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Preliminary Paper

for AID/Washington

concerning

Proposal and Feasibility Evaluation

for

a Private Commercial Funding and

Investment Corporation in Pakistan

December 4, 1984

ASIA/PNS

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PRELIMINARY PAPER CONCERNING A PRIVATE COMMERCIAL FUNDING AND INVESTMENT CORPORATION IN PAKISTAN

(December 2, 1984)

Introduction and Summary

This paper sets forth a preliminary discussion of the proposal for USAID to facilitate establishment of a privately owned and operated financial institution in Pakistan, to supplement existing government owned or controlled banks and development finance institutions. Following the introduction and summary, certain specific matters are amplified.

The paper has been prepared based on the assessment of representatives of private sector international financial institutions under contract to USAID, who have determined that there are market needs in Pakistan which could be met by such an entity, and that it could be a commercially feasible, profitable entity, with support of USAID financing during the initial period. The report builds upon USAID's strategic interest in assisting the development of Pakistan's financial system. This goal is part of the approved CDSS and was first presented in an earlier AID/Washington general approval to the Mission. The purpose of this preliminary paper is to provide a general description of the proposal and to solicit views and questions which may be considered during further design work. It is anticipated that after further work, a formal Interim Report (targeted for February 15) and then a Project Paper (targeted for August 1) would be submitted.

The project builds on the concept previously presented to the Minister of Finance, most recently in September 1983 discussions with AID

Director McPherson, at which time it was indicated that MOF would be receptive to a proposal to establish "an investment company", but "not a bank". This proposal develops on the idea of an investment company, and is driven by USAID goal to foster development of private sector financial institutions to develop free market financial services in Pakistan. The GOP has indicated that it will consider the matter further only upon presentation of a specific proposal, and thus the matter has now been evaluated by the Mission and consultants obtained through the Bureau of Private Enterprise.

The result is the attached draft Report "Proposal and Evaluation of a Private Commercial Funding and Investment Company in Pakistan", prepared for use in talking to potential investors, consisting initially of international commercial, merchant, investment banks, insurance companies, etc. The draft report will be revised after the members of the consulting team review and comment on the draft between now and mid January.

A final Commercial Feasibility Report is to be prepared after discussions by selected team members and a Mission representative with potential investors in January. In addition, an abridged version of the draft report will be prepared for informal discussions with the GOP, accompanied by an explanation of its compatibility and desirability with the goals of the GOP for development of the financial system in Pakistan, including the system as it will operate under Islamisation of the banking system. Careful attention will be paid to informing, in advance of any formal proposal, GOP officials of the thinking involved and the desire to fashion an entity which meets real needs in Pakistan and will be commercially feasible.

Summary of Proposal

The attached Draft Commercial Feasibility Report (Appendix A) proposes the establishment in Pakistan of a private financial institution (referred to as Commercial Funding and Investment Corporation of Pakistan, or "CFIC"). The proposal has been prepared after an evaluation of the market for financial services in Pakistan. The market survey examined both the current market needs and anticipated needs during and after completion of Islamisation of the banking system to be accomplished starting January 1, 1985.

The evaluation was conducted by a group of highly qualified and experienced individuals representing a wide spectrum of skills in commercial banking, merchant banking, development banking, securities market making, central banking, chartered accountancy and related economic and legal matters (See Appendix B). The approach of the team's market survey was not to come to Pakistan with a set of predetermined lines of business in mind and see if these could be developed in Pakistan, but rather to examine the market for financial services in general, both as it currently exists and is expected to develop after Islamisation. Based upon this analysis, the method called for the team to determine if gaps and opportunities exist in the market for services that are not now provided or for better and more innovative services. Only if needs and opportunities were identified would the team proceed to determine if a private entity could provide such services on a commercially feasible basis (assuming some USAID support during initial phases). The team was asked to consider whether financial institutions of international standing would be interested, and to prepare a report of the nature and calibre bankers and substantial investors would expect to see.

The attached draft Working Copy Report is the first and unpolished version of the team conclusions, and is now being sent to team members for review and revision. It is anticipated that during January this draft report in revised form would be discussed by team members with selected possible condidates for investment in international market centers (New York, London) to obtain their views on whether the proposed entity, CFIC, is one in which they are potentially interested and if they have changes in emphasis to suggest. In this way the team will further test and refine their conclusions as to the commercial feasibility of the proposal. A final report is expected in early February. This report will be the basis for formal solicitation of investment interest.

The team's evaluation of the market brought to light a number of specific needs not adequately, or in some cases not at all, met by existing institutions. Based on these needs, the team has preliminarily proposed establishment of an entity to provide the following services: (1) market making in short-term, Islamic financial instruments, including mark-up promissory notes, bankers acceptanc s, bills of exchange, drafts and Profit and Loss Sharing ("PLS") Certificates; (2) project development and finance along with local currency and foreign exchange lending and loan syndication; (3) leasing, hire purchase and similar asset-based financing; (4) short-term lending and borrowing to support its operations; (5) corporate finance activities and advice; (6) export/import finance, buyer's and suppliers' credit financing; and (7) foreign exchange operations associated with its other activities.

In addition, the proposed entity would explore a number of new opportunities in financial services. These include: development of markets for trading longer term Islamic financial instruments; receivable factoring and finance; warehouse financing under warehouse receipts; investment and portfolio management and advice; private export credit insurance; commodity finance; and other financial activities that offer market opportunities for profitable services.

The proposed entity would earn its income from the trading spreads between buying and selling short-term instruments, fees and commissions for providing financial services, returns and mark-ups from offering lending facilities to its clients, foreign exchange commissions for operations connected with its other business, hire purchase and leasing income, and income from other financial services.

As explained in the report, the team believes that the proposed Islamisation of the banking system along the lines currently contemplated in Pakistan will not advisably affect the demand for services of the kind identified by delivery by the proposed company. (See separate section of this Preliminary Paper on "Effect of Islamisation on Proposed Entity".)

As indicated, the team identified and developed a group of recommended financial services which could be provided by a private specialized financial institution. These services were developed as a package. Failure to undertake any one or more of these services will cast doubt on the feasibility of undertaking others. The needs of the new organization involve the ability to have some profitable activities which continue while others are coming on stream (e.g., market making) or have a cyclical profit and loss record (e.g., project finance or corporate finance report).

In order to understand the relationship between the respective segments of the market and the financial service products involved, a matrix is attached on the following page. In addition, the matrix indicates the relative priority attached to the financial services from the perspective of CFIC.

As reflected in the attached Draft Report, the proposed entity has been designed as a commercially feasible, profit making entity. Pro forma financial statements are included, demonstrating a projected profitability building over the initial 5 year period. USAID financial support has been assessed in the projected financials during the initial period in the form of subordinated loans and Special Participation Term Certificates, which are similar to debentures or preferred shares.

A working hypothesis about the structure and composition of the shareholders was developed by the team. The team suggested that authorized share capital should be $ 25 million, but that only $10 million should be paid in at the initial stage of operations. Capital calls in the third and fifth year would bring paid-in capital to the authorized total. AID funds would be made available to the capital structure of the Company in the form of non-interest bearing subordinated debt ($10 million), and in the form of interest bearing long-term notes or debentures (suitably Islamic in form) ($15 million). The team suggested that, ideally, the initial infusion of equity (the $ 10 million in share capital) be raised in the proportions of 40 percent from international banks and 60 percent from individuals residing outside of Pakistan. The 40 percent bank shares might ideally be subscribed in equal shares by New York investment and commercial banks, a London commercial bank and a Gulf commercial bank. These allocations are, of course, tentative and hypothetical. They represent the diversity of international parentage and technical financial know-how which the proposed company would require to conduct the full range of contemplated services. AID funds would be subscribed to the capital structure on the basis that they would over time be drawn down, or at least that all concessional AID capital assistance would be liquidated gradually as the company matured and reached its profit goals. The detailed discussion of possible association of USAID financing follows in a later section of this preliminary paper.

As to the organization of the proposed entity, it is envisioned that it be invorporated as a joint stock company in Pakistan, with private shareholders. At the outset shareholding will come from abroad. The proposal would be to attract outside equity capital from the financial markets of USA and Europe. The advisory services of a leading international bank or individuals well known in the international financial community would be helpful in identifying and packaging the equity sources in such a way as to conform with the social and economic policies of the GOP, as well as providing appropriate private backing and support to make the company a viable and profitable investment.

The Draft Report indicates that it would be most desirable to obtain significant investment - preferably a majority - from the following groups of investors: (1) Major, international commercial banks, especially those with offices in Pakistan; (2) Major international investment or merchant banks, including those with particular interest in the Near East and the Sub-Continent; (3) Major international financial institutions, such as insurance companies and trading companies. Other individual or corporate shareholders should be sought as well. In all cases, careful vetting of the proposed list of potential shareholders will be an essential pre-requisite to obtaining consent and goodwill of the GOP. Once the proposed entity becomes established and needs additional share capital, it would then make good business sense to open the shareholding to Pakistani business houses and private investors, if acceptable to the GOP.

The development of this proposed company is highly dependent upon assistance from USAID. The company is starting business in Pakistan at a time of change and it is offering new services at the same time. It would not be possible to undertake the investment and attract high quality investors without USAID's involvement.

The team proposed that USAID's contribution be to provide funds in the form of non-interest bearing subordinated debt and a Special Participation Term Certificate bearing a near market mark-up rate equal to 8% interest during the start up period. After the organization has achieved stability and relative profitability, the institution will progressively reduce the concessional nature of USAID's involvement. The proforma financed statements attached to the draft report indicate that the progress of the reduction is directly related to earnings. In order to speed up this process, the stockholders will agree that no dividends will be paid until the end of the third year. The dividend rate would be limited to a conservative maximum of 50% of profits each year. Prior to start up, all parties will agree that whenever dividends are paid an appropriate adjustment shall be made in the concessional assistance that USAID has provided. Alternative methods of associating USAID funds with the company (e.g. convertible debentures) will be considered, as discussed in a separate section of this preliminary paper.

The estimates for business have been made on what is believed to be a careful and conservative basis. They are subject to wide variation because these are new fields of business, and the climate and marketplace in Pakistan is uncertain. However, there are several factors which will allow the overall risk to be controlled to a considerable degree:

1. In the market making area, the quality of the credit risks involved will be the highest in Pakistan. The paper is of short-term duration so that interest rate fluctuations will not create massive problems.

2. Leverage of the business is not high; about ten times. USAID is providing not only a subordinated note (in the amount of $10 million) which is the equivalent of equity, but also a long-term Special Participation Term Certificate in the amount of $15 million at the lowest end of a market rate (8%) which will give stability, improving the maturity structure of the liabilities and encourage other SPTC funds.

3. Back up lines of bank credit for the trading operations are envisioned for 100% of inventory outstandings.

4. Reasonable reserves for bad debts are established - even for bank guaranteed instruments held in inventory: 1% for leases, 1 1/4% for term loans, and 1/2% for short-term paper. These special provisions lend credibility to a conservative approach to business.

The new company will have the highest quality staff, selected on the basis of specific expertise in the areas to be supervised. Such staff may be either expatriate or local citizens, depending on qualifications. The staff is proposed to start at 50 during the first year and rise to 100 during year 3. Staff arrangements will reflect the priority of the specialities involved and will resemble those of an international investment house.

(End of Summary)

The remainder of the Preliminary Paper provides elaboration of the proposal and discusses certain issues alluded to in the above Summary, under the following headings:

A. The Macrofinancial Context

B. Strategy in dealing with GOP, and time schedule for further reports to AID/Washington

C. Specific Matters for Consideration

   a. Relationship to earlier discussions

   b. Possible methods for association of USAID funds to the proposed entity

   c. Equity ownership

   d. Effect of Islamisation on proposed entity

   e. Responsibility for incorporating and staffing proposed entity

   f. Specifics to be dealt with subsequently

D. Working Copy Draft Proposal

Appendices:

A. Draft Bankers Report

B. Method of Preparation of Proposal

C. Illustrative Master Timetable

A. THE MACROFINANCIAL CONTEXT: A BRIEF PERSPECTIVE

1. Historical Review

The history of formal modern banking in Pakistan is a relatively short tale. Although the trading ports of the southern coast and the great commercial center of the Punjab in Lahore have long traditions of commerce and merchant finance, the banks of the subcontinent were largely based in Calcutta and Bombay in the years before Partition. These banks had branch networks which extended throughout much of what came to be Pakistan, but senior financial managerial talent was concentrated in India. After 1947 there was a substantial migration of Muslim bank officers and financiers to Pakistan and the branch networks, now cut off from their parent banks, were quite rapidly built into powerful and well-managed private banking coporations. Many of the great Muslim family fortunes wedre associated with banking houses in independent Pakistan. Over the next 25 years Pakistan produced a very sizeable cadre of Muslim bankers who serviced the financial interests of much of the Arab world as well as those of East and West Pakistan. By the late 1960's Pakistan bankers were a fixture on the international banking scene in London, Zurich and Frankfurt as well. The financial banking sector grew and diversified rapidly, particularly in the 1960's fostered by private initiative and private investment. In 1971 the government of Zulfikar Ali Bhutto nationalized a number of major industries and, a few weeks later, shipping, banking and insurance. Bank nationalization was a major economic intervention which gave the Government direct control over almost all credit allocation. Prior to 1971 84% of the investment in industry had been financed with private bank credit. After 1971 only the "kerb" on "Hundi" market remained a source of private credit to

Pakistani industrialists.

The government that came into power in 1977 embarked on a program of reforms aimed at the revival of economic growth, restoration of financial stability and returns of private sector confidence. Initial reforms were aimed at two objectives: curbing the public sector's deficit by reducing its role and its size and liberalizing the economy. The banking and financial sector was not, however, greatly affected by those reforms. Until the beginning of the Islamisation of financial operations in 1981, it remained, on the whole, as tightly controlled as it had become just after the nationalization of commercial banks under the Zia regime. The banks were marginally profitable until inflation rate began to decline and part of the interest rate structure became positive in 1981-1982. In 1982 and in 1974, the exchange rate continued to be determined by the State Bank, capital flows to be stringently controlled, and the interest rate structure determined by the State Bank. Credit continued to be allocated through nationalized banks in accordance with a very detailed and rigid annual credit program. International banks' activity was limited to about 10% of the national credit markets; nationalized banks were still notably inefficient. It was in this context of a highly regulated and somewhat dormant financial intermediation sector that the government began in, 1981, to introduce fundamental reforms aimed at Islamising the economy.

2. Structure of Pakistan's Financial System

a. Overview

The financial system in Pakistan consists of: (i) five nationalized commercial banks (NCBs); (ii) eighteen foreign commercial banks (FCBs); (iii) four specialized commercial banks; (iv) eight development financing institutions (DFIs); (v) several insurance companies; (vi) two stock exchanges; and (vii) a housing finance corporation. The State Bank of Pakistan (SBP), the central bank, regulates and directs the financial system. Within the overall policies set by GOP and the SBP, the Pakistan Banking Council (PBC), a de facto regulatory agency of GOP, guides and regulates the functions of and flow of funds to the NCBs, while the Ministry of Finance monitors the operations of the other financial institutions.

b. Commercial Banks

With total assets of Rs 194.6 billion, or 80% of the assets of the financial system as of June 30, 1983, and a branch network of around 7,200, commercial banks play a dominant role. The five nationalized commercial banks (NCBs) together accounted for about 91% of deposit,85% of advances, and 82% of commercial bank net profit after taxes.

The share of the NCBs in total commercial bank profitability has increased from 72% of the total profits of the system in FY 78 to 81.1% in FY 82. However, the profits of NCBs are still low and performance is mixed. The average return on risk assets last year ranged from 0.09% for Allied Bank to 1.0% for Habib Bank, about one-third of the average returns by foreign banks. While part of the problem is overstaffing in the NCBs, low salary levels reduce the impact of overstaffing; operating costs (staff and other expenses) as a percentage of average deposits of

NCBs were 3.8% in FY 78 and 3.4% in FY 82 compared with 5.2% and 5.5% for the foreign banks. The low profitability of the NCBs is caused mainly by four factors: (1) GOP's credit allocation policies which direct the NCBs to finance priority sectors at low interest rates; (2) the establishment and expansion of "low profit" branches in rural areas; (3) non-payment of interest on loans to the public sector; and (4) overstaffing.

c. The Specialized Financial Institutions

Four specialized banks: the Agricultural Development Bank of Pakistan (ADBP),and Industrial Development Bank of Pakistan (IDBP), the Federal Bank for Cooperative (FBC), and the Punjab Provincial Cooperative Bank (PPCB) also fund medium and large industry. ADbP is the largest single financial institution lending to the agricultural sector, while IDBP lends to small and medium-scale manufacturing units. The Federal Cooperative Banks acts as a central bank for provincial cooperative bank and agricultural cooperative credit societies in the provinces.

A number of specialized financial institutions also provide assistance to industry, small businesses and housing. PICIC, the only financial institution with significant private ownership, makes foreign exchange loans to medium and large-scale industry. NDFC provides term financing and working capital to the public and private industrial sectors. Three joint venture companies, Pak-Kuwait, Pak-Libya and Pak-Saudi, have been established recently to provide loans and venture capital to industry. The Small Business Finance Corporation (SBFC) mainly provides short and long-term loans to small-scale industries and businesses. The Investment Corporation of Pakistan (ICP) specializes primarily in arranging equity financing for industrial enterprises and

National Investment Trust (NIT) operates mutual funds and unit trust savings schemes respectively. ICP also underwrites equity issues and arranges industrial financing through consortia of NCBs. Bankers Equity Ltd. (BEL) provides risk capital to private industry by underwriting equity issues and arranging consortia finance participation from NCBs while the Equity Participation Funds (EFP) provides direct equity support to small-scale projects mainly in underdeveloped areas. The need for housing finance is met by the House Building Finance Corporation. A new leasing firm, the National Leasing Development Corporation, is just getting underway. They anticipate an AID (PRE revolving fund) loan of $2.5 million this year.

d. Industrial Lending

In FY 79 - FY 80 GOP assigned mandatory, fixed investment lending targets for industry to the commercial banks to prevent them from discriminating against term loans bearing the concessional 11% interest rate. The targets were discontinued in FY 81 because the banks found it difficult to meet their allocations due to other constraints on individual development particularly shortage of foreign exchange, and the banks' limited capacity to undertake feasibility studies.

In FY 82, based on the Annual Credit Plan for private investment, the SBP provided an allocation for private sector fixed industrial investment lending of Rs 1.7 billion (US$ 134 million). Although the target was not mandatory, unused amounts could not be utilized for other purposes. In FY 82 and FY 83 about 80% of the target was met.

The increase in the number of institutions involved in term financing has meant more outlets as well as certain overlaps. NDFC, while not a scheduled bank, has been allowed to perform most commercial banking functions, and its growth has outperformed IDBP and PICIC. IDBP is a scheduled bank, but its cannot provide working capital finance (a major bank business) and it has chosen not to perform full banking operations, although it is allowed to raise short-term deposits. PICIC funds itself from multiple lines of credit and does not perform banking functions such as deposit taking, export finance, and participating in the inter-bank market for its resources.

In spite of the government-owned and operated NCBs' increasing involvement in industrial term financing, most have not developed credible project appraisal capabilities. About 80% of the NCBs' lending for fixed industrial investment has been carried out through consortia organized by BEL, ICP and NDFC. While these institutions attempt to provide appraisal and supervision services for large-scale consortium financing, the NCBs' increasing involvement project financing suffers seriously from a lack of experience.

e. Deposits

Bank deposits have grown steadily in recent years. The overall growth in deposits of almost 60% in 4 years is important. However, the pattern of bank deposits has also changed. The banks have relied upon personal savings and have expanded personal deposits from 64% of the total in 1978, to 70% in 1982, but government deposits have declined from 7.5% to 6%. Corporate savings have remained constant at about 18%.

Another change is in the composition of the depositors. Between

1978 and 1982 the number of depositors increased from 13.3 million to 18.1 million, while the average size of account rose from Rs 4,000 to Rs 4,600. This occurred without significant increases in the average rate of interest.

At the same time, fixed long-term deposits have increased by 85% between 1978 and 1982. Time deposits over four years maturity, grew to Rs 6,192 million or 7.4% of total deposits at June 30, 1982, within one year of introduction. At end of March 1984 this had grown to Rs 11.3 billion on 9.4% of total deposits.

f. The Capital Market System

After a good start in the late 1950s, when substantial savings were invested in new equity issues and dividend rates were high, the capital market experienced a period of stagnation from the late 1960s to the end of the 1970s and played a limited role in providing industrial financing. At present, in spite of GOP's emphasis on private investment, the capital market has not become a significant source of funds for industrial investment. Of all listed shares, 85% are controlled by management groups or by government-owned and operated investment institutions. Highly concentrated asset holding is eased only marginally through floatation of mutual funds. However, most new issues floated in 1982 and early 1983 were oversubscribed and trading volume has increased indicating renewed public confidence.

Public companies (i.e., private sector firms with publically traded shares) have tapped general savings through issuance of appropriate marketable debt instruments for investment financing only to a limited extent. Most issues - debentures - were privately placed with financial institutions and even if listed, their placement has prevented any active trading. Low interest rates have restricted take up and the major reason for bank participation in these issues is achievement of credit targets. Thus, public companies, faced with financial institutions reluctant to lend, and an absence of a secondary market for corporate bonds are occassionally forced to borrow in the unofficial credit market. Thus changes (using monetary policy tools) in the existing institutional framework to impart flexibility and responsiveness are necessary. Pakistan needs independent money market trading houses to make markets in corporate commercial papers and debentures; these should have the ability to raise term deposits as well as limited resort to the State Bank. The introduction of leasing as a supplementary source of project finance through independent companies will add to the flexibility of the system as will setting up of independent venture capital companies to complement the role of existing financing institutions. The GOP is aware that the capital market has not been a major source of funds for industrial development and is studying appropriate measures to resolve the situation.

3. Islamisation and Financial Institutions

The transformation of Pakistan into a fundamentalist Islamic state is the ultimate objective of the present Government, which came into power in 1977. An Islamic state has been defined in Pakistan as a religious form of welfare state that provides for social justice in every walk of life and ensures sufficient redistribution of income and wealth to satisfy the basic needs of the poor. By 1984 the process of Islamisation was touching many facts of society in Pakistan.

Central to the Zia Government's goal of transforming the present social and economic system into an Islamic one is the elimination of interest, which is viewed by a many of Pakistani religious scholars and by the Council of Islamic Ideology as conflicting with essential Islamic principles.

In June of this year the Finance Minister startled Pakistan's Bankers with a timetable for total Islamisation of the banking system which went further and faster than almost anyone had expected.

In conjunction with his annual Budget Speech, the Finance Minister instructed the nation's banks to prepare for Islamization of dealings with the Government by the beginning of calendar year 1985 and for completely Islamic transactions (public and private) by the summer of 1985. The only exclusion from his sweeping injunction was financing terms for donor assistance which were to remain on conventional interest terms for the time being until mutually agreeable alternatives could be formulated.

The following Islamic financial system measures have been introduced by the present government in its endeavor to Islamise the financial sector:

a. As an initial measure for eradication of interest, "Profit and Loss Sharing Accounts" ("PLS") were introduced as an alternative to fixed interest savings accounts. These provide for return to the depositor only out of profits.

b. Participation Term Certificates ("PTC") were introduced as an alternative to fixed rate debentures and are similar to preferred shares. PTCS provide for return to the lender only out of the profits. PTC holders rank equally with shareholders in entitlement to a share of the profits of the venture, and can have a right to convert into shares in specified proportions in case of loss. The terms being used now for PTCs reportedly also allow the tender to appoint directors in case the enterprise suffers specified losses. This has caused a good deal of difficulty, and preference of businessmen not to use PTCs.

c. As a further measure for eradication of interest, a special law has been enacted to encourage "Modarabas", similar to a mutual fund. A Modaraba is a form of equity and share investment in an undertaking managed by a separate company. A Modaraba is a legal person and may be formed for a fixed period, at the end of which the undertaking would be wound up or dissolved and the profits (or losses) shared in accordance with the investment of the parties.

d. The "Musharika" has been introduced as a form of partnership in which partners contribute their money, efforts or skill.

e. "Bai-Salam" has been introduced as one of the short-term financing measures. It could be defined as an interest-free hire purchase agreement to finance the acquisition of machinery and equipment as well as durable consumer goods, under which the bank shares the ownership with the borrower. "Bai Musjjad" is the other short-term financing measure introduced. This is defined as a sale under which the price of the item procured is payable, on a deferred basis, either in lumpsum or in installments. It is an operation similar to leasing in which the lessor, or the bank, retains ownership of the asset and the lessee, or the customer, has possession and use of it against payment of a specified rental over a specified period.

Another Islamic fiscal measure introduced by the GOP is "Zakat", or Islamic wealth tax. This is a tax on investments and other financial assets, to be used for charitable purposes. Zakat is recovered at the rate of 2.5% of the value of an asset determined in the manner laid down in the Zakat and Ushr Ordinance 1980.

Zakat will not be recoverable in respect of shares and debentures of other companies held by a company. In addition, no Zakat is recoverable from a company where a majority of its shares are owned by foreign investors. Thus, if the proposed company is formed as a foreign-controlled company, no Zakat will be recoverable on its investments and other financial assets. However, if it is controlled by Muslim citizens of Pakistan, Zakat will be compulsorily recovered (other than on shares and debentures) from it in the manner laid down in the Zakat and Ushr Ordinance in respect of its investment and other financial asset.

At present Zakat is not compulsorily recoverable on "loan receivables". However, under the Second Schedule of the Ordinance, a Muslim may pay Zakat on loan receivables on a voluntary basis if he feels like paying the same. This voluntary basis is not applicable to banks, financial institutions and companies.

4. Future

The main influence upon the financial marketplace will be the overall performance of the Pakistan economy. It would appear that prospects are good for continued growth and a widening of the demand for financial services - particularly in view of the changes required by Islamisation.

At the same time, increased savings may result as income increases, becomes more widely distributed, and inflation is checked. The introduction of Islamic banking can assist in increasing deposits, attracted by higher yields and freer markets.

The two important policy issues relevant to the commercial banking system are interest rate levels and structure, and also the credit allocation system. SBP is charged with regulating both. In the past, the levels and structure of the interest rate have been utilized by SBP to pursue two contradictory objectives: increase the rate of savings through attractive deposit interest rates and promote investment in certain sectors and activities by offering low cost financing for them through the commercial banks. The result has been a crossed interest rate structure that had to be subsidized, either by GOP, the non-preferred sectors, or the banks. Some relief has been offered to the banks through low cost refinance lines for specific purposes, e.g., exports. More recently, with the adoption of Islamic instruments, both for deposits and loans, the lid has been taken off interest rate levels, at least on part of banking activity, and the crossing effect partially eliminated. GOP is committed to proceed in this direction, so that the issue of the interest rate level and structure have not been directly addressed. The result is that Islamic finance may help Pakistan to move towards implicit interest rates that reflect current price movements and towards a freer market interplay between savers.

B. STRATEGY IN DEALING WITH THE GOP, AND TIME SCHEDULE FOR REPORTS TO AID/WASHINGTON

5. GOP Strategy

The CFIC proposal looks rather different from USG and GOP perspectives. From the USG perspective it is an institution which can bring the forces of the marketplace to bear upon the pricing, allocation and efficient provision of capital to industrial and commercial users in the private sector. An organization which can bring efficiency and competition into the financial services marketplace is consonant with fundamental USG tenents about development and about broad economic management.

From the GOP perspective, however, the significance of CFIC is that it offers:

- transfer of valuable international financial technology
- an international "seal of approval" for Pakistan's Islamic Banking reforms
- an injection of fresh external capital (over and above AID resources and indigenous capital)

- a bridge between the formal financial sector and the vast informal "Hundi" market, where 40% to 60% of all private Pakistani capital circulates outside the tax and monetary framework of the nation
- an opportunity to support Sixth Five Year Plan goals of expanded private sector industrial development with meaningful actions and with resources
- enhanced interbank and inter-corporation short-term liquidity through the market making functions of CFIC
- an opportunity to recapture international-class expatriated Pakistani banking talent from Zurich, London, Kuwait and other places to which it fled after bank nationalization in 1972

USAID's strategy in developing the project with our GOP counterparts will build upon these important features of the proposal from the Pakistani perspective. While our concerns for liberalization, deregulation and market forces in the financial sector guide our interest in CFIC, we do not anticipate making these aspects the centerpiece of our negotiations. The free marketplaces aspects of the CFIC proposal were quickly recognized by Pakistani figures in the business and financial community, and were lauded by most of them (even by senior executives of the large nationalized commercial banks who continue to have a keen interest in serious, bottom-line banking).

It is our intention to share the revised Commercial Proposal for CFIC (following inputs from the banking team and redrafting by Mr. Leigh Miller) with the GOP along with a companion document which presents the project rationale and lays out the important issues which will require GOP concurrence and GOP decisions or policy waivers.

This first round of discussions (tentatively planned for late January) would seek general reactions from the senior management of the Ministries of Finance and Planning. It would be unrealistic and counterproductive to seek firm final approval for CFIC at this time. We would, however, want a clarification of any "go-no-go" issues and general agreement on the process by which we would be soliciting private foreign investment in CFIC.

This first dialogue on the CFIC proposal (in contrast with a history of dialogue on the general concept of an investment house) would precede submission of the formal CFIC Interim Report document to the Asia Bureau in mid-February. The period from AID/Washington approval of the Interim Report in mid-March through Project Paper submission in August would entail a number of rounds of discussions with the GOP. As investors are identified they will indicate specific areas of clarification and assurance upon which their investments will be contingent. AID legal review will identify other areas. The process of legal development of CFIC lending to incorporation will identify still other issues which need GOP decisions. At this stage it is not productive to second-guess all of the issues and decision requirements which will be encountered in the project development. USAID/Islamabad recognizes, however, that the dialogue will require sustained inputs from USAID management, from the Ambassador and (perhaps) from management levels in AID/Washington.

2. <u>Project Development Process - AID/Washington</u>

Before preparation and submittal of an Interim Report, through this preliminary paper the Mission would like to elicit comments on the proposal from the respective offices and persons in AID/Washington who will be involved in the formal review process at various stages. The Mission would hope to be able to consider such comments when preparing the formal interim report.

We expect to have preliminary views from potential investors in mid January and plan to discuss the proposal with the GOP the latter part of the same month and receive the final commercial feasibility report in early February. An Interim Report would be submitted to AID/Washington by February 15 and a review requested on/or about March 10. A completed Project Paper should be in AID/Washington for review on August 1. The Project Agreement could be signed in October/November of 1985 depending upon the rapidity with which the GOP responds.

C. SPECIFIC ISSUES FOR CONSIDERATION

a. Relationship to Earlier Discussions

Industrial finance in Pakistan is channeled almost exclusively through nationalized commercial banks and government controlled finance institutions. The proposal discussed in this paper to establish a private financial institution, CFIC, builds on the concept in the Mission's Project Identification Document (PID) submitted on July 17, 1982, and the PID approval in August 24, 1982. The PID approval suggested that consideration be given to establishment of a private investment finance company to provide a broad range of services to enterprises.

This suggested approach followed out earlier explorations to identify a way to facilitate private sector involvement in economic activities, including mobilization of capital. Thereafter, in the PID development process, emphasis was placed on evaluation of real needs and opportunities to allievate restraints to private sector development, including services that could assist in this. This approach was agreed in AID/Washington.

Following project development work in the spring and summer of 1982, the focus narrowed to a new privately owned financial institution. This led to a desk review of the possibility of establishing a financial institution with very broad ranging services. This review was circulated to various officials of the GOP for informal consideration. In May 1983, the Mission received a letter from the Ministry of Planning indicating several elements in the desk review proposal were unacceptable to the GOP, principally (a) the entity should not be a deposit taking one, and (b) it should be 55% owned by GOP or GOP controlled financial institution.

Following this, in discussions in September 1983, AID Administrator McPherson and the Minister of Finance discussed the prospects for establishment of a private sector financial entity. The response was that "a bank" could not be established, but that an "investment company" might be considered. In addition, the word "finance" could not be used in the name of such an entity.

Accordingly, the decision was made to follow up the PID approach with evaluation of the feasibility of establishing in the private sector a commercially profitable entity providing a number of financial services (from those of a merchant/investment bank to a leasing company). Legal issues were evaluated starting in August 1983, and commercial feasibility was planned to be completed in early 1984, but was delayed until the arrival of the team in November 1984.

As indicated earlier, the approach of the commercial feasibilty evaluation was not on whether a particular type of entity could be established, but on what services the financial market needs which are not being adequately met, and then whether a commercially successful entity could be fashioned to meet these needs. As explained in the draft feasibility report, a CFIC type entity could assist in addressing a number of needs in the economy (see B "Environment - Pakistan Economy - CFIC Implications").

Because of the delay from the time of the original development of the PID until now, and the changing circumstances in Pakistan -- especially the proposed Islamisation of the banking system --- it is believed appropriate to provide AID/Washington this preliminary paper as the proposal is taking shape, prior to a formal Interim Report, expected around mid-February.

In the period intervening since 1982, similar goals to those discussed above have led the Private Enterprise Bureau to provide loan funds for a joint IFC and GOP/government instution/private section leasing company in Pakistan, National Development Leasing Corporation. The Mission concurred in this investment, and AID/Washington indicated that this investment may provide USAID a basis to seek GOP approval of future 100% private leasing companies.

b. <u>Possible Methods for Association of USAID Funds with the Proposed Company</u>

1. <u>Background</u>

The financial experts team has recommended an approach to AID financing which they believe to be ideal from the perspective of the project goals and to be acceptable in terms of AID requirements and procedures. This approach is contained in the draft commercial proposal and is also discussed below. The team's proposal is not, however, the only vehicle for AID financing. At this stage Mission believes it is useful to lay out the possible alternatives. Some of these are not likely to be attractive to the private investors and others may be unacceptable to the GOP. It is appropriate, however, at this stage in project development to present the range of possibilities. The Mission will continue to use the team's proposal of subordinated debt combined with debentures until the issue has been fully aired with AID/Washington. This approach is legal and has precedents within AID's history of intermediate credit work. It is not, however, the only possible alternative.

2. Objective of AID Financial Participation

If privately owned, well managed financial intermediaries existed in Pakistan, AID would not be seeking to assist in starting a new one. It is because there are no such intermediaries and because AID will finance only private sector programs through market oriented, private intermediaries in Pakistan, that the current project is being proposed. The basic role of AID capital is to assist the private investors in CFIC to overcome the obstacles which will face a pioneer private sector finance house in its early years. The object of AID's investment in CFIC will be to provide incentive for others to also invest in the Company. At the same time, AID's investment should not provide a windfall to the company or the other investors. In selecting the investment vehicle AID will seek to keep its active participation in

Company operations to a minimum. To this end the Mission will be exploring various vehicles for providing funds to CFIC during the project design process. However, at this point the two that are the most likely candidates are the first two mentioned below:

3. Methods of Investment

(i) Combination of Debt and Special Participation Term Certificates (SPTC)

With SPTCs the investor does not receive interest. Instead he or she participates in the profit and loss of the Company much as a shareholder would. A major advantage of this method is the SPTCs are treated as equity by the Company and not a liability, thus improving the Company's debt/equity standing. Under this method, AID may be able to reduce its investment in the Company more quickly than if it were tied exclusively to straight debt. The SPTC could be converted to shares and sold and the smaller loan could have a shorter payback period. Also, the profit accruing on SPTCs would be allowed as a deduction for computation of the taxable income of the Company. To this extent, this method of financing may be more beneficial for the Company as compared to issuance of shares. However, heavy valorem stamp-duty may be attracted by SPTCs at the prevailing rate of 3% of the principal amount of the SPTC.

(ii) Direct Loan(s)

Under this method AID would provide one or more direct loans to CFIC. To ensure that the Company's capacity to borrow is not affected, the AID loans would most likely be subordinated to other debt of the Company. They may provide for moratoriums on payment of interest and repayment of principal as well. The major advantage of this method is minimum involvement of the GOP. Funds could be transferred more rapidly to the company. If the GOP were involved the funds would have to go through the Ministry of Finance, which, based on experience in other projects, causes delays of up to six months. It also will keep GOP direct involvement in the operations of the Company to a minimum. Because the Government does not take possession of the funds and then turn them over to the Company, there is less reason for the Company to be subjected to GOP internal audit requirements (except for those required of any financial institution) and less risk of the GOP requiring involvement in the selection of company personnel and intervention in other company operations. A final advantage is that under direct loans AID's investment in the company would be liquidated automatically as they were paid back.

iii) Loans through Government of Pakistan

Under this approach, funds could be made available by USAID to the Government of Pakistan for re-lending to the Company. This method is subject to two problems. First, as is the present practice, the Government of Pakistan may charge interest on the re-loan on the Company thus increasing the cost of the funds to the Company. Second, as the recepient of a Government loan, the Company would become subject to monitoring by the Government and to audit by the Government Audit Department, resulting in frequent intervention in the affairs of the Company.

Other methods for associating funds with CFIC can also be considered, including those discussed below.

(iv) Loans through Commercial Banks in Pakistan

Under this approach, funds could be made available by USAID to commercial banks in Pakistan for re-lending to the Company. This manner of financing will be subject with such difficulties as: (a) the cost of funds to the Company may be increased, and (b) the Company may become subject to intervention by the banks. All commercial banks in Pakistan are subject to the control of the State Bank, and are required to comply with instructions from time to time issued by the State Bank of Pakistan. The nationalized banks are subject to the further control of the Banking Council. The State Bank of Pakistan/Banking Council may issue such instructions to banks in Pakistan which may require them to closely monitor use of funds provided by them by way of loans to borrowers in Pakistan. Such monitoring may result in interference by the banks in the affairs of the Company.

The banking team did not pursue the idea of lending through banks because its and the Mission's purpose in designing a private sector financial institution would not favor operating through the existing government dominated financial institutions.

(v) Loans Guaranteed by USAID

Under this approach, the Company could raise loans in rupees or foreign currency from banks/financial institutions against guarantees furnished by USAID. These may be bank guarantees obtained and furnished by USAID on behalf of the Company. The comments on channelling USAID loans through banks are equally applicable to this approach: (a) the cost of funds to the Company will become relatively more expensive as compared to direct loans by USAID; and (b) in respect of loans raised from Pakistan banks, unnecessary interference in the affairs of the

Company from these banks may be faced. Possibly this latter problem could be alleviated through borrowing in markets outside Pakistan, which could have the advantage of introducing the Company to international markets. Of course, this would advertise the close identity between the Company and USAID.

The financial experts team did not pursue this approach because it would increase the cost of funds to the proposed entity and would not involve direct use of AID funds, as anticipated.

(vi) Shares - USAID could make an investment in shares of the Company that have no voting rights or whose voting rights have been stripped away permanently or temporarily.

In Pakistan it has been an often-used practice to issue preferred shares, with a preferential right (either cumulative or non-cumulative) to dividends at a fixed rate if declared, and to distributions on liquidation, but which have no rights to voting. The preference could be to a specified, even low, rate of return, such as 1% of nominal value. The preferred could also be "participating", in the sense that after payment of its fixed amount it could participate in regular dividends. It may also be possible to limit the preference to dissolutions. It may be possible to have preference shares redeemable by the proposed Company out of a capital redemption reserve. In addition, possibly the shares could be able to be made convertible into or exchangeable for voting shares, such as in case of a sale by USAID to the other sponsors or others. It is understood that USAID is allowed to hold convertible debentures. Therefore, it also should be allowed to hold non-voting shares with rights to convert into voting shares.

Another possibility, although not common in Pakistan, is to have two classes of common shares, Class A with voting rights and Class B without voting rights, subject to obtaining GOP approval for the non-voting aspect. The rights to dividends and other rights possibly could be varied, so long as all holders of one class have equal rights. It should be possible to provide that the non-voting shares are convertible into or exchangeable for voting shares, such as on a sale by USAID.

It should be pointed out that the new Companies Ordinance gazetted in October 1984 but not yet declared effective, may limit or even ban preferred shares, or could contain other restrictions on shares with different rights. In this case, the share alternative would have to be revaluated.

Finally, it should also be noted that if the company issues shares, it will have an income-tax disadvantage. While interest payments accruing on loans would be deductible for computation of taxable income of the Company, dividends paid on shares would not be deductible. Thus, the tax liability of the Company will be relatively higher if USAID subscribes shares instead of providing funds by way of loan.

The financial experts team did not pursue the use of shares because of the Mission's understanding that this is not the usual approach for AID and because the Mission has been led to believe that the GOP prefers the funds pass through the GOP.

(vii) Modaraba

Another kind of Islamic security (besides the Special Participation Term Certificate approach described earlier) that could be considered is the "Modaraba", whereby the investor has no say in the affairs of the Company, and is entitled only to receive a share of the profit as specified by agreement. Thus, these securities also probably would not constitute equity in the U.S. sense of entitling the holder to voting rights. They are more akin to "trust participation certification" or rights of beneficiaries to earnings from assets or shares held in a trust.

Modarabas could offer attraction in the sense that fund income is not taxable if 90% is paid out to Modaraba holders. However, Modarabas could also involve significant difficulties. The approval process for designing and issuing Modarabas is complex, and will involve scrutiny to assure that proceeds could not be used in any activity which itself could involve interest payments (riba). Apparently, it is necessary to receive approval of a Religious Board that the matter does not violate the strictures of Islam. The financial experts team did not consider this still unfamiliar Islamic Modaraba approach as fruitful as the SPTC built on the more usual PTC approach.

In conclusion, as indicated earlier, at this point in the project development, it appears that the most attractive methods of associating of USAID funds with the proposed company is the method suggested by the team and reflected in the draft Commercial Feasibility Report -- through combination of debt and Special Participation Term Certificates (SPTCs). Another alternative is direct loans to the Company. However, during project development, these and other alternatives will be evaluated.

No matter what financial vehicle is eventually selected for associating USAID funds with CFIC, requirements will be built in to reduce the concessional nature of AID's investment as the Company achieves stability and profitability. The rate of reduction will be directly related to company earnings. To speed up this process, all investors will agree that no dividends will be paid until after the third year of company operations. Afterwards, the dividend rate would be limited to a maximum % 50 of profits each year.

4. Withdrawal of Earnings/Principal

In the Interim Report and the Project Paper, consideration will be given on what to do with the profits imputed to AID's investment and the principal of any loan or investment funds. The goal will be to determine a feasible method whereby the AID funds could continue to be available in Pakistan to conduct activities without GOP re-approval, consistent with AID project objectives. Alternatives under consideration include:

a. Allocate the funds to continue to be available for CFIC to on-lend in projects;

b. Transfer of profit or principal to a permanent part of equity;

c. Establishment of a fund and organization to carry out training in business operations and investment for the general public; and

d. Establishment of a mechanism to provide grants to local charitable and/or educational institutions.

Any selection will be made with the intention of maintaining AID's monitoring responsibilities at a minimum.

c. Equity Ownership

As indicated in the draft Report, the team proposes that the equity ownership of CFIC be 100% foreign. This entity should not be identified with any Pakistani group of investors, because (a) the GOP will not wish to allow the "22 families" to participate, and (b) the entity should be independent of outside pressures from local owners. The team's strong view is that the entity should be free from the pressures of, and "jockying" for position by, local investors. The international institutions investing - commercial, merchant and investment banks, insurance companies, etc. - need to be able to develop the entity without interference, diversion of local investors, or the stigma of looking like "M's company" or "Family Y's company", a common perception for businessmen in Pakistan. Accordingly, it is proposed that the equity be 40% owned by the international institutional investors and 60% by individuals located in the US and European markets. The initial non-institutional investors presumably would be wealthy individuals and sophisticated investors who would individually invest substantial sums. As indicated, of the total authorized equity of $25 million, 10 would be put up initially, with commitments from the investors for the remainder to be put up over the five year period.

A hypothetical investor mix might look as follows:

INSTITUTIONAL INVESTORS	%	SHARE OF 1st 10 MIL	SHARE OF TOTAL $25 MIL
NY Investment Bank	10	$1 million	$2.5 million
US Commercial Bank with Pakistan interests	10	$1	$2.5
London Commercial Bank with Pakistan interests	5	$0.5	$1.25
London Merchant Bank	5	$0.5	$1.25
A Gulf Bank	10	$1	$2.50
INDIVIDUAL INVESTORS			
European Investor "X"	20	$2.0	$5
Overseas Pakistani Resident Abroad "Y"	15	$1.5	$3.75
Gulf Investor "Z"	25	$2.5	$6.75
	100%	$10.0 Million	$25.0 Million

As pointed out in the draft Report, once the company becomes established, it could make good business sense to raise further capital through the Pakistani markets.

As the proposal takes further shape, the question of who the investors should be will be evaluated. In all cases, the names of potential investors would be vetted with the GOP.

d. Effect of Islamisation on Proposed Entity

The GOP has announced that the banking system in Pakistan will be Islamised in 1985. Currently the banks and the government are working closely to develop the appropriate legal framework and documentation, and the government has committed to continue this collaborative approach. The draft proposal reflects the views of the bankers that Islamisation as currently envisioned will not have an adverse effect on the proposed entity, CFIC. The proposal has been designed to meet actual market needs, which will continue and which will not be impeded by Islamisation. Extensive conversations were held with banking institutions and with officials active in the formulation of how Islamic finance will operate. A further examination will be possible after January 1, the date by which the basic legal framework and documentary approaches are planned to be finalized. However, as indicated in the Draft Proposal (See "Marketplace - Effect of Islamisation of Banking on Market Segments"), the team's view is that the services proposed will be possible to provide under Islamic principles. This is because of the following:

(a) Islamisation will not be applied to foreign currency finance,

(b) As to short-term finance, current overdraft facilities will be replaced by loans based on mark ups related to specific goods and assets, and all internal trade related finance would be handled on the basis of "mark up" and "mark down".

(c) Market making in instruments which had already been issued in conformity with Islamic principles (principally short-term mark-up/mark-down instruments) would be in conformity with Islamic requirements and it is reported that appropriate instruments will be devised to facilitate such activities.

(d) As to long-term finance, profit and loss sharing arrangements create certain uncertainties (such as in Participation Term Certificates and Modarabas), but hire-purchase and leasing are being introduced in Pakistan, especially because they conform in many respects to Islamic trading finance principles, and these may be used for asset-based finance.

(e) Concerning project finance, the provision of long-term finance could be affected in general by the prohibition of interest; however, it is anticipated that lease finance could be employed along with foreign exchange loans, and that other financial instruments will be devised to allow needed continuation of project development and finance. Certainly the authorities in Pakistan do not intend to allow a lapse in these activities.

(f) Equity finance is fully consistent with Islamic requirements and there is no indication that Islamisation will have an adverse effect in this regard; in fact, it may be possible that the Islamic preference for profit sharing finance may lead to encouragement of equity finance.

In general, therefore, it is anticipated that under the approach to Islamisation currently being followed by the government, potential needs which the banking team has discerned in the market will not be adversely affected by Islamisation and will continue during the transition and after implementation of Islamisation of the banking system, except for possible concerns and delay in longer term finance, where new instruments will be developed.

In addition, in a number of places in the Commercial Feasibility Report it is pointed out that Islamisation will in some way foster the needs to be serviced by the proposed entity, including: (a) unfixing rates of return on loans, which would provide requirements for risk taking by financial institutions, for which the proposed entity would be in the forefront of financial institutions in Pakistan; (b) if bankers are to possibly share in losses of projects, more professional project feasibility evaluation will be required, for which the proposed entity would have enhanced capability; and (c) with Islamisation and unfixing of rates of return, there is an even greater need for financial intermediation through a secondary market, and market making in short-term instruments will be a principal activity of the proposed entity.

In sum, then, as presently proposed, the banking team does not see Islamisation as having a dramatic disruptive effect on the services proposed to be provided by CFIC. Thus, while Islamisation may cause anxiety to those outside Pakistan who have not studied it, it has been taken into account in designing the proposed entity. This goes back to the approach taken by the team in evaluating whether a private financial entity was needed in Pakistan -- the approach was not to come to see if a pre-determined list of possible services provided elsewhere could be provided in Pakistan, but rather to determine what market needs appear in the current and changing market, and then to determine if they could devise services to meet these needs. Senior Pakistani and foreign bankers, including Pakistanis directly involved at the Government level in Islamisation, indicate that the requirements of the Pakistan economy are not to be seriously disrupted by Islamisation, and agree that the market needs and services identified by the team will continue and should be met.

e. Responsibility for Incorporation and Staffing Proposed Entity

It is anticipated that a highly qualified expatriate financial executive would be recruited to run the operation of the proposed entity. Expatriates could include Pakistanis working abroad. It is expected that the investors and USAID will require a highly qualified international recruiting firm to conduct a thorough search for candidates. In addition, during the process of locating potential investors - international commercial banks, merchant/investment banks, etc - it is expected that potential investors will suggest candidates, and ultimately as a condition to investment will insist on certain agreed upon persons.

The normal course would be that once the potential investors determine their actual intent to invest, the selection of senior staff would be determined by the investors. Once the chief executive is chosen, he will be charged with staffing the company.

In addition, once the investors have been determined, it is expected that they will carry out the actual incorporation of the company.

Accordingly, USAID role will be focused on feasibility work prior to actual incorporation and staffing. This work would include use of consultants (presumably those on the team) to continue to shape the proposal and locate potential investors. (Funding for these efforts, as for the evaluation already constructed, would come from the Mission's Project Development Funds.)

f. Specifics to be Dealt with Subsequently

As the proposal is evaluated and takes more firm shape, a member of issues of a more technical nature will require evaluation. These include:

(1) Specific documentation for types of instruments to be used when Islamisation is finalized. This is currently being worked through by the State Bank of Pakistan, the Pakistan Banking Council and the banks and financial institutions, and is expected to be completed and in place by January 1, 1985, which schedule could slip. As indicated earlier, discussions with numerous parties involved indicated that these documents will not be dramatically different from those discussed in the Commercial Feasibility Report in connection with the proposed financial services. As to longer term instruments, the documentation will take somewhat longer to be worked out.

(2) As indicated in the draft report (See "Environment - Political, Legal and Regulatory Framework"), a number of specific approvals will be needed for the establishment of CFIC and the conduct of its business, and relaxations of certain requirements or rigidities will be required. It

is anticipated that these matters, which have been the subject of earlier extensive review (See "Legal Feasibility of a Private Financing and Investment Company in Pakistan"), will be examined in light of the proposal as it takes shape and the interest and requirements of potential investors are determined and the views of the GOP clarified. The feeling of the team, which the Mission shares, is that if the GOP gives clearance of the concept of the proposed entity, it should be forthcoming in providing certain specific approvals and relaxations for the Company's foundation and operation.

In sum, then, the main objective thus far has been to determine the commercial feasibility of a possible private financial institution; this process will be continued with approaches to leading international financial concerns, and at the same time informal discussions will be held with the GOP on the particular entity now envisioned. As potential investors provide their views and ultimately indicate their interest, the review with the GOP will take on an even more specific character and evaluation of specific questions will be accelerated.

D. DRAFT PROPOSAL ATTACHED

Attached as Appendix A is the draft Commercial Feasibility Report prepared by the consultants, entitled "Proposal and Evaluation for a Private Commercial Funding and Investment Corporation in Pakistan". The Report is a first draft which is yet to be reviewed and revised by the team members, which is expected to occur between now and mid January. The Report will be revised following January discussions with potential investors, and a final Report submitted in early February. Thus, ideas and wording may need change, and the draft is provided to show the basic concept, which has been described in the "Summary" at the beginning of the paper. The Mission has given informal comments to the team for consideration in revising the report.

In addition, a somewhat abridged copy of the Draft Report will be prepared for informal discussion with GOP officials, particularly in the Ministry of Finance. In the abridged version, certain emphasis would be deleted on subjects which may be counter productive to such discussions, such as emphasis on free market allocation of resources.

METHOD OF PREPARATION OF THE PROPOSAL

The objective of the Private Investment Corporation Team was to assess the range of financial services currently provided in Pakistan and to determine whether more or better servies are required -- and whether providing them through a private financial entity would be profitable.

The team consisted of international bankers, investment house executives, lawyers and chartered accountants from both the U.S. and the U.K. It was headed up by co-leaders Leigh M. Miller, former Director of the American Express merchant bank in London and senior Vice-President of American Express International Corporation in New York, and Charles C. FitzGerald of Lazard Brothers, a London merchant bank.

Other members of the team included Sidney Bennett, Vice-President, First Interstate Bank of America (formerly United California Bank), Douglas C. Gunesekera, former Deputy Governor of the Central Bank of Ceylon and Executive Vice-President, Asian Development Bank, and Terrence Reilly, an international and finance lawyer formerly with a leading Wall Street law firm and a consultant on capital market development in numerous countries.

In addition, two other members of the team, Khalid Saeed, owner and Managing Director of a London bank engaged in Islamic banking and an advisor to Lazard Brothers, and William Pedder, South Asia specialist for Lazard Brothers served, without receiving compensation, which should give some indication of the level of interest in this project from some financial quarters.

The team met with the heads of financial institutions, both private commercial and government operated, the Governor of the Central Bank, the Banking Council (a de facto bank regulatory agency of the GOP), the chief executive officers of development finance institutions, the head of the Karachi Stock Exchange and a leading stockbroker, the senior partners of major accounting firms, insurance company executives, and leaders in the business and industrial community.

These frank and thoroughgoing sessions were assessed by the team members each evening and ultimately served as the basis for deriving the views presented in the Draft Report. During January, the proposal and evaluation will be discussed and tested with financial institution investor candidates in major financial centers (New York, London) to determine potential interest and views.

Appendix A
(SEE SEPARATELY
BOUND EDITION)

WORKING COPY

Proposal and Feasibility Evaluation

for

a Private Commercial Funding and

Investment Corporation in Pakistan

(December 4, 1984)

(Note: This Working Copy is to be reviewed by all parties, and a revision prepared during December. It has not been formally reviewed and approved by USAID/Islamabad)

ILLUSTRATIVE MASTER TIMESCHEDULE

(November 28, 1984)

Draft for Comments by All Parties

The following is an illustrative timeschedule, for use only to track four processes which must be followed simultaneously: (i) development of project concept, (ii) discussion with potential investors, which will shape the project, (iii) GOP review and approval, and (iv) AID Washington review and approval. The purpose is to have the GOP and USAID Washington involved from the initial stages. No commitments can be made that the following schedule could be met, as that will depend on events as they develop. Thus, the schedule is only for illustrative purposes, and to array before the participants subjects to be dealt with and obtain comments on time needed and possible subjects to be added.

The principal potential delay factor is expected to be the discussions with the GOP. GOP will be deeply involved during the first 4 to 5 months of 1985 with budget preparation. In addition, the rolling of the three year plan and the Annual Development Plan will absorb great effort and time. Finally, review of Project Paper aspects by the GOP could be an extended process. Accordingly, emphasis will be placed on early and continued dialogue with GOP officials. All GOP project development process aspects step in the following time schedule have been marked with a star (*).

The names and addresses of all participants are set forth following the timeschedule.

Abbreviations:

USAID/I = USAID Islamabad

AID/W = AID Washington

Banking Team = Banking Team Partipicants,
as indicated at end of Illustrative Timeschedule

Commercial Feasibility
Report = The Report prepared by Banking Team

Abridged Commercial
Feasibility Report = Copy of the Report prepared by Banking Team,
used in discussion with GOP

Item	Date	Responsibility
Commercial Feasibility Evaluation	Nov 6 - 25	Banking Team
Prepare Preliminary Draft Commercial Feasibility Report		
a. First Draft	by Nov 24	Banking Team
b. Cleaned up Draft reflecting USAID/I preliminary views	Dec 2	
c. Copies to all Banking Team Members for Revision	Dec 6	USAID/I
d. Prepare Draft Abridged version of Commercial Feasibility Report	Dec 15	USAID/I
e. Comments on Draft by All Members of Team	Dec 20	Banking Team
f. Revised Commercial Draft Feasibility Report	Jan 6	Banking Team Leader
g. Final Report	Early Feb	Banking Team
Preliminary AID Report to AID Washington	Dec 7	Banking Team/ USAID/I
Obtain samples of accepted and rejected Interim Reports and Project Papers on Financial Institutions	Dec 15	USAID/I AID/W
*Informal Discussions with GOP officials and delivery of Abridged Version of Feasibility Report, and GOP Rationale and Statement of how GOP Project Development Procedures will be addressed. Goal: to obtain a general "go" or "no go" indication (not formal approval)	Dec/Jan	USAID/I
Comments from AID/W on Preliminary Paper	Dec/Jan	AID/W
Begin drafting of Interim AID Report to AID/W		

Item	Date	Responsibility
a. Determine Outline b. Assign drafting: First draft due by Jan 25 (Note: The Interim Report is a formal document containing much of the information in a Project Paper. It receives formal review in Washington. Thus, it must be prepared with care)	Jan 10	USAID/I (J. Blackton)
Revise Timeschedule	Jan 15	USAID/I
Discussion of Proposal with potential interested parties/ investors to gain reactions and ideas for possible tailoring	Mid Jan	Banking Team Members as appropriate, and USAID/I representative (J. Blackton)
*Progress Discussions with GOP officials	Mid Jan	USAID/I
Evaluation of Legal Framework and Documentation adopted for Islamisation	Mid Jan	Banking Team Members as appropriate
Proposed Return visit to Pakistan to finalize Commercial Feasibility Report	Latter Jan	Selected Banking Team Members
Prepare PIO/T for Project Paper writer(s) (16 person weeks)	Late Jan	USAID/I
First Draft of Interim AID Report to AID/W		
- Received internally	Jan 25	USAID/I
- Comments given	Jan 30	USAID/I

Item	Date	Responsibility
Review of specific issues concerning approvals and requirements for establishment of proposed entity	Latter Jan/ early Feb	Banking Team Members as appropriate
Review by internationally recognized advisor on compatability of proposed entity's activities with credit ceiling and supply limitations of the type required by IMF	Feb	Banking Team Leader and Selected Expert (possibly Rimmer De Vries Ch. Economist _ Morgan Guaranty Trust)
Revised Draft of Interim AID Report to AID/W		
- Received	Feb 7	USAID/I
- Comments given	Feb 10	USAID/I
*Further discussions on more formal and specific basis with GOP, reflecting revisions based on discussions with potential investors. Submit Final Abridged Commercial Feasibility Report	Early Feb	USAID/I Banking Team Members as appropriate
Revise Timeschedule	Feb 13	USAID/I
Final Interim AID Report to AID/W dispatched (requested approval by March 10)	Feb 15	USAID/I AID/W
Project Paper writer(s) located	Early Feb	
Check status of AID/W Review of Interim AID Report and schedule for final review by March 10	Feb 28	USAID/I
Comments and Approval of AID Interim Report received in Karachi	March 10	AID/W
*Further discussions with GOP as appropriate	March 10-15	USAID/I
Project Paper writer(s) arrive	March 14	
Begin preparation of Project Paper:		

Item	Date	Responsibility
a. Determine Outline		
b. Assign all parts for drafting		
c. Reflect any issues raised in review of Interim AID Report	March 15	USAID/I
(Note: The Project Paper is a formal document required to meet specific and detailed requirements, including numerous appendices)		
*Continue discussions with GOP as appropriate	March/April	USAID/I
Negotiations with potential investors. Determination of legal requirements for same (including securities law questions)	March/April	Investors, Banking Team Members as appropriate
Revise Timetable	April 17	USAID/I
Continue Preparation of Project Paper	May/June/July	USAID/I
Revise Timetable	May 15	
*Continue Discussions with GOP	May/June/July	USAID/I
Review First draft of Project Paper	Mid May	
Continue Negotiations among investors	May/June/July	Investors, Banking Team Members as appropriate
Project Paper complete and dispatched to AID/Washington (requested approval Nov 1)	August 1	USAID/I

Item	Date	Responsibility
Project Approval process on-going in AID/W. Project Agreements and legal formalities being discussed between AID and Investors	Sept/Oct	AID/W
Project Paper approved, receive funding allotment, agreement with GOP signed and all legal formalities with investors completed	by Nov 1	USAID/W USAID/I
All conditions precedent and disbursement met	Dec 15	USAID/I
Implementation of establishment of company	Nov - March	Investor Founders (USAID/I)

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