BANKING IN PAKISTAN

A Background Paper for Policy Dialogue

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I. INTRODUCTION

A. Background

This paper contains material for use by the Administrator and by his staff in preparing for a high level policy dialogue with senior officials of the Government of Pakistan on matters relating to the deregulation of the financial system in Pakistan. USAID/Pakistan has been seeking to commit $50 million to a Private Development Corporation Project which would be a private investment firm, mobilizing private Pakistani capital and financing private Pakistani manufacturing and commercial ventures. Several major policy issues stand in the way of such an initiative. These issues are not only obstacles to sound private sector programming in Pakistan by A.I.D., but they are profound obstacles to resource mobilization and private sector growth in general. These issues include:

- public sector dominance of the financial markets
- overmanagement of the credit system by the central government
- interest rate structures which discourage longer-term, developmental lending to the private sector
- a commitment to rapidly introduce Islamic banking on a national basis before the financial markets and financial institutions have developed a capacity to handle Islamic financial transactions of a sophisticated nature.

B. Organization of the Paper

This paper draws directly from previous work on the financial sector done by USAID, USAID's consultants and other donors to present a short descriptive overview of the financial sector, a discussion of some major policy issues and a short agenda of items for possible inclusion in the Administrator's discussions with the GOP. Part II describes the major institutions in the financial system with particular emphasis upon those which relate to industrial and longer-term financing. Part III looks at the implications of Islamization of financing in Pakistan. Part IV draws upon the approved Country Development Strategy of the Mission in Islamabad in reviewing the policy setting and Part V present policy dialogue options for discussion and development in AID/W.

II. 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) two 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 deposits; 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 three 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.

Since 1979, a limited number of steps have been taken to improve the overall performance of the NCBs: branch expansion is no longer automatic and a number of branches which were considered uneconomical were closed down; hiring of staff, except for middle level management, has been stopped, a performance review system has been introduced and bank employees can now be fired after three months' notice; promotion is now supposed to be based more on merit than on seniority; NCBs will be allowed to build their capital to a prudent level, by limiting dividends to GOP for the next three years; and central training institutes (e.g., Institute of Bankers) are being strengthened.

In the area of term lending operations, commercial bank long-term lending to the manufacturing sector (37% of total advances) is above the level observed in many developing countries. This is due in large part to GOP's policy of encouraging commercial banks to provide term loans for industry through consortium lending led by ICP, Bankers Equity Ltd. (BEL) and NDFC. From FY 78 to FY 81, advances by the commercial banks increased from Rs 28.5 billion to Rs 57.4 billion, with public sector manufacturing enterprises receiving the major share.

C. The "Specialized Banks"

Four specialized banks: the Agricultural Development Bank of Pakistan (ADBP), 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. The Industrial and Term Financing System

Notable changes in the industrial financing system during the last decade have been, inter alia: the emergence of a government monopoly on credit, the creation of a number of non-bank financial institutions; the decline in the relative importance of established institutions, increasing government intervention in the credit markets and the emergence of the NCBs as a major force in term lending. Initially, PICIC and IDBP were the main institutions providing term financing for industrial development. However, in 1982 NDFC was allowed to diversify its activities to include lending to the large and medium-scale private sector. The government-owned and operated NDFC is now the largest industrial lending institution in Pakistan. Other government-owned and operated institutions such as BEL, ICP and the joint venture companies have also increased their role in term financing for private industry. As a result of these changes, PICIC and IDBP's share of private sector term financing has decreased considerably.

In FY 79-FY 80 GOP through the SBP assigned mandatory fixed investment lending targets to the commercial banks to prevent them from discriminating against term loans for industry 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 industrial investment, particularly shortages 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.

Although the increase in the number of institutions involved in term financing means more outlets, a certain amount of institutional "clutter" has been created in the process. 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 has chosen not to perform full banking operations; while empowered to raise short-term deposits. IDBP's Charter restricted its working capital financing.

PICIC is restricted by the Nationalization Act of 1974 from performing banking functions such as deposit taking, export finance, and participating in the inter-bank market. Thus, PICIC is forced to rely almost exclusively on multilateral lines of credit for its resources. PICIC also is subject to corporate tax whereas NDFC, and the three

Pak-Middle East joint investment companies are exempt, although they compete in the same market.

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 instructions attempt to provide appraisal and supervision services for large-scale consortium financing, but the NCBs' increasing involvement project financing suffers seriously from a lack of high quality project evaluation and supervision capabilities.

E. 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 only tapped general savings through issuance of appropriate marketable debt instruments for investment financing 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.

III. ISLAMIZATION OF THE BANKING AND FINANCIAL SYSTEM

A. Overview

In June of this year the Finance Minister startled Pakistan's Bankers with a timetable for total Islamization 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.

Although many express dismay and discomfort, most bankers taken the timetable seriously and are struggling with its implications for their operations. If adhered to, the timetable would make Pakistan the first and only nation in the world to fully or even largely Islamize its banking and finance system. Significantly, the major OPEC countries in the Arab World have not instituted national Islamic banking. Islamic banks operate in a number of countries, such as Egypt, but they form a minor part of the total financing system. Islamic banks such as the Dar Al Mal in Switzerland have found a niche in the world marketplace, but have not captured a significant slice of international transactions from Islamic countries.

Briefly stated, Pakistan is pioneering in the realm of full national Islamic banking with little evidence of adequate preparation for what will be a very arduous and dangerous expedition. The <u>concepts</u> of Islamic banking are widely known, but the tools remain largely underdeveloped and unseasoned. Early experiments which simply replaced "interest" with "charges and fees" have been abandoned as un-Islamic and fully-vetted, religiously acceptable alternative tools have not been tested by time and the marketplace.

The experience of Pakistan with Islamic banking over the past few years has taught a few lessons. It has also produced a few positive results which should not be discounted. This section of the briefing paper reviews the legal and constitutional background to Islamization of the financial markets, the recent experience of partially Islamic banking in Pakistan and the policy risks associated with comprehensive Islamization.

B. Legal and Constitutional Framework

It is the declared policy of the Government to Islamize all spheres of public life, including economic life. Islamic principles preclude the charging of interest ("riba"), and alternative forms of financing are being evolved as a substitute. Some would say that these new financing methods are being "imposed" more than evolving. The relation of these mechanisms to Western interest-based credit allocation systems has not yet been worked through. The difficulty lies not only in the development of the mechanisms themselves, but also in making them practicable in an existing system that implies approaches and procedures based on the interest-based they are intended to supplant.

Under Chapter 3A of the Constitution of Pakistan, the Federal Shariat Court may decide that any law or provisions of law is repugnant to the injunctions of Islam. Upon such determination the law or provision ceases to have any legal effect. The definition of "law" excludes "financial laws", but only for a specified period, after which the Court will have authority to give judgement on such laws and the arrangements and procedures adopted under them, including determinations whether any of these involve the charging of interest, which will be prohibited. The period was originally to be three years, expiring in February 1982. In 1980, the period was extended to expire in May 1983, at which time it was extended to May 26, 1984. Presumably, another extension will be adopted.

A number of Islamic financial system measures have been introduced in Pakistan:

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. These 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". 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.

These forms and instruments of Islamic finance have not yet become popular, particularly because of unfamiliarity with what they involve and recently because of some dissatisfaction by borrowers with the relatively high costs involved and the requirement of PTCs lenders for a right to participate directly in company management in case of losses. However, pursuant to Government policy, PTCs have now become a standard substitute for debentures financing at the Government controlled financial institutions.

The Company's role as a financier and investor will be affected by the measures taken by Government for eradication of interest and by judgements of the Federal Shariat Court in relation to "financial laws" after the Court is given authority to consider these laws. For example, CCI might insist that the Company invest in PTCs, and not in debentures. It is difficult to determine the effect of the Federal Shariat Court's decisions on financial laws, but it can be imagined that the same shall be radical. Equally important will be the pressure to design Islamic financial instruments, which will involve difficulties and uncertainties, and, as in the PTC, possible conflicts with existing financial instruments. Thus, it should be clearly understood that the Company will not operate as an investment bank or merchant bank in a Western financial center, but must be prepared and able to deal with Islamic financial system approaches and mechanisms, with the complexity and dislocations they can involve.

Another Islamic fiscal measure introduced by the Government 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. The First Schedule of the Ordinance sets forth the categories of investments and other financial assets on which Zakat is "compulsorily" recoverable. Briefly, these are: saving bank accounts, deposit receipts and accounts; saving/deposit certificates; NIT units; ICP Mutual Fund Certificates; Government securities; company securities, including shares and debentures (other than those held by companies); and annuities and life insurance policies and provident funds.

Zakat is recoverable only from (a) Muslim citizen of Pakistan and (b) a company a majority of the shares of which are owned by Muslim citizens of Pakistan. Certain sects of Muslims are authorized to be exempt from ZAKAT based on their beliefs.

In all cases, no Zakat will be recoverable in respect of shares and debentures of other companies held by the Company. In addition, no Zakat is recoverable from a company where a majority of its shares are owned by foreign investors. Thus, if the 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 and financial institutions and companies. Nevertheless, a possibility that cannot be ruled out is that either the Government itself or the

Federal Shariat Court may impose Zakat on loan receivables on a compulsory basis, and even from banks and financial institutions and companies. If this is done, a majority of Pakistan-owned company would be very badly hit. In such an eventuality an exemption will be required.

C. Bank Deposits

On January 1, 1981, interest-free counters were opened in most branches of Pakistani banks and one foreign bank. These counters function in parallel with conventional bank operations, giving depositors the choice of operating an interest-free or an interest-banking account. Depositors choosing the interest-free or PLS option share in the profits/losses of investments financed with funds deposited in the PLS accounts of each bank. Since funds deposited in PLS accounts can only be invested in non-interest bearing operations. The SBP has stipulated that a number of operations such as commodity financing, trading operations and import bills can only be transacted on a mark-up or commission basis, which are consistent with Islamic principles using funds from PLS accounts. Five to ten percent of the profits of such operations are kept in a reserve fund to offset possible future losses and equalize rates of return over time. An important incentive to savers is the income tax exemption of up to Rs 15,000 p.a. on PLS accounts.

Since their creation PLS deposits have grown rapidly. On June 25, 1981, total PLS deposits amounted to Rs 2.6 billion and a year later stood at Rs 7.9 billion, with Rs 3.3 billion in savings deposits and Rs 4.6 billion in time deposits and accounting for 10.3% of total deposits in Pakistani banks. Rates of return on PLS accounts are declared every six months and have been consistently higher than the minimum rates on conventional deposits prescribed by the SBP. Annualized rates of return on PLS accounts during FY 82 varied among banks and ranged from 10.75% - 12% for six month deposits to 14.5% - 15.5% for deposits of five years or more. Minimum annual rates on interest-bearing deposits of equal maturity range from 9.0% to 12.75%, respectively.

Bank Lending

Since October 9, 1979, banks have extended a small amount of interest-free production loans to subsistence farmers and fishermen for the purchase of seasonal inputs and to cover maintenance costs. These loans which have a ceiling of Rs 6,000 are mostly disbursed in kind. Borrowers who fail to repay within two months of harvesting have to pay the ongoing interest rate. Since July 1, 1981, the banks have also made interest-free loans to deserving students who must repay when they complete their studies and find employment.

On June 1, 1982, the nationalized commercial banks launched the Musharika financing scheme designed to meet the working capital requirements of trade and industry on a PLS basis. A Musharika can be defined as a business arrangement whereby the parties contribute capital and/or entrepreneurial skills and share the profits according to a pre-agreed formula. A loss, however, is shared in proportion to the funds contributed by each party. As with any other contract the conduct of a Musharika is governed by the terms and conditions of the agreement freely reached by the parties. In order to reward management performance, the banks allow a management bonus to be paid out of realized profits. The pre-agreed bonus is payable upon achievement of projected profits and may vary according to performance. In cases of shortfall, banks may pay the management bonus at a reduced rate instead of forfeiting it completely.

The SBP is encouraging banks to extend Musharika financing to selected customers and so far about 20 agreements have been announced. Although there is considerable uncertainty as to how Musharikas will operate in practice, expectations are that, at least initially the rate of return for banks will tend to be around 14%, which is the current rate of interest on working capital loans. Thus, in terms of return on funds, Musharikas will not differ from conventional working capital hours.

In addition to Musharikas, two other financing arrangements conforming to Islamic principles are being introduced gradually: hire purchase (Bai Salam) and leasing (Baj Muajjal). Under an interest-free <u>hire purchase</u> agreement, in addition to repayment of the principal the financial institution receives a net imputed rental value in price of interest. In the case of <u>leasing</u>, Islamic financial principles are likely to be incorporated by providing for variable and adjustable lease rentals.

On June 26, 1980, the legal framework of Pakistan's financial and corporate system was modified to permit the introduction of a new financial instrument and a new form of company, both conforming to Islamic principles; the Participation Term Certificate and the Modaraba company.

Participation Term Certificates

(PTCs) are transferable corporate instruments based on the PLS principle and are intended to replace debentures for raising medium and long-term local financing for industry and trade. Instead of receiving interest, as in the case of debentures, PTC holders will share in the profits/losses of the issuing companies. PTCs can be issued for up to ten years, are secured by a fixed mortgage on company assets, and the claim on company profits supersedes the shareholders' claim. Although the PTC share of profits should be based on the ratio of PTCs to the company's paid-up capital plus reserves, PTC agreements so far have specified a fixed share of profits. PTC holders are only being allowed to retain an amount of profit equivalent to 17% of the face value of the PTCs in each accounting year. Furthermore, if the company pays the share of profit within 30 days of the close of its annual accounts, the company will be allowed a rebate of 2% and PTC holders will retain a share of profit equivalent to only 15%. Losses in one year can be made up by the company out of profits earned in subsequent years. A small sample of the financial projections of projects requesting PTC financing, however, indicates that project sponsors take 15% p.a. as the cost of PTC funds. One feasibility report, for instance, warns that ".....the project is not expected to pay full return of 15% to PTC holders in the first year ....."

PTC financing was initially restricted to the operations of the ICP, the NIT and BEL, but has been extended to include the NCBs. As a result, most of the NCB consortium term financing is now being done by PTCs. Although this type of lending technically represents higher risk for the banks, returns will be substantially higher than the 11% ceiling imposed by the SBP on conventional term lending. During 1982, PTC financing through ICP and BEL-led consortia amounted to Rs 1.2 billion.

D. The Policy Risks of Full National Islamic Banking in Pakistan

Until June of this year, the Government of Pakistan appeared to be treading a careful path between a political imperative to be seen to be introducing new financial practices consistent with Islamic tenets and a pragmatic requirement to avoid a disruption of the financial flows required by a modern industrializating economy. For institutions dealing with foreign loans and credits, the Government had given an assurance that they will continue to function on the basis of interest. The Government continuously emphasized its determination to continue the process of Islamization but (until June 1984) took pains to underline the need to proceed gradually and cautiously.

The Government's new timetable for full Islamization by July 1985 appears to mark a radical shift in style. Allowing a reasonable margin for electoral considerations (elections are scheduled to take place before March 1985), the timetable still seems to depart from the mix of political craft and pragmatism which had marked the issue until this summer.

Some consequences of the move to full Islamic banking are difficult to predict. There is no precedent or model to look to for heuristic guidance. There is very little experience in interfacing Islamic and international banking tools. While the two systems co-exist in a few countries like Egypt and the Sudan, they do not really inter-relate. Islamic banks do transactions which are, in the main, fully discrete and separate from transactions by conventional banks. Some borrowers do have relations with both types of banks, but seldom is a banking instrument executed across the lines between the two banking worlds. On the other hand, the experience to date in Pakistan and elsewhere with partially Islamic banking suggest some of the consequences we can expect. They are not all negative. Islamic banking does, for example, seem to offer a way out of the trap of managed interest rates which Pakistan has erected around its financial markets over the past fifteen years. Unfortunately, the GOP is not taking full advantage of this opportunity. Some of the policy risks (and benefits) are considered below.

To start with the good news, the most positive effect of Islamization so far has been the freeing of financial rates of return, particularly for term lending. Since GOP has chosen not to impose restrictions on the terms and conditions that can be negotiated between lender and borrower, the new instruments are more responsive to market conditions in the financial sector. This applies particularly to PTCs, hire-purchase and leasing. In addition, evidence gathered from interviews with managers of financial institutions dealing with Islamic instruments, indicates that they have evolved business practices which, while consistent with Islamic principles, reduce considerably the uncertainty inherent in a PLS system. It appears that every effort is made by financial institutions to prevent borrowers from declaring returns which would be lower than the equivalent return obtained under an interest-based operation. At the same time, indications are that in the case of short-term lending, institutions will expect returns not higher than returns available on working capital loans (i.e., 14% p.a.). Returns for term funds are expected to be set at 15% p.a., (possibly higher for leasing), which represents a more realistic pricing of capital than the controlled rate of 11% for interest-based term lending. This development represents a major involvement for the NCBs, which before the introduction of PTCs were directed to provide increasing amounts of term financing for industry at the unprofitable rate of 11% p.a.

Lending and investing on a PLS basis will require considerable strengthening of the project appraisal and supervision capabilities of financial intermediaries, particularly the government-owned commercial banks. Since a lender's return technically depends on the borrower's profitability, the public sector commercial banks, which currently provide most of the working capital financing of trade and industry and a substantial proportion of term financing, will be forced to focus more on the viability of particular projects rather than relying almost exclusively on their clients' creditworthiness. At the same time, because of the higher risk inherent in this participatory mode of financing, lenders are likely to demand greater accountability from the corporate sector. Greater accountability, tighter accounting and auditing requirements, and an improved flow of information from the corporate sector are important themes for the U.S. policy dialogue on banking in Pakistan.

In its desire to move to an interest-free system, GOP has precluded the use of interest rates as a policy instrument, even though most of the financial system continues to operate on the basis of interest. Although the system seems to be evolving alternative means to price control — which need not be inconsistent with efficient financial intermediation and resource allocation — the Government has seriously reduced its policy flexibility by abandoning interest rates. As a result, the Government is even more likely to continue to rely on a highly centralized and regulated system of credit allocation to meet its developmental objectives.

There is considerable danger that during the coming twelve month transition period, in which both systems work in parallel, companies with high rates of profit and investors with profitable projects will opt for interest-based financing, while less profitable and more risky ventures will prefer PLS arrangements. Unless considerable control is exercised by the authorities, the PLS segment of the financial system could be burdened with a high concentration of less profitable or more risky operations. The need to prevent this segmentation of portfolios will require the continuation of a high degree of regulation and government intervention in financial markets. In addition, it is possible that the higher involvement of lenders in project appraisal and supervision, as well as the higher risk implicit in the PLS system, could increase the <u>cost of financial intermediation</u>.

A further potential problem relates to the <u>term transformation</u> possibilities of a PLS system. If the use of funds is strictly separated according to their origin, the provision of term lending for investment would be limited by the volume of term deposits and the banks' function of transforming short-term liabilities into long-term advances would be severely constrained. Even where term transformation takes place, because of the need to declare returns every six months and the strong competition between banks to attract PLS deposits, the system has a potential bias in favor of short-term quick-yielding investments. Thus, it is possible that long gestation industrial projects would be disadvantaged in relation to trade financing. In order to prevent this, the Government will continue to intervene directly in financial markets and will continue to maintain a tight control on the system of credit allocation. Here, again, is a major issue for the U.S./GOP policy dialogue on banking.

Pakistan's limited experience with financial Islamization appears to be having both negative and positive effect on the financial system by allowing rates of return to reflect more accurately market conditions, particularly for term lending. It is likely that one of the consequences of the process of Islamization will be a continuation of government intervention and control of financial markets and credit allocation.

IV. FINANCING THE PRIVATE SECTOR: A POLICY OVERVIEW

The Sixth Five Year Plan places great emphasis on the private sector in mobilizing new investment resources and in taking the lead role in most areas of industrial activity over the balance of the decade. The private sector emphasis of the plan has been hailed in the international donor community, but experience with the government-dominated financial machinery of Pakistan has given rise to serious questions about the capacity of that system to service the private sector mandate of the Plan. There are significant policy problems in three key areas: (1) domestic financing for private sector activity; (2) equity financing for private sector ventures; and, (3) foreign exchange term financing for private sector projects. There are some interesting potential solutions to these financing constraints in the emerging Islamic Financial Sector which are mentioned briefly in this section and at greater length in

Section III above), but which have yet to provide a sufficient track record to permit any meaningful assessment of their implications for Pakistan's private sector.

The growth and distribution of domestic credit in Pakistan is regulated by direct and selective controls. Although the State Bank can employ indirect instruments (liquidity ratios, reserve requirements and rediscount rate), it relies almost entirely on credit ceilings, combined with detailed suballocations. The chief instrument used to direct credit is the Annual Credit Plan which incorporates subtargets for public and private sectors, by economic sector, by large and small businesses, by priority sector financing schemes, by source among commercial and specialized banks and non-bank financial institutions. Within these overall targets, financial institutions can choose the firms and purposes for which they lend. Although efforts are made to monitor progress and improve coordination, this system of credit allocation suffers from a number of difficulties: (a) it limits the allocative functions performed by the financial system; (b) it is slow to respond to changing economic circumstances; and, (c) it can discriminate against the private sector groups when the needs of the public sectors are too large relative to total allowable credit.

In the area of foreign exchange financing for private investors, the constraints are quite serious. The two public sector institutions which have provided most long-term foreign exchange financing, PICIC and IDBP, have been constrained in the amounts of foreign exchange resources they can raise from international commercial sources by a history of internal financial problems. Both survive on concessional resources from the multilateral donors, and both institutions have substantial arrears on outstanding loans. The foreign and domestic commercial banks have not been provided with an interest rate setting which makes them a significant factor in overall term financing in foreign exchange. As a result, the majority of private sector foreign exchange term financing is actually undertaken on a short-term commercial basis with an unwritten commitment from the bankers to continually roll over the commercial notes as long as the borrower's credit standing remains strong. Needless to say, this is not a structure conducive to private sector undertakings with longer payout periods or substantial negative cash flows in the early years.

Equity financing in Pakistan is also an area where the policy setting is poor. Few local private investors are able to provide full local equity from their own resources. Investors argue that equity financing is at a disadvantage relative to other saving and investment instruments available in the country. The returns on government bonds, debentures and various public schemes are relatively high and, in addition, are free from tax up to a certain limit. Furthermore, given the high taxation on corporate savings, the potential for internal financing is limited. Foreign equity, on the other hand, is usually subscribed in the form of machinery and equipment and, much in the same way as suppliers' credits, imposes restrictions on project design and the choice of technology.

Some flexibility is being introduced into the financial system recently through GOP's process of Islamization (See Section III above). Financial institutions will be allowed to negotiate the terms and conditions for leasing and hire purchase and for a number of new financial instruments, such as Participation Term Certificates (PTC) and Musharika which are consistent with Islamic principles. PTCs have replaced debentures and enable the issuing company to raise capital for a specified period not exceeding 10 years excluding the grace period and entitle the holder to a share in the profits of the issuing company. Musharika is an arrangement by which banks provide working capital on the basis of profit and loss sharing rather than on a formal interest basis. Experience with Islamic financial instruments in some Middle Eastern countries suggest that they have the potential to reasonably and accurately reflect market conditions and the real opportunity cost of capital. This evidence, however, comes from settings where the traditional Western banking systems are strong and where governments have been traditionally positive towards the private sector. It remains to be seen whether the same market orientation will emerge in Pakistan's Islamic financial system, given the legacy of centralized government regulation and control of financial markets and the substantial bureaucratic forces opposed to a broadened role for the private sector.

Both USAID and the Embassy have been actively engaged in discussions of financial sector policy issues with the Government of Pakistan. AID's emphasis has centered around the deregulation of financial institutions, and has used our proposed financing of a private sector financial intermediary as the basis for policy discussions with senior GOP officials. The Embassy has led a continuing dialogue on the vexing issues related to creating reasonable and fair competitive conditions among the foreign commercial banks, the domestic commercial banks and the public sector specialized financial institutions. Progress on both the

AID and Embassy policy dialogues has been painfully slow, but we have had some success in sharpening the GOP's appreciation of the issues and in strengthening the hands of those elements in the GOP most favorable to financial deregulation and liberalization.

Despite this limited progress, a potentially extensive policy agenda faces the US Mission in the coming years. Not all of it is appropriate "grist" for the Administrator's discussions, but some points are relevant. We remain concerned that Pakistan's financial sector, as currently structured, will simply prove incapable of responding to the private sector financial requirements of the Sixth Five Year Plan. A.I.D. policy dialogue issues which remain include:

a. centralized allocation of credit, which largely preempts the intermediating and allocative functions of the financial system;

b. crossing interest rates (deposit rates rise while lending rates fall with maturity), which has created a short-term bias within the banking community;

c. a plethora of institutions with overlapping responsibilities, resulting in unbalanced and fragmented financial, managerial and technical capacity;

d. regulations which discriminate against foreign banks in favor of nationalized Pakistani banks despite the fact that the former banks' performance by any yardstick has been demonstrably superior to that of the nationalized banks;

e. an uncertain capital market characterized by limited trading, concentration on speculative share transactions, limited volume of new issues, and lack of a secondary market for corporate long-term financing through debentures;

f. several government-sponsored savings schemes which offer extremely attractive, tax-free rates of return, to the extent that commercial banks and the stock market are unable to compete, with the result that massive amounts of private savings are being diverted into financing the public budget deficit;

g. lack of programs to channel remittances from overseas Pakistanis (now totalling $3 billion per year) into investment, with the result that the vast majority of these resources is used for consumption;

h. an enormous parallel or "black" market of untapped (or at least unregulated) resources in the form of financial assets which are not declared to the authorities; and,

i. a need for a sounder technical base for financial "Islamization", and a better definition of its place in the overall system.

Since the Government owns all the major financial institutions, controls the rationing system used to allocate credit, sets interest rates and operates several attractive savings schemes, it enjoys a virtual monopoly in savings mobilization and allocation of financial resources. Although the availability of credit to the private sector has improved considerably as a result of the Government's improved fiscal performance of recent years, the dominance of the public sector in resource allocation nevertheless results in a residual allocation to the private sector. Moreover, the financial system as currently constituted encourages private sector activities characterized by risk aversion and short-term, quick-turnover transactions. Without some adjustments, any rapid resurgence of private investment such as the Sixth Plan envisages could be seriously threatened by inadequate financial support.

An important change which the GOP could make without great financial cost would be to begin moving away from direct credit controls towards an interest rate structure which reflects the cost of resources for long-term investment. This will be difficult to accomplish politically, given the impetus toward interest-free operations which Islamization has introduced, but it is essential if the GOP is to realize its Sixth Plan strategy of reinvigorating the private sector. By restoring some element of market pricing for financial resources, the need for mandatory credit ceilings would gradually be reduced. To channel credit toward priority private sector investments the Government could offer some type of refinancing formula for certain types of loans (small industry, agriculture, etc.) which would encourage the banks to seek borrowers and put any subsidy burden on the Government itself.

Short of wholesale interest rate liberalization, there are numerous adjustments in the structure of the financial system which would provide more incentive for banks to look beyond the short-term. There is also a need to review the roles of the specialized financial institutions and redefine their responsibilities. As it stands today, however, Pakistan's financial system may be unable to respond to the private sector mandate of the Sixth Plan. USAID progress on developing our proposed private sector financial intermediary will provide an early litmus test of the prospects for policy change in this vital sector.

V. CONSIDERATIONS IN PREPARING THE ADMINISTRATOR'S AGENDA FOR A POLICY DIALOGUE

Several forces are at work simultaneously in the banking/finance policy arena. The forces of deregulation and privatization are represented by the foreign banking community, by the old family fortunes which backed the major finance houses of pre-Bhutto, Pakistan and (to a degree) by elements of the technocracy in the Planning Ministry.

Resistance to banking liberalization comes from many quarters. The old-line bureacrats continue an étatiste, interventionist tradition which dates back to the Raj in both India and Pakistan. They are intrinsically suspicious of market forces and of the degree of unpredictability which deregulation implies. They are also, in the main, believers in the doctrine that "profits" in the financial sector represent capitalist exploitation and an "unearned returns" to the lesser orders who inhabit the worlds of trade, commerce and finance. There is little genuine belief in the time-value-of-money among the bureaucratic "old guard" and still less in the notion that capital has an opportunity cost and will not be deployed unless that cost is recovered. Resistance also comes from elements of the Islamic leadership who see almost all traditional financial operations as un-Islamic. Substantial grassroots political resistance to the deregulation of banking comes also from populist and leftist elements who fear a return to the days of the "twenty-two families" whose wealth and influence were said to reign supreme in Pakistan.

The task before senior U.S. officials in a dialogue on liberalized finance is to strengthen the hand of the relatively modest supporting faction while calming the fears of the opponents of liberalization. The latter task is by far the greater one.

Several themes may merit consideration in thinking through a strategy for policy discussions. The final product, however, should be simple, focused and non-technical. The themes which suggest themselves include these below:

- Private Banks can Best Serve Private Borrowers. Pakistan's Sixth Five Year Plan calls for a massive increase in private sector productivity. A financial sector in which all domestic banks are government-owned is not likely to service the capital needs of the private sector to meet these challenging targets. Public banks will surely service public sector requirements first, and there will be a "crowding out" of credit for private investors.

- Private Banks can Mobilize more Private Savings. Pakistan is facing a resource mobilization crisis. The tax structure is outmoded and is yielding about all it can without a major overhaul (which is not in the cards right now). Public sector savings schemes have tapped significant resources to finance the GOP's growing public deficits. Private savings will be best mobilized by private banks which can pay (unregulated) market rates to properly align the (private) demand for credit with the price which (private) suppliers of capital (i.e., savers) expect.

- Private Banks will Improve Pakistan's Reputation in International Finance Circles. Pakistan has not been unusually successful in attracting private investment from foreign sources. Foreign investors, particularly those with the capital and technology which Pakistan seeks, look at the banking sector as a bellwether of the investment climate. A regulated, public-sector-dominated banking system with no private domestic banks is not reassuring. The presence of foreign bank branches does not allay this concern, particularly when they are treated on less-than-equal terms by the GOP.

- Total Islamization of the Banking System is Risky. No country in the world has gone as far in Islamizing finance as Pakistan has proposed to go by July next year. The world's financial institutions aren't ready to cope with Islamic banks and Pakistan's trading relationships are jeopardized (both on the export and import side) by disturbing banking patterns which are well developed and have been proven through usage.

Domestic goals are also threatened by rapid Islamization. Major private sector investors are still recovering from the seven years of Bhutto socialism. The gradual return to a somewhat more market-oriented economic regime has only recently begun to restore business confidence. The gains since 1977 could be lost in a single stroke if Pakistan goes too far and too fast in Islamizing the financial system. It is a maxim of international finance that business confidence takes decades to build but only days (or hours) to destroy.

- AID's Role. AID has planned (since the negotiations of 1981) on a private sector financial initiative. We are carrying $50 million in outyear money for this purpose. A major legal review of the feasibility of establishing a privately-owned investment corporation has been completed (legal report available with ASIA/PNS and PRE Bureau). The findings are guardedly positive. A high level banker's mission, jointly organized by USAID/Islamabad and by PRE, is scheduled for September/October of this year to determine the commercial feasibility of a private investment corporation. The Administrator could build upon these initiatives to tie the "policy dialogue" to hard commitments of AID assistance when and if these policy objectives are accepted.

The PRE Bureau has already processed a loan from their revolving fund to a mixed public sector/private sector leasing corporation which makes commercial and industrial leases available to both public sector and private sector firms. This loan can be presented as a "bridging step" which indicates that A.I.D. can deal with public financial intermediaries on a transitional basis; however, our next financing move ($50 million for a Private Investment Corporation) would have to be on a fully private basis with private sector ownership and with a private sector loan portfolio.

UNITED STATES AGENCY FOR INTERNATIONAL DEVELOPMENT

MISSION TO PAKISTAN

Cable : USAIDPAK

HEADQUARTERS OFFICE

ISLAMABAD

7/26/84

THE DIRECTOR

MEMORANDUM

TO : Mr. Fred Fischer, ASIA/PNS

FROM : John S. Blackton, (A)DIR JSB

SUBJECT : Administrator's Policy Dialogue on Banking in Pakistan: Background Paper

At the suggestion of ASIA/PNS I have rather quickly put together the attached paper. It is intended as a "sourcebook" for those who will have to prepare formal briefing material for the Administrator if and when he undertakes discussions with senior GOP officials on banking issues.

It doesn't make sense to try to write a formal briefing paper here where we cannot work directly with front office staff. The comparative advantages lies with the Asia Bureau in that regard. I hope, however, that this material will make the task easier for the staff officers who do the final briefing paper.

The key issues are three:

- an increasingly urgent need to reopen Pakistan's financial markets to privately-owned and operated financial intermediaries

- a need to very substantially reduce government intervention in the credit markets in terms of: credit and interest regulations; mandated ceilings on lending operations; and systematic biases in credit favoring public sector borrowers

- a need for prudence in the rate and scope of Islamizing the national banking system, and a possible reconsideration of the July 1985 deadline for complete Islamization of all domestic banking operations (including the operations of American and other foreign banks in Pakistan).

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If the PRE Bureau is able to assemble the team of U.S. bankers who will do the commercial feasibility assessment on our Private Investment Corporation project, it will be important to see that they meet the Administrator and that some careful orchestration is done to make these two initiatives mutually supporting.

Attachment: as stated

cc: Mr. Charles Greenleaf, AA/ASIA
    Mr. Eugene Staples, DAA/ASIA
    Mr. Larry Crandall, ASIA/DP
    Mr. John Westley, ASIA/DP