of Securities and Financial Markets

Many reports that discuss the Pakistan capital markets suggest the need for additional types of securities, particularly commercial paper. Under the Companies Act, preferred stock is not permitted to be issued. Other securities, such as convertible debentures, are not seen in Pakistani markets, and market participants are not generally familiar with these instruments. Apparently, issuance of such securities is permitted only on an ad hoc basis with the permission of the GOP.

The availability of a wide range of financial instruments enhances the functioning of capital markets as issuers have more options for obtaining capital and investors have a selection of investments that provide them with varying degrees or return based on the risk taken. Commercial paper, in particular, is important as it provides an alternative to bank financing. Of course, any such instruments would be required to comply with Islamic principles regarding the sharing of profit and loss.

Another key segment of the financial markets, mortgage loans, is absent in Pakistan. The availability of mortgage loans is a key ingredient for assisting in the growth of a middle class by providing individuals with equity in their own homes. Apparently, the principal reason mortgages are not available is that the legal system does not provide adequate remedies to permit lenders to foreclose. A significant new private financial sub-sector could be developed if a swift, nondiscretionary foreclosure remedy became available. The International Finance Corportion ("the IFC") is entering into a joint venture with PICIC to create a housing finance company. It is unclear how the IFC is addressing the legal issue.

b. Recommendations

USAID should encourage the GOP to gradually change its social policies to adopt a free market approach while addressing GOP concerns regarding wider distribution of ownership. Emphasis should be placed on the following:

- o Private mutual funds should be created to compete with NIT. The benefits provided to NIT, as well as the restrictions imposed, should be gradually removed so that other mutual funds can compete.

- o Tax and other incentives might be provided by the GOP to encourage the creation of ESOPs and stock option plans. (USAID may package some of these products and provide assistance in their implementation and regulation.)

- o The requirement that companies become public should be gradually removed, but only in conjunction with changes in interest and financial sector pricing policies that encourage companies to become public.

- o The price permitted to be charged by companies for the issuance of their securities should be based on market value. In cases where securities offerings are firmly underwritten (rather than underwritten on a "best efforts" basis), the price should be determined by the underwriter. Of course, the goal should be to create a functioning, regulated market so that pricing restraints can be removed entirely as soon as possible.

- o USAID should encourage the GOP to permit private institutions to determine the types of securities they will issue, provided the securities comply with Islamic principles.

- o Changes in the legal system should be encouraged in order to develop a mortgage loan market. Laws must be amended to remove discretion from courts in foreclosing on notes and mortgages and to permit courts to swiftly remove defaulters from their property if loans are not repaid. Obviously, some due process protections for the borrower are required. Once again, a compromise can be reached that will achieve both goals, as is done in other countries. While some of the legal provisions that presently inhibit mortgage loans were designed to protect people from being removed from their homes, the effect is to make the lower and middle class renters instead of homeowners.

2. Problems with Investor Confidence

a. Discussion

Central to an efficient stock market is a perception that an investor will have a fair opportunity to participate in the potential for profit. Although all world markets have some degree of inefficiency that provides advantages to market participants and insiders, if abuses in the market are perceived to be great, general investors will avoid the market. The Karachi Stock Exchange, like other developing country markets, reputedly does not provide a fair playing field.

i. Disclosure

The principal problem in the marketplace mentioned by most market participants is the lack of timely and accurate disclosure. Timely disclosure of financial results of operations, as well as material developments affecting a company, are essential to a functioning securities market. Sufficient standards for disclosure in prospectuses and annual reports are in place in Pakistan, but compliance is poor.

Central to adequate disclosure is accurately audited financial statements. Without proper financial reporting, the value of a company cannot be determined and comparisons between companies cannot be made. While international accounting principles are technically required to be applied to financial statements of listed companies, significant discrepancies apparently occur because of corruption.

The Companies Act specifies the financial statement requirements for listed and unlisted companies. Financial statements of unlisted companies are not required to be prepared in accordance with international or any other accepted accounting principles.
The Institute of Chartered Accountants licenses and regulates accountants and an examination and four years of experience are required in order to obtain a license. The Institute has disciplinary power, but can only issue a reprimand for violations of accounting practices. In order to issue a reprimand, a complaint must be filed and heard by both an investigation committee and the full Institute. Hearings must be held at each level. Revocation of a license may only be effected by the High Court. The Corporate Law Authority has the authority to fine accountants for abuses. Reportedly, disciplinary procedures by the Institute and the CLA are virtually nonexistent.

Apparently the level of training of accountants in Pakistan is relatively high. However, some practitioners reportedly have difficulty maintaining economic independence from their clients. The Institute has recently formed a standards review committee, which will review the work of accountants. This is intended to be more of a training than a disciplinary effort. A more formalized training program is also being organized by the Institute.

Even accurate disclosure is often insufficient to attract small investors to developing country markets as the typical small investor is unable to understand financial statements and disclosure documents. In addition, remedies for inaccurate disclosure are currently ineffective due to the inadequate court system. Even if the court system operated effectively, small investors would require additional protection as court costs generally inhibit the filing of suits.

Participation in the marketplace by private institutions is thought to provide the best protection for small investors. Another effective tool used in the United States to encourage adequate disclosure is the imposition on accountants and underwriters of liability for false and misleading statements in a prospectus. While on paper Pakistani law imposes liability on these parties, including underwriters and accountants, these provisions are not enforced.

ii. Insider Trading and Market Manipulation

Many of the persons interviewed suggested that the system is rampant with insider trading and advantages. Brokers obtain proxies from their customers in order to elect themselves to the boards of directors of trading companies. With information obtained from these positions, trading advantages may be obtained. NIT and the Investment Corporation of Pakistan ("ICP"), hold such large blocks of securities of certain companies that they are in a position to dominate and manipulate trading. NIT and ICP also have representatives on the boards of companies in which they trade.

There is a "short swing profits" law in Pakistan which requires repayment to the company by officers, directors and holders of 10% of a company's securities of any profit from the purchase and sale of securities within a 6-month period. There is also a general antifraud rule which prohibits misleading statements, but there is no direct prohibition on trading by insiders and any other persons (including promoters, accountants, advisors and their tippees) who possess material non-public information. In the United States, general antifraud prohibitions similar to those in Pakistan are used by the courts to prohibit insider trading. A direct statutory prohibition is preferable, however.

iii. Enforcement

The Corporate Law Authority ("CLA") has jurisdiction over enforcement of the securities laws, including disclosure and insider trading. Historically, the CLA has been inadequately staffed and has served a bureaucratic, rather than an enforcement, function. The staff required for financial and supervisory work, such as financial analysts, lawyers and accountants, are not in adequate supply to the supervisory bodies, primarily due to funding constraints. These difficulties are compounded by the uncompetitiveness of Civil Service salaries, although staffing has improved recently and the CLA has authority to hire consultants. The agencies exercise their supervisory functions in a passive rather than active mode, by reviewing information which is required to be submitted to it rather than through spot checks or independent investigation. The CLA reports that it has begun to take a more active role in examining problems of multiple subscription applications and would like assistance in the methodology of investigating insider trading violations.

Both civil and administrative cases for failure to disclose, inaccurate disclosure and insider trading are nonexistent. The unresponsive court system also provides an impediment to effective enforcement. In general, the legal system in Pakistan is very slow. The courts are crowded and, despite the creation of a separate Company Bench to handle Company Act issues, it takes forever to get a final judgment. In part, this is because the appellate courts are too numerous and not selective as to which cases they will agree to hear. It may take six months to get a judgment entered and may take twelve years to get a case heard, without taking into account delays which may result from appeals. The CLA is taking steps to improve the agency and welcomes USAID suggestions.

iv. Protection of the Interests of Minority Shareholders

Most private sector Pakistani companies are closely held by family interests. While companies over a certain size have been required to list 50% of their shares on the Exchange, management control remains in the hands of the family. The companies generally do not pay dividends, and reportedly retain significant benefits for the family members to the detriment of the minority shareholders. These practices are a direct result of the failure of market forces to make raising capital in securities markets advantageous. Accordingly, companies that would prefer not to go public, but are forced to do so, find other ways to maintain their benefits. The requirement that companies list their securities on the Exchange distorts the marketplace. Nevertheless, as discussed above, this requirement may be necessary to address the GOP's objectives of spreading ownership of shares until a freely functioning capital market makes it advantageous for companies to obtain capital in the securities market. Other methods of distributing ownership, such as employee stock ownership plans and investments by pension funds held for the benefit of employees, as described above, are preferable methods of distributing ownership and have been effective in other developing countries, such as Korea.

The Companies Act has sections providing a cause of action for "oppression and mismanagement." These provisions reportedly are not often applied, however, because of high legal costs and because the statute requires that 20% of the shareholders join in the action. The Act does not impose on majority shareholders, officers and directors a more general fiduciary duty to minority shareholders, an important concept in the laws of the United States and other democratic countries. Pakistan also does not permit class action lawsuits, which would make it more feasible and affordable for a holder of a small block of securities to take action.

Due to the grip on companies that family interests possess (combined with the subsidies provided by nationalized banks for non-commercial reasons) many publicly traded and privately held companies are reportedly inefficient. Reports have been made that national banks and DFIs will not foreclose upon defaulted loans and do not sell the companies to the public because of loyalty to the owners. As noted, these companies are also unresponsive to minority shareholders. In a free market system, these companies would either be forced into bankruptcy or taken over, either through purchases on a stock exchange or through a negotiated sale to the highest bidder.

The CLA is concerned with the failure of certain companies to pay dividends and comply with disclosure requirements. It has been suggested that new owners should be allowed to take over a public company if (a) disclosures are not made in a timely fashion, (b) dividends are not declared on a prolonged basis, or (c) a bid is made that is not matched by management. The latter approach is similar to that sometimes used to resolve disputes in privately held companies (called a buy-sell provision).

A committee has been formed by the GOP to assess means to address the failure by many companies to pay dividends.

b. Recommendation

- The principal focus of the PIE Program to improve investor confidence should be on strengthening the application of disclosure requirements and improving enforcement capabilities. The focus of the CLA should be on enforcement as compared to bureaucratic review of disclosure documents. As enforcement efforts may prove difficult in this climate, however, preventive methods such as restrictions on trading while a person is a member of a company's board of directors and penalties for nondisclosure should also be considered. Delisting is often used in other countries to penalize offenders. However, in this market, many companies would prefer not to be listed, so this penalty would likely be ineffective. Broker regulation, including introduction of professional standards for licensed brokers and review of brokers' transactions should be a function of the CLA. Independent representation on the Stock Exchange Governing Board should also be considered.

  CLA representatives believe they have sufficient authority so that an independent agency is not required. The CLA has rulemaking authority and authority to impose fines, as well as the power to liquidate a company or to appoint an administrator of a company. Independence of a securities regulatory authority is generally preferable, however.

- The Institute of Chartered Accountants should be encouraged to establish an effective self-regulatory body of accountants. Any training programs that may be undertaken in conjunction with the Institute should be conditioned on implementation of an effective disciplinary function. Accountants should be required to apply the same accounting standards to all financial statements for both public and private companies.

3. Institutions that would Encourage Investor Participation

a. Discussion

i. Investment Advice; Credit Ratings

There are no entities in Pakistan that perform the function of analyzing investments and advising the public regarding the merits of a particular investment. Credit rating agencies and investment advisory organizations provide an important service in the marketplace by evaluating investments for investors who do not have sufficient time, resources or knowledge to make the evaluation. Credit rating agencies provide ratings for corporate bonds, preferred stock issues, municipal bonds, bank certificates of deposit, and other debt or quasi-debt instruments using standard symbols (AAA, AA, etc.) The ratings perform a credit risk function and are valuable to unknown companies contemplating borrowing in public markets and to investors interested in assessing the creditworthiness of a particular borrower. Credibility is essential to the operation of a rating organization and usually arises from its being independent of any issuer's business. Due to the lack of sophistication of the investing public, these types of entities would be beneficial in improving the integrity of the markets, provided they are independent from brokers and issuers, are adequately regulated, and the quality of reported financial information can be improved to enable these entities accurate data to analyze.

ii. Improving the Capabilities of the Stock Exchanges

KSE representatives indicate that the KSE is being computerized, has the capacity for increased trading and is in fact more sophisticated than many developing country stock markets. The KSE is presently constructing a research and training facility, which will include a library and research center.

Settlement and clearance procedures have been computerized, are operating effectively and apparently have capacity for growth. Settlement and clearance procedures, which are being developed in connection with the sale of government securities, should also enhance this process. Representatives of the KSE have visited many developed and developing country exchanges to obtain and provide training.

The KSE and brokers are self-regulated and have not inspired investor confidence. Historically, brokers in Pakistan have not been held to any standards of education, competence or net worth. The KSE has newly implemented requirements for transferees of exchange seats, including experience and net worth criteria. No examination is required, however. The KSE rules were recently amended to permit corporations (other than NIT, ITC and foreign entities) to become members of the KSE, provided they purchase a seat on the KSE from an existing member.

Exchange rules governing brokers are inadequate. Brokers act as both agents and for their own account, thereby creating a conflict of interest. While both of these functions are also permitted to be exercised by the same party in Western exchanges, rules exist over those exchanges to protect the customer, such as "best execution" rules and rules requiring that priority be given to client orders. There is no independent surveillance department of the KSE to monitor broker transactions. Brokerage fees are fixed, while other countries have allowed the prices to be established by market forces. While market pricing encourages efficiency and allocates resources based on services provided, the KSE probably is not yet prepared for this change.

b. Recommendation

- o USAID should consider assisting in the development of private investment advisory organizations, a credit rating agency and other institutions to act on behalf of small investors. In Indonesia, a governmental entity acts as a market maker to stabilize the market and to assure that small investors are protected. This governmental intervention distorts a true marketplace, however, by subsidizing market declines and capping potential gains. A better approach is to encourage private mutual funds, whereby small investors can participate in the marketplace through the expertise of fund managers. In Korea, insurance companies and other institutional investors have been buyers of significant blocks of securities indirectly on behalf of small investors. The former Korean Securities Investment Trust allowed small investors to make monthly installments for the purchase of securities, which were held in custody by a securities company. Loans to encourage these entities could be provided. Funding could be considered in conjunction with the ADB to encourage creation of a credit rating agency.

- o Application has been made and granted to create a stock exchange in Islamabad that would be independent from the Karachi Stock Exchange. The grant of the application has been challenged and the matter is presently before the courts. If created with credible market participants, the Islamabad exchange could provide the required competition for the KSE. USAID should consider providing technical assistance to the Islamabad Stock Exchange to encourage competition between the exchanges (see Technical Assistance section).

4. Need to Improve Liquidity of Market

a. Discussion

Market depth, in the form of an active secondary trading market, is one of the most important functions of a stock exchange. Without an active secondary trading market to assure investors of liquidity, it is difficult to effect primary distributions. In U.S. markets this function is generally performed by specialists or market makers. Specialists and market makers are always available to purchase and sell securities at quoted bid and asked prices.

There are no specialists or market makers on the KSE, and historically the Exchange has not provided a good secondary market. NIT and ICP, which hold the most significant portion of potential market float, tend to hold shares rather than trade, thereby further limiting the availability of shares for trading.

Trading has improved on the KSE recently, particularly with the introduction of s. Many s have been floated on the Exchange and these issues have accounted for a significant portion of the volume on the Exchange. The principal advantage of s is that there is no tax at the company level (this also means there is little incentive to falsify results of operations) provided dividends are declared to the extent of 90% of profits. Dividends may be paid in the form of a stock dividend.

The introduction of investment banks should improve liquidity if the banks are able to underwrite securities of additional companies. Underwriters commissions are presently limited to 2 1/2 percent, an amount which may be an insufficient incentive to investment banks to promote the securities of all but blue chip companies. Exchange rules have recently been amended to permit corporations, including investment banks (but excluding NIT, ICP and corporations with foreign ownership) to become members of the Exchange by purchasing the interest of a present member.

A proposal has been made to permit pension funds to invest a portion of their assets in the stock market. According to one financial executive, most pension funds are self-managed by individual companies and/or their employees. In addition, the Government has a pension fund for government employees. The Central Board of Revenue carefully regulates which securities pension funds can invest in. Allowing pension funds to invest in stocks should greatly increase liquidity of the marketplace.

Another factor affecting liquidity is the large unofficial financial market in Pakistan. Integration of the unofficial market into the formal markets could significantly improve liquidity. Pakistan has a large unofficial or parallel financial sector, generally consisting of:

- the "Hundi" (informal promissory notes) system of foreign exchange transactions
- credit arrangements in the non-corporate cotton textile sector
- merchant credit operations particularly in the commodities market
- arrangements within the non-corporate banking sector.

The informal sector operates chiefly through brokers who know or identify borrowers who are retailers requiring inventory financing; cottage industries requiring finance to purchase raw material; or commodity traders requiring financing of purchase of grain, spices and other commodities. The unofficial market does not participate in the official economy due to the illegal nature of the transactions, tax evasion and bureaucratic inefficiencies.

Flotations of bearer certificates by the GOP, such as the issuance of WAPDA Bonds, Bearer National Funds bonds, foreign exchange bearer certificates and NIT bearer certificates have attracted some of these funds into the official economy due to the anonymity provided. The GOP has been trying to get some of the large public sector institutions to borrow from the market instead of relying solely on the budget. Consequently, flotations of bearer investment certificates have been used. In fact, half of the funds held by NIT are evidenced by bearer bonds. These certificates have been able to compete with other attractive opportunities, such as the former Khaas certificates, only because the bearer feature drew extensive "black" funds from the informal market. WAPDA issues in 1988 and 1989 attracted aggregate subscriptions of Rs 3.5 billion and 5.6 billion respectively.

Measures taken to increase the participation in the market of investment banks should improve the liquidity of the securities markets. The underwriting function is indispensable to a healthy primary market, and participation in the market by private institutions also appears to be the best protection for investors in a developing securities market. However, the primary problem with liquidity results from macroeconomic issues described above under "Interest Rate Structure."

Other suggestions that have been made to improve liquidity are:

(1) Institutions, such as pension funds, should be encouraged to invest a portion of their funds in securities.

(2) Commissions permitted to be earned by underwriters should be increased to provide an incentive for increased offerings.

(3) Encouragement should be provided to financial institutions, such as investment banks, to underwrite securities.

(4) Underwriters should be encouraged to make a market in shares they promote for a certain period of time.

(5) Issuers should be entitled to repurchase their own shares.

(6) Bearer certificates should be permitted.

Suggestions (1) and (2) are sound. When the Indonesian government adopted a regulation authorizing pension funds and other institutions to buy securities on the Jakarta exchange, significant additional liquidity was provided to that exchange. Under Pakistan labor laws, companies with a certain number of employees, capital or fixed assets are required to establish an employee's participation fund into which 5% of annual profits must be paid. Consideration could also be given to permitting or requiring these funds to be invested in the company's stock. Studies have shown that where commissions are determined between the underwriter and the sellers, as in Korea, the primary markets are more active than in countries, such as Indonesia and Taiwan, where commissions are limited. Suggestions (3) and (4) require further study, but may be tied to any change in the law regarding deregulating commissions for underwriters. In this connection other incentives, such as tax incentives or loans may be considered to private sector market makers, but these should be undertaken with caution as a freely trading market will provide sufficient incentives for companies to make markets.

While suggestion (5) would improve liquidity and is generally permitted to a limited extent in developed country markets, it is probably not wise in a system where insider trading is not adequately controlled.

Suggestion (6) should be considered seriously. Channeling of a portion of the unofficial market into the securities markets could significantly improve the liquidity of the markets. The most effective tool for encouraging the investment of unofficial funds is the availability of bearer certificates, which are not presently permitted for private companies. While bearer certificates do not assist in the tax collection system, the unofficial market generally evades tax in any event. In fact, if dividends become nontaxable, the tax collection aspects of registered securities diminish. For these reasons policies should be encouraged that establish private mutual funds with bearer certificates in order to attract this market. The allowance of bearer certificates should not be a condition to grants and loans. Due to the sensitivity of the issue of permitting illegally obtained funds to escape taxation and be readily integrated into the economy.

b. Recommendation

USAID should concentrate its efforts to improve liquidity on the macroeconomic issues described under "Interest Rate Structure," while encouraging a policy dialogue about the additional measures to improve liquidity as discussed above. Assistance to the new investment banks to encourage underwriting, in the form of loans and technical assistance would be appropriate while the dialogue is taking place.

III. TECHNICAL ASSISTANCE RECOMMENDATIONS

In identifying areas where USAID/Pakistan might provide technical assistance to the GOP, the Capital Markets team targeted activities where USAID assistance would complement proposed policy reforms, where it would be welcomed by the GOP and where it would produce the greatest rewards or benefits in terms of strengthening the capital markets in the near to medium-term. The major categories of technical assistance are institutional strengthening, seminars and training, promotion and feasibility studies, with potential counterparts including (but not limited to) the Karachi Stock Exchange, the State Bank of Pakistan, the non-bank financial institutions and selected public sector enterprises.

A. Public Education

As a result of our meetings with a broad cross-section of the public and private sectors, the Capital Markets team concluded that one of the most important steps needed in improving the environment for private sector investment is a campaign, in coordination with a local media consultant, to educate the public on the benefits of private enterprise, private investment and a free market to Pakistan's economic and social development. On several occasions we were told that what many Pakistani workers seek is a secure job that, while modest in terms of pay, requires little to no effort. At one government-owned mill, for example, absenteeism averaged 60% on a normal day, but dropped to 0% when the mill was idled and work ground to a halt due to a lack of electricity. Such an attitude on the part of labor, should it persist, will make it exceedingly difficult for the Government to implement a privatization program and will discourage private investors, whether foreign or domestic, from investing in Pakistan. Through a public education campaign, Pakistanis could be encouraged to take pride in their work and to contribute to the development of their country. Programs to educate the people on the meaning of share ownership, the role of mutual funds and employee stock ownership plans, the purpose of levying an income tax and the duty of workers and businesses to contribute to the cost of public services could be another important element of this campaign.

Our team was told that the NIT and ICP have made certain efforts to educate the public on share ownership. Expanding television coverage on the financial markets should also help the public to become more aware of commercial matters. A coordinated, comprehensive campaign - in addition to promoting A.I.D.'s goal of open markets and open societies - would greatly support the Government in achieving the goal of increasing private investment.

Timeframe: Immediate

Requirements: Local media consultant

B. Securities Market

The development of an efficient securities market is necessary to enable Pakistan to mobilize the long-term capital required for sustained economic growth and expanded private sector investment. In our discussions with other donor agencies, it was suggested that USAID/Pakistan could play an important role in the development of the securities markets by offering a program of multi-year, multi-dimensional technical assistance to the major participants in the securities markets. USAID/Pakistan assistance might include the following:

1. Assist in Strengthening the Institutional Capacity of the Corporate Law Authority to Regulate the Securities Markets

USAID/Pakistan could assist in strengthening the institutional capacity of the CLA (or its independent successor) to regulate the securities markets by focusing on the skills, training and staffing needs of the CLA; organizational structure; information and automation needs; the preparation of written materials such as training or procedures manuals; and the ability of the CLA to institute timely and effective corrective actions. The CLA specifically requested USAID assistance in obtaining computers, training CLA staff in their use and developing a microfilm facility to record and store financial information on its universe of 22,000 (public and private) companies.

The principal technical assistance efforts in this area should relate to strengthened enforcement. In general, the laws regulating the securities markets, while basic, are adequate. The need for additional rules may become apparent as these efforts proceed. At that time, technical assistance may be required to develop rules and regulations. At present, it is expected that the State Bank of Pakistan will be regulating the new IFCs, such as Cres Bank and Interbank. As more IFCs, modarabas and merchant banking organizations are created, the SBP's capabilities should be expanded and improved to handle their regulation and supervision, perhaps with technical assistance from USAID.

Timeframe: Years 1-3, with additional assistance as needed.

Requirements: Specialists in areas including stock market enforcement, organization and management and broker-dealer regulation.

2. Assist in Strengthening the Capacity of the Institute of Chartered Accountants of Pakistan to Promote Improved Accounting Practices

The quality of reported information on companies in Pakistan has important implications for the financial markets. USAID could develop a project to examine, in conjunction with the Institute of Chartered Accountants of Pakistan (ICAP), the desirability of strengthening the Institute to operate in a similar manner to the U.S. Financial Accounting Standards Board (FASB) and the American Institute of Certified Public Accountants (AICPA) to develop better financial reporting standards and an effective self regulatory system. This may be done in conjunction with the Institute's proposed training program. ICAP plans to offer review courses on internationally accepted accounting and auditing standards to make sure that members of the profession know what they are. Once these courses are offered, ICAP intends to introduce stricter sanctions for non-compliance. As a condition to receiving USAID assistance, USAID and the ICAP could develop measures that would be introduced to improve the enforcement and disciplinary system.

In addition to ICAP, support for training activities could be directed at the Accounting Technicians Institute and the Institute for Management Accountants. During our meetings with the Corporate Law Authority, we learned an Accounting Technicians Institute is being formed with support from sources such as the World Bank, the Institute of Chartered and Management Accountants and the Auditor General's Office. This institute will be headquartered in Karachi with branches in several cities. Graduates will earn a technician's certificate (below the level of a CPA). The governing board is currently reviewing course materials available from the International Federation of Accountants and would like to receive technical assistance in designing the course curriculum and examinations. It would also welcome assistance in obtaining computers, audio-visual aids and library materials.

The Institute for Management Accountants is being set up with help initially from the Canadian Institute of Cost and Works Accountants. The institute will also be based in Karachi with a small branch in Islamabad. It would also welcome technical assistance in designing course materials and examinations and in obtaining computers, audio-visual aids and library materials.

Timeframe: Years 1-3

Requirements: CPAs with experience at the FASB and AICPA and training and curriculum design specialists

3. Support the Establishment of a Chartered Financial Analysts Program

USAID could examine the feasibility of creating a professional association of chartered financial analysts (CFAs) and in establishing self-supporting CFA courses that would be offered on an ongoing basis. USAID could initiate discussions between one of the business training institutes and the Securities Analyst Association in the United States about developing a program for training, testing and licensing CFAs. These CFAs would provide advice to investors who are lacking in the time or knowledge to evaluate investment opportunities. Companies such as the NIT, the ICP, the brokerage firms and the investment finance companies might send their employees to be trained and licensed as a CFA. The courses might also be attended by individuals interested in being qualified to work for one of these firms. While USAID might consider offering some seed money to recruit and train instructors, design the curriculum and licensing exams and offer pilot courses, the CFA program should become self-supporting within a relatively short time. A professional association for program graduates could offer refresher courses and a program of seminars or workshops, and should help in promoting a high level of standards for the profession.

Timeframe: Years 2-4.

Requirements: Chartered financial analysts with experience in training and licensing CFAs.

4. Support Improvements at the Karachi Stock Exchange, and Communications Linkages and Increased Competition with Other Exchanges

Officials at the Karachi Stock Exchange described their capital spending program and were eager to know whether USAID might provide any assistance. KSE has raised 6.5 million rupees through its members to erect a new building. They now need an additional 5.5 million rupees to purchase equipment for a library and research center (for example, microfilm equipment and an air conditioning system). They admitted that additional funding might be raised through their members but having tapped their members to finance the construction of the building, they are seeking external assistance for the first time. According to stock exchange officials, a request for funding has already been presented to the IFC in the amount of $100,000. They have also discussed possibilities for receiving funds from the Asian Development Bank and the Japanese. USAID should monitor these offers of technical assistance and their outcome, at which point USAID might want to consider the need for further assistance.

Monitoring of the country's stock exchanges by the CLA will be required as the securities market grows. In connection with the monitoring process, communication linkages between Karachi, Lahore and other parts of the country should be assessed. There will probably be a need to disseminate information on trading activities at the Karachi market rapidly to the rest of the country as the market develops. Technical assistance in this respect has apparently already been requested from the IMF.

A case concerning the development of the Islamabad Stock Exchange (ISE) is currently before the High Court and could be resolved by the end of this year. According to government officials, creating an exchange in Islamabad will not only give investors in the region easier access to the capital markets but could result in much needed competition with the Karachi Stock Exchange. The officials claim that unlike the KSE, the ISE is willing to allow the NIT, the ICP, banks and DFIs to become members. Membership would allow them to enact trades on behalf of customers in any part of the country, including Karachi. USAID should consider providing technical assistance to each of the country's stock exchanges. If plans to develop the ISE go forward, USAID could play an important role in helping to set up the ISE and in encouraging competition with the Karachi and Lahore exchanges. At present, none of the donor agencies have specific plans to offer such assistance.

Given the need for an organized exchange to compete with the KSE, the team had considered a recommendation that USAID encourage the development of an over-the-counter market. This vehicle for encouraging competition with an established exchange has been tested and implemented successfully in other developing countries such as Indonesia. While the ISE should reduce or eliminate the need for an OTC, this option should be considered after the ISE has been in operation for a number of years.

While the Karachi exchange is presently being computerized and settlement and clearance functions are adequate, their needs could change as the environment changes. At some point a central depositary system might be created for the handling and holding of securities on behalf of customers. Stock exchange officials noted occasional delays in processing transactions when the party selling the shares is travelling or the selling party is deceased. A central depositary institution could issue a negotiable receipt for shares held beneficially for their owner and charge a fee in order to become self-supporting. A possible USAID role would include preparing a feasibility study for a depositary institution, assisting in locating domestic (or foreign) partners/investors, assisting in the formulation of financial and operating policies, providing financial assistance for start-up operations in the form of loans, loan guarantees and co-financing mechanisms - and assisting in the recruitment and training of managers. Attracting a U.S. or foreign bank as a partner could help the institution in establishing a reputation for fair play.

The team considered recommending a visitation program for the top officials of the exchange but learned that such visits have already taken place to New York, London, Japan and India.

Timeframe: Ongoing technical assistance, years 1-5

Requirements: Specialists in stock exchange operations, information technology, organization and management.

5. Provide Seminars and Training Programs to Securities Market Participants

USAID could consider co-sponsoring seminars and training programs for underwriters, brokers, venture capitalists, CLA and stock exchange personnel and other market participants on subjects such as the following:

- Financial Instruments
- Financial Statement Analysis
- Raising Capital Through the Equity Markets
- Pricing Shares
- Capital Markets Disclosure Requirements
- Prospectus Preparation

Such courses might be offered through one of the local stock exchanges, chambers of commerce or business institutes. While USAID might provide some seed money to get the courses started, a goal should be to encourage a well-respected institution to offer them on a continuing basis.

Timeframe: Years 2-4, with ongoing follow-up by a local institution

Requirements: Implementation would require specialists investment bankers, financial analysts, securities markets regulators and experts in financial instruments and training.

6. Assist in the Development of a Credit Rating Agency

This could be an important area for USAID assistance since the availability of impartial information (i.e., rating agencies such as Standard and Poors or Moody's) contributes greatly to capital market development. The IFC helped to establish a successful private sector credit rating agency in India. While the IFC has considered creating such an agency in Pakistan, no actions have been taken. A possible role for USAID would be to conduct a feasibility study in coordination with the IFC for the development of a private sector, self-supporting credit rating agency and to initiate discussions with S&P or Moody's regarding possible collaboration with a Pakistani partner.

Timeframe:	Years 3-5, once progress has been made in improving the quality of financial information and increasing the proportion of private sector funding raised through the capital markets as opposed to through the banking system.
Requirements:	Sources of expertise on establishing financial information utility services include industry leaders such as Standard & Poors and Moody's.

C. State Bank of Pakistan

In its capacity as the central bank, the State Bank of Pakistan is responsible for ensuring the soundness and liquidity of the banking system. Its proper role is to supervise and monitor banks and to set and implement monetary policy. The following are recommendations for possible USAID activities regarding the central bank:

1. Provide Technical Assistance in Establishing a Centralized Credit Bureau

While credit rating agencies such as Standard & Poors and Moody's assign standardized ratings to debt and quasi-debt instruments, credit information bureaus such as Dun & Bradstreet issue reports on the credit history and the total, system-wide outstandings to any borrower or group of companies on behalf of banks and commercial creditors. As such, they play an important role in bank lending decisions and can help to improve the overall credit quality of the banks' loan portfolios.

During the interviews, we learned that the Bank of France is already involved in setting up a credit information bureau within the State Bank of Pakistan. NCBs already report loan information to the State Bank of Pakistan on a regular basis, but this information needs to be entered into a centralized credit information system that can be accessed by computer within the SBP and at any branch office.

USAID should monitor the situation in order to determine what role it might play (for example, offering technical assistance, equipment or funding) to support this project. As soon as it becomes practical, and in accordance with the GOP's privatization program, USAID could assist in spinning the credit bureau off to the private sector, where the bureau's profitability would depend on providing reliable information in the format most useful to customers.

Timeframe: Unspecified

Requirements: Specialists in credit information collection and analysis, central banking and information technology.

2. Provide Assistance in Developing a Secondary Market for Government Debt

The GOP has taken several steps toward the development of a mechanism for auctioning government bonds and treasury bills. The IMF is assisting the MOF in developing a government bond market. A timetable for establishing the auction process has reportedly been prepared. At the present time, however, the system is such that the Government targets the interest rate for each auction and refrains from selling if its targets are not met.

USAID could hold discussions with the IMF and the MOF to determine what role it could play in helping to institutionalize the auction process and develop an active secondary market in government debt. Possible activities include supporting the automation of the auction process or providing training courses for government bond dealers and traders.

Timeframe: Unspecified. This will need to be determined based on discussions with the new government and its position regarding the auctioning of government debt instruments.

Requirements: Specialists in central banking, macroeconomics, bond market development and information technology.

D. Private Non-Bank Financial Institutions

USAID could play an important role in supporting the development of private non-bank financial institutions, such as investment finance companies, modarabas and/or leasing companies and venture capital companies. The team's recommendations for possible USAID activities are as follows:

1. Support the Development of Private Non-Bank Financial Institutions

USAID could support the development of private financial institutions such as venture capital companies, investment finance companies and modarabas by (1) supporting the IESC in matching Pakistani companies with retired U.S. business executives with investment banking, financial management or entrepreneurial backgrounds; (2) encouraging the development of local consulting firms offering business development or financial advisory expertise; or (3) providing direct, short-term technical assistance to selected financial institutions for which local expertise is not available.

The IESC Director has an extensive roster of retired businesspeople and would be happy to support USAID's PIE Program with executives in investment banking and financial services. The development of local consulting firms could also be encouraged, perhaps with IESC assistance, so that financial institutions would have access to fee-based advisory services on an on-going basis. According to one source, local consulting firms consist mostly of accountants and MBAs and would benefit from training and assistance in broadening their range of expertise. Alternatively, USAID could support the development of consulting services through the local, private chambers of commerce. USAID might also consider supporting the development of new financial advisory institutions. A possible USAID role would include the preparation of feasibility studies, assistance in locating foreign partners/investors, assistance in formulating financial and operating policies, and the provision of loans or loan guarantees.

Timeframe: Years 1-5

Requirements: U.S. executives (including IESC) with business development, investment banking, venture capital and management consulting backgrounds.

E. Insurance Industry

The life insurance industry in a number of developing countries is privately held and plays a key role in marshalling private savings for productive industrial development. As discussed earlier, the GOP recently passed a law allowing private insurance companies to enter the life insurance business in Pakistan. At the current time, however, only one company, Adamjee Insurance Company, is able to meet the capital requirements.

The Managing Director of Adamjee Insurance Company expressed an interest in taking advantage of the new law allowing private companies to get into the life insurance business and to establish a joint venture with a foreign insurance company. He is corresponding with various American and Canadian insurance companies in search of partners for such a venture.

USAID could assist in developing a private life insurance industry in Pakistan. In particular, USAID could:

1. Assist in Identifying and Encouraging a US Life Insurance Company to Conduct a Feasibility Study for Investment in Pakistan

USAID could provide technical and/or financial assistance for a feasibility study for a joint venture between Adamjee Insurance (or any other company that is able to meet the capital requirements) and a U.S. insurance company. In addition to promoting increased business for U.S. insurance companies in Pakistan, such a joint venture would provide Pakistan with access to managerial and technical skills in the new field of underwriting life insurance policies.

Timeframe: Unspecified

Requirements: Specialists in underwriting life insurance policies in developing countries and in joint ventures.

F. Privatization

Privatization is an intensely political activity requiring, above all, leadership and tenacity on the part of the Government. The present opposition to privatization by the unions in Pakistan is no greater than that experienced by other countries, many of which have already implemented successful programs. Over the long term, the transfer of ownership in entities such as Pakistan International Airlines and Muslim Commercial Bank to the private sector will enable the GOP to meet several important objectives, namely, increasing the supply and quality of vital services, improving economic efficiency, developing the capital market through new share listings and reducing the strain on the fiscal budget.

Although the GOP claims to support privatization, recent divestitures, such as Pakistan International Airlines, have targeted only partial divestitures of shares and no change in the management or control of these organizations. Before offering any technical assistance, a policy dialogue should be held to ensure that the GOP is committed to privatization and that the Government is clear on the meaning of and strategies for such a program.

Several firms have already provided advisory services to the GOP on the privatization of Muslim Bank, including Rothchild, A.F. Ferguson and Ford Rhodes Robson Morrow. During August, 1990, a World Bank team will be helping the GOP to prepare a detailed, phased plan for privatization.

Through its program of technical assistance to the capital markets, USAID will contribute to the GOP privatization program in many ways. Capital markets help to attract domestic capital to privatized assets. They also help to broaden the ownership of these assets among the population, creating a larger constituency for privatization.

In addition to the above, USAID might provide the following types of technical assistance to support privatization:

- o Assist in Determining the Appropriate Method of Privatization for Each Enterprise

- o Assist in Preparing Candidates for Privatization

- o Valuations
- o Labor Deployment Strategy
- o Monitoring the Privatization Process
- o Assist in Restructuring Public Sector Enterprises Prior to Sale
- o Assist in Developing a Promotion Campaign to Educate the Public on Privatization

Timeframe: To be determined in conjunction with the GOP's program

Requirements: Specialists in areas such as privatization techniques, the design of privatization programs, company valuations, labor deployment strategies, program monitoring, investment banking, engineering, organizational design and restructuring (including management and accounting systems) and promotion.

G. Nationalized Commercial Banks

As in many parts of the developing world, credit tends to flow to companies and individuals endowed with substantial collateral and political influence. As a result, the creditworthiness of a borrower is but one factor figuring into the lending decision. While the team considered the possibility of providing training to bank personnel in credit analysis and cash flow lending techniques, such courses are unlikely to have much impact until the NCBs are run on a sound, commercial basis.

There appears to be no shortage of opportunities for bank personnel to receive training. In 1989, the Pakistan Banking Council offered 200 courses for bank employees from the cashier to the senior vice president level. Bank training institutes exist in each of the major cities. Each of the NCBs has four banking institutes, with a separate staff for each institute. They train approximately 2,000 people per year, from the junior levels to the top executives. In 1990, 60 people were sent abroad to attend courses at Harvard, the Arthur D. Little Institute and other centers, partly on scholarships provided by USAID. During our visit to Karachi, a banking course was being offered by Chase Manhattan Bank at a local hotel. Finally, the Pakistan Banking Council plans to break ground very soon in the construction of the "National Institute of Banking and Finance Islamabad" which will offer courses to bankers from around the country in a residential program modelled after the executive education programs in the U.S.

In our opinion, the greatest problem affecting the banking sector and bank lending practices is not related to training but a lack of competition and the heavy degree of government influence in the banking system. Until some form of privatization is introduced, banks are unlikely to accept the higher risk associated with cash flow based lending and will continue to rely on collateral and political connections. As a result, the team does not recommend offering technical assistance or training to the NCBs at this time.

H. Private Sector Managers/Investors

In our meeting with the American Business Council, we were told that much needs to be done to create a better environment for foreign investment in Pakistan. They listed the following:

- Create a level playing field (ex. foreign banks can not lend to public sector institutions: same rules should apply to everyone)
- Eliminate ceilings on foreign ownership (usually 49%) on all companies except those in sensitive industries such as defense
- Lower taxes (effective rates are as high as 73-74%)
- Reduce government borrowing (to prevent crowding out of the private sector)
- Increase protection of intellectual property rights
- Reduce the number of bureaucratic approvals needed to start or expand operations

In terms of technical assistance, the ABC described the lack of promotional materials on investing in Pakistan of a sufficient quality to impress or even satisfy most foreign investors. They suggested that USAID could provide the following technical assistance:

Support the Development of Promotional Materials on Investing in Pakistan

USAID could provide a grant, perhaps to a local advertising agency, to examine the promotional materials available from neighboring countries, which are generally superior, and to develop comparable materials for Pakistan. A comprehensive Doing Business in Pakistan guide is also needed, with information on local laws, regulations, investment incentives and export processing zones.

As an additional measure, it should be recommended that the Board of Investment develop a more aggressive attitude in attracting foreign investment, providing a higher level of customer service and a one-stop investment information shop.

Timeframe:	Preparations could begin in Years 1-2 with the materials finalized and distributed in Years 2-3 depending on the then-present investment climate.
Requirements:	Experts in trade and investment promotion and advertising.

IV. INVESTMENT PACKAGING

The Capital Markets team discussed with market participants possibilities for an USAID role in the creation of new investment packages and financing methods that would assist in the process of improving the capital markets. The principal areas in which opportunities were identified concern products that may be created by the new investment banks, the creation of private mutual funds, venture capital companies and mortgage banking and the development of mortgage-backed securities and employee stock ownership plans.

Cresbank indicated a general lack of familiarity with various financial instruments, but was eager to have the input from an experienced investment banker to assist in identifying investment opportunities and creating alternative financing tools. In this connection other Islamic financial instruments may be devised (witness the success of the modaraba), such as new financial instruments designed for pension funds. Other products may be devised to assist in the merger and acquisition process --if policy changes are made to improve the corporate restructuring environment-- and to assist in mobilizing financial resources for acquiring new technology and managing troubled enterprises.

Another area where USAID could offer assistance is the area of venture capital. There is a distinct shortage of venture capital available in the organized financial sector to fund new start-up companies. The commercial prospects for venture capital in Pakistan are promising. Pakistanis are entrepreneurially inclined and there are attractive market niches for starting new ventures. The country, with a population base of 110 million people and a strong middle-class consumer sector, offers many opportunities for new ventures. The Asian Development Bank (ADB), in partnership with a group of Pakistani investors, is in the process of establishing a venture capital company in Karachi. In a recent feasibility study conducted for the ADB, various venture capital opportunities were identified, including:

- Agribusiness/Aquaculture/Horticulture
- Biotechnology
- Computer and Communications Technology
- Natural Resources and Building Materials
- Communication and Media
- Tourism and Leisure
- Retail Distribution Systems

- o Financial and Commercial Services (such as consulting services and export trading companies).

USAID could offer technical and/or financial assistance to individual projects meeting USAID's objectives. Financial assistance could include loan guarantees or quasi-equity participation from local currency funds. USAID could also encourage and assist other investors in the creation of other venture capital companies.

Another potential area for USAID assistance is the creation of private mutual funds. Mutual funds are the best mechanism for encouraging small investors to participate in the securities market. NIT and CIP, which operate mutual funds, are both government owned and operated; at present there is no private mutual fund in Pakistan. It is not quite clear which laws apply to mutual funds, and which authority has jurisdiction over their operation, except that the Corporate Law Authority must approve all of the securities that are offered to the public.

Other investment packaging opportunities for possible USAID assistance could relate to privatization. For instance, USAID could participate in the investment packages which are designed for employee buyouts and/or employee stock ownership plans (ESOPs). The private investment banks and mutual funds could benefit from the technical assistance and financial involvement of USAID in facilitating potential privatization of the state-owned enterprises. The Asian Development Bank is contemplating the establishment of a special fund for providing investment, as a catalyst, in the newly privatized enterprises in Asian member countries. Coordinated efforts by USAID and the ADB could culminate in a more successful approach to privatization.

Investment packaging is the function of financial institutions, such as the new investment banks, venture capital companies, and private development finance institutions. USAID should establish a set of criteria against which the investment packages designed and offered by these institutions can be evaluated for possible USAID participation.

In conclusion, the following table summarizes the recommendations for policy reform, technical assistance and investment packaging and indicates the relative priority of each recommendation on a scale of one to ten (with one being the highest priority). Items receiving highest priority, such as Liberalization of the Interest Rate Structure and Deregulation of the Financial Sector, are generally those which are: (1) considered the most important, (2) need immediate attention and (3) will result in the greatest overall gain or benefit under the PIE Program.

SUMMARY OF RECOMMENDATIONS

	Priority
I. POLICY REFORM	
A. LIBERALIZATION OF THE INTEREST RATE STRUCTURE	
• Reduction of the Budget Deficit	1
• Reduction of Government Reliance on the State Bank of Pakistan for Financing the Deficit	1
• Treasury Bill Auctions	1
• Reduction of the Number of Direct Credit Programs	3
• Reduction of the Proportion of Total Credit Provided by Direct Credit Programs	1
• Gradual Reduction of Interest Rate Subsidies	3
• Defining Priority Sectors Narrowly	1
B. FINANCIAL SECTOR INSTITUTIONAL REFORM	
• Deregulation of the Financial Sector	1
• Autonomy of State-Owned Commercial Banks	3
• Consolidation of Certain Activities of State Bank	5
• Privatization of State-Owned Commercial Banks	1
• Autonomy of the State Bank of Pakistan	1
C. INSURANCE INDUSTRY	See TA Recs.
D. PRIVATIZATION	
• Encourage Strong Commitment by GOP to Privatization	1
E. TAX POLICY ISSUES	
• Support IRS Assistance to Improve the Tax Collection System	1
• Assist in a Study of the Impact of Varying Tax Rates on the Capital Markets to Develop Policy Recommendations	1
F. SECURITIES MARKET ENHANCEMENT	
1. PROBLEMS AFFECTING CORPORATE PARTICIPATION IN THE MARKET	
• Assist in Creating Private Mutual Funds	3
• Encourage Creation of ESOPS and Stock Option Plans	7

Key: 1 High Priority
10 Low Priority

HV

	Priority
1. PROBLEMS AFFECTING CORPORATE PARTICIPATION IN THE MARKET(CONT'D)	
• Advocate Removal of the Requirement that Companies Become Public in Conjunction with Macroeconomic Changes	8
• Encourage Changes in the Pricing System	5
• Encourage the Creation of Additional Securities	4
• Advocate Legal Changes to Assist in the Creation of a Mortgage Loan Market	4
2. PROBLEMS WITH INVESTOR CONFIDENCE	
• Encourage the Strengthening of Corporate Law Authority Enforcement Capabilities	2
• Encourage Adoption of Uniform Accounting Principles and the Development of Effective Disciplinary Programs	1
3. PROBLEMS WITH MARKET INSTITUTIONS	
• Encourage the Creation of Investment Advisory Organizations and a Credit Rating Agency	2
4. PROBLEMS WITH LIQUIDITY	
• Encourage Increased Market Participation by Institutional Investors	2
• Encourage Public Offerings through Underwriting Process by Financial Institutions	4
• Encourage Efforts to Attract the Informal Market	4
II. <u>TECHNICAL ASSISTANCE</u>	
A. PUBLIC EDUCATION	
• Support a Campaign to Educate the Public on the Benefits of Private Enterprise, Private Investment and a Free Market	3

Key: 1 High Priority
10 Low Priority

	Priority
B. SECURITIES MARKET	
• Assist in Strengthening the Institutional Capacity of the Corporate Law Authority to Regulate the Securities Markets	2
• Assist in Strengthening the Capacity of the Institute of Chartered Accountants to Promote Improved Accounting Practices	3
• Support the Establishment of a Chartered Financial Analyst Programs	3
• Support Improvements at the Karachi Stock Exchange, and Communications Linkages and Increased Competition with Other Exchanges	3
• Provide Seminars and Training Programs to Securities Market Participants	1
• Assist in the Development of a Credit Rating Agency	2
C. STATE BANK OF PAKISTAN	
• Provide Technical Assistance in Establishing a Centralized Credit Bureau	1
• Provide Assistance in Developing a Secondary Market for Government Debt	1
D. PRIVATE NON-BANK FINANCIAL INSTITUTIONS	
• Support the Development of Private Non-Bank Financial Institutions	2
E. INSURANCE INDUSTRY	
• Encourage Investment by a U.S. Life Insurance Company in Pakistan	4
F. PRIVATIZATION	
• Assist in the Design, Implementation and Monitoring of Privatization of Specific Enterprises	Contingent on Results of Policy Dialogue
G. NATIONALIZED COMMERCIAL BANKS	No Recommendation
H. PRIVATE SECTOR MANAGERS/INVESTORS	
• Support the Development of Promotional Materials on Investing in Pakistan	2
III. INVESTMENT PACKAGING	
• Establish Investment Criteria	1

Key: 1 High Priority
10 Low Priority

APPENDIX A:

LIST OF PEOPLE INTERVIEWED

LIST OF PEOPLE INTERVIEWED

Adamjee Insurance Company Ltd.

Mohammed Choudhury
Managing Director

American Business Council of Pakistan

S. Rafat Ali Hashmi
Secretary

Nicholas C. Procaccini
Pfizer Laboratories Ltd.
Member

Robert F. McCusker
Interpak Shaving Products Ltd.
Member

Syed Umer Ali Shah
CIGNA Insurance Co.
Member

S. Ali Raza
Bank of America
Member

Mahmud G. Dossa
Exxon Chemicals
Member

American Express Bank

Arif M. Allarakha
Vice President

Asian Development Bank

Graham Muller
Country Representative

Bankers Equity Limited

Mr. Shamsi
Senior Executive Vice President

B.R.R. Capital Modaraba

Siddique Dawood
Chairman

Safdar Rashid
Chief Executive

Moin A. Haroon
General Manager

Khalid R. Sadique
General Manager - Finance

Citibank

John M. Beeman
General Manager

Corporate Law Authority

Momtaz Abdullah
Chairman
Corporate Law Authority

Shamim Ahmad Khan
Member, Additional Finance Secretary and
Controller of Capital Issues

CresBank

Nessar Ahmed
Chairman

Mehmood Ahmed
Vice President

Federation of Pakistan Chambers of Commerce & Industry

Raja Abdul Rehman
President

Aziz Y. Siddiqui
Secretary General

Ferguson Associates

Khalid Rafi
Partner

Pervez Saeed
Director

Habib Bank

Shabbir Ali Merchant
Executive Vice President

House of Prudential

I. A. Hanfi, Chairman
(former Governor, State Bank of Pakistan)

International Executive Service Corps

Ralph T. Clausen
Country Director

International Finance Corporation

C. John Pott
Country Representative - Islamabad

Anita Ahmed
Investment Officer - Washington, D.C.

Investment Corporation of Pakistan

Mati ur-Rehman
Chairman

Investment Promotion Bureau

Syed Muzaffar Ali Shah
Director General

Karachi Stock Exchange

Jahangir Siddiqui
President

Mohammed Yasin Lakhani
Vice President

Ghani Usman
Honorary Treasurer

Mansoor Ahmad Khan & Co.

Mansoor Ahmad Khan
Senior Advocate

Ministry of Finance

R.A. Akhund
Secretary

Javed Noel
Joint Secretary of Investment

Qazi Alimullah
Additional Secretary

Shamin Ahmad Khan
Additional Secretary
Privatization Wing

Zafar Iqbal
Joint Secretary, Finance

Mohammad Faheem
Joint Secretary, External Finance

Ministry of Planning

Shaukat Kazmi
Joint Chief Economist

Farooq H. Naek

Farooq H. Naek
Advocate High Court

National Development Finance Corporation

Nader Morshed
Chief Economist & Executive Vice President

Muhammad Bashir Chaudhry
Executive Vice President, Private Energy Division

Abid Naqvi
Assistant Vice President, Economic Division

National Development Leasing Corporation

Mohammad Muzaffar
Managing Director

National Investment Trust

A.K.M. Sayeed
Senior Vice President
Finance and Investment

Shahid Ghaffar
Senior Vice President
Project Appraisal and Monitoring

Overseas Investor Chamber of Commerce and Industry

Salamat Rizvi
Secretary

Pakistan Banking Council

A. A. Sakrani
Chairman

Pakistan Venture Capital Company

Azhar L. Ansari

Prime Minister, Office of the

V. A. Jafarey
Advisor, Finance and Economic Affairs

State Bank of Pakistan

I. H. Garni
Deputy Governor

Dr. Ashraf Janjua
Economic Advisor

Mr. Sebghatulah
Executive Director, Banking Control

Shamshad Ashraf Khan
Executive Director, Banking Inspection

21st Century Consultancy & Management Services

A. Sami Qureshi
Chief Executive

Dr. Furqan Ahmad Rabbani
Director

Afzal Sultan
Director

United Bank Limited

Abdul Razik Siddiqui
Senior Vice President
Coordination, Investment and Finance

World Bank

Ismail Dalla
Senior Financial Specialist

Michael Klein
Industry, Trade and Finance

Abdallah El-Maaroufi
Resident Representative

APPENDIX B:

BIBLIOGRAPHY

BIBLIOGRAPHY

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APPENDIX C:

PROJECT STAFFING AND MANAGEMENT

PROJECT STAFFING AND MANAGEMENT

Investment Specialist/Team Leader

Mr. Jalil Shoraka is President of the Aries Group, Ltd., a Washington-based international consulting firm. In March, 1990 he led a team of experts to Pakistan in order to conduct a comprehensive study of the capital markets for the Asian Development Bank. The purpose of that study was to assess the structure, operations and status of intermediaries in the securities market and to identify factors either inhibiting or promoting their growth and development. Mr. Shoraka has led similar assignments for the Asian Development Bank in India, Sri Lanka, Thailand, the Philippines, Indonesia, Taiwan, Singapore and Hong Kong. His distinguished career includes service as the Chairman and Chief Executive Officer of the Iran Overseas Investment Bank, President and CEO of Bank Melli, and Counselor to a U.S. Presidential Task Force on the role of central banks in employee stock ownership plans in developing countries. Mr. Shoraka holds an MBA from New York University.

Stock Market/Regulatory Specialist

Ms. Jan Aalbregtse is an attorney with Stoel Rives Boley Jones & Grey in Seattle, Washington. She specializes in corporate and securities law and advises clients on corporate organizations, securities offerings and acquisitions and divestitures. She was formerly Special Counsel, Office of International Corporate Finance at the Securities and Exchange Commission. While at the SEC, she interpreted securities laws relating to distributions into securities markets, secondary market trading, insider trading, and laws affecting foreign issuers. She prepared a study of international securities markets and their regulation and has been published on the subject on the internationalization of securities markets. Ms. Aalbregtse hold a JD from Notre Dame University School of Law.

Macroeconomist

Mr. Haris Jafri is a principal associate with Robert R. Nathan Associates, Inc. Mr. Jafri is an economist specializing in monetary, fiscal and balance of payments policies and financial sector development policies. During his 25 year career with the International Monetary Fund, Mr. Jafri analyzed policy issues in many countries in Latin America and was the IMF's Resident Representative in Honduras. Since 1983, Mr. Jafri has undertaken economic analyses and formulated policy prescriptions for a wide variety of consulting assignments around the world, including Pakistan and Bangladesh. Mr. Jafri holds a Masters degree in Economics and completed coursework for a PhD in Economics from the University of California, Berkeley.

Development Finance Specialist

Mr. Donald Green is President of Donald S. Green Associates, Inc., a consulting firm specializing in development economics, finance and private sector development. Mr. Green has an extensive career in international consulting, having established his own firm in 1987 and been a consultant with SRI International for 13 years and Robert R. Nathan Associates for 3 years. He also spent several years as a Vice President of International Banking at Bank of America, was the Director of International Economic Programs at the U.S. Office of Management and Budget and a Program Economist for the Latin American Division of the U.S. Agency for International Development in Washington. Mr. Green holds a Masters degree in Economics from the University of Chicago.

Technical Support/Finance Specialist

Ms. Julia Philipp is a Senior Consultant in Price Waterhouse's Office of Government Services. In February, 1990, she was project manager of a team that conducted a reconnaissance of the financial sector in Thailand. The purpose of the assignment was to develop a set of recommendations for expanding Thailand's equity market, mobilizing national savings and strengthening the the commercial banking sector. Prior to joining Price Waterhouse, Ms. Philipp was an Associate in Corporate Finance at Chemical Bank Investment Banking in New York. Ms. Philipp holds an MBA in Finance from the Wharton School.

Project Oversight

Project oversight was provided by Mr. J. Richard Breen, Director of the Financial Sector Development Project. Mr. Breen has held several senior-level positions in the U.S. government, including Associate Assistant Administrator for the U.S. Agency for International Development. In the private sector, Mr. Breen has held a number of senior management positions, including President of an international corporation. Mr. Breen holds an MPA from Syracuse University and completed the Key Executives Program at the Harvard Business School.