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Pakistan Innovative Finance Forum

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Islamabad

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Innovative Financial Solutions for Infrastructure Finance: Synthesis of Takeaways

Karandaaz Pakistan, in partnership with the Asian Development Bank Institute (ADBI), Japan; and the Pakistan Resident Mission of Asian Development Bank (ADB) organized a two-day conference on November 25-26, 2019 in Islamabad. The conference shared views on innovative financing. Multiple panels deliberated on: (i) innovative structures of infrastructure financing, (ii) Public and Private Partnership (PPP) models for conventional and inclusive social infrastructure, (iii) challenges and opportunities in building a viable and sustainable infrastructure project pipeline, and (iv) key legal & regulatory challenges in attracting private sector financing and credit enhancement and de-risking solutions.

Annex A provides the programme for the day; the discussions and lessons of the infrastructure session are synthesized below.

INFRASTRUCTURE REQUIREMENT AND SPENDING IN PAKISTAN

Pakistan's infrastructure spending is one of the lowest in the region and it is estimated that due to inefficiencies in overall infrastructure, the country loses approximately USD 6 billion of its GDP per annum. Presently, the country's annual infrastructure spending equates to 2.1% of GDP which is half of what is spent by Bangladesh, 1/3rd of India and 1/5th of China's annual infrastructure spending. And given that Pakistan's population is estimated to rise by another 75 million in the next 15 years, these infrastructure gaps are likely to widen. In the wake of the past and future demand scenario, Pakistan's investment requirements are estimated to be over $500-600 billion or equivalent to 8-10% of GDP, which is well above the present levels of 2- 3 % of GDP.

Given the stressful fiscal situation, government deficit rose to 8.9% of GDP in FY19 rendering reliance on public finance as a source of financing for infrastructure development a challenge. In this context, promoting private sector investments in infrastructure and nurturing effective partnerships with the private sector are essential. A prerequisite for attracting private sector investment is recognized to be stronger and predictable legal and regulatory as well as policy and institutional capacities across the federal, provincial and municipal levels.

Political structures need to align themselves and the federation should launch distinct efforts to align, harmonize and streamline policies and offer effective guidance to the provinces and local governments, and facilitate/fast track approvals and due diligence by reducing red tape in the system. Few efforts have been underway to facilitate approvals. For instance, the Central Development Working Party (CDWP) has now been authorized to approve developmental projects costing up to PKR 10 billion while bigger projects accede to the Executive Committee of the National Economic Council (ECNEC).

Among multilateral institutions, ADB has had a long standing involvement in infrastructure, supporting both sector reforms and specific investments in infrastructure development in Pakistan. Recently, ADB has supported Laraib Energy, a subsidiary of the Hub Power Company, which is the first hydropower IPP in Pakistan, and funded the debt portion of the project cost. In addition, ADB in collaboration with the UK's Department for International Development (DFID), has provided USD 100 million to the provinces of Sindh and Punjab each to strengthen their PPP frameworks and investments in the provinces.

INNOVATIVE FINANCING SOLUTIONS

Worldwide infrastructure development is being support with innovative structures, new approaches and modalities; new capital raising avenues are required to reduce overreliance on banks' capital. In Pakistan, financial intermediation has been uniquely constrained. More recently, on the liability side the country has seen a combination of increase in currency in circulation from 25% to 40% of the total deposit base and short term deposit base. On the asset side banks' tendencies to invest their liquidity in risk free government securities (Treasury Bills) have also constrained the advance. Deposit ratios and infrastructure investments are typically risk intensive and require long term funding. For instance, despite an uptake in energy projects only 15% of bank assets are outstanding in the energy sector.

There is need for the Government to reflect on new approaches and modalities to finance the growing infrastructure requirements. First, on the financing side, it is critical to deflect large proportion of bank assets in treasury bills. One proposal is to establish a Government Securities Fund for public's direct investment which would release the need for commercial banks to hold such securities and hence improve overall liquidity in long term papers. The funds released from commercial banks would divert banks' capital to the private sector. Government securities fund could also play a market maker role and offer liquidity for investors if debt management capacities of the government are strengthened.

An effective yield curve and fixed rate long term bonds will enhance liquidity and tradability in longer tenure instruments while also providing a hedge against interest rate risk. Project finance in its true sense of limited or no recourse arrangements can spur growth of infrastructure projects. Adequate availability of funding for private infrastructure has a higher multiplier effect due to increased economic activity and efficiency in goods and people's mobility. This will eventually generate revenues to settle the Government's debt liabilities.

Second, there is need to recognize that institutional investments play a critical role in financing infrastructure but its stifled in Pakistan. Both pension and insurance industry reforms would be critical as both segments have been underexploited with the public sector pension system under stress.

Lack of breadth and depth and weak confidence in stock markets have held back growth of Assets under Management (AUM) of the mutual fund industry. Hence these have remained low, around PKR 300 billion, even though outstanding under government bonds (PIBs and T-Bills) is in the range of PKR 18 trillion. Third, floating Islamic finance instruments such as Modarabas in place for infrastructure related projects, under the PPP structure, would be an avenue. In India, specialised non-bank financial institutions (NBFIs) have become instrumental vehicles to cater to the underserved clientele. In Pakistan however, the NBFI sector is small and driven by one player, Orix Leasing, which accounts for 80% of the leasing market.

Fourth, deeper and vibrant domestic capital markets are a prerequisite for infrastructure finance and development. The SECP's initiative to promote a conducive regulatory environment for Private Equity Funds and Real Estate Investment Trusts (REITs) shall provide some stimulus and equity financing options for developmental projects. The need to regulate the real estate market through a Real Estate Regulatory Authority is however urgently required though one needs to deal with the complexities of the post 18th Amendment as the subject has been cascaded down to the provinces, which has increased legislative hurdles.

To enhance the bankability of projects and ease financial pressures, there is need to explore innovative financing methods, including Green bonds, ESG funds and crowd funding, securitization, etc. Development banks could serve as mezzanine creditors and take on a subordinate role among creditors to improve the credit profile of projects. The commercial banks and multilateral institutions can take the risk during construction phase, while in operational phase capital markets and other instruments can be tapped through securitization. Commercial banks such as Habib Bank Limited (HBL) are already exploring the development of a product on this structure. In addition, land value capture infrastructure financing modalities have been popular across both developed and developing countries whereby countries/municipalities have promoted innovative structures and floated bonds that spurred infrastructure development. These deals enhance bond market development and offer higher return options. In addition, area generated economic growth can than generate tax revenue spill overs and offer financing for attracting private investment in infrastructure that would not otherwise have been possible.

Further issuance of Islamic bonds is a tried and tested option. Jazz Telecom issued Sukuk bonds to finance capex related to procurement of licenses. The Sukuk was blended with the partial risk guarantees issued by GuarantCo. which enhanced the instrument's credit rating and was helpful in attracting investments from financial institutions. Karandaaz Pakistan is also working to establish InfraZamin, a Pakistan domiciled company for issuance of credit enhancement facilities in local currency, thereby providing a hedge against unforeseen devaluations. The costs for these enhancement facilities go as high as 300 basis points. With increased uptake however, the costs are expected to come down with time.

Acquisition of project land is a cumbersome process in any infrastructure related project and often accompanied by delays and escalating land appreciation which impacts project cost. For example, in Malaysia land value makes up 50% of the overall project costs. Developing land trusts, where the land can be leased out to the project company over an extended tenure, with original land owners retaining the title was recommended as a potential option to overcome this challenge.

This arrangement will not only reduce the project cost but will also unlock the value of the idle land through spill over effects as infrastructure investments have the potential to induce small and medium enterprise (SME) development and growth. Usually infrastructure investments offer return through user charges which are riddled with collection complexities, spread over time and also insufficient. In order to increase tax revenues, infrastructure investment can be structured to spur spill over effects generated from the entrepreneurial and business developments which can then be taxed, generating incremental revenues.

Mortgage financing is another area that needs to be developed. Housing loans comprise 0.25% of GDP in Pakistan, while India is at 9% and for more developed markets of the UK and USA the figure goes as high as 80%. Pakistan has one of the highest urbanization rates in the world and this has led to a severe shortfall in housing infrastructure as well. Housing demand increases by 700,000 units per year. Only half of this demand is met; the balance is added to the total shortfall which is now projected at 8-10 million houses. Through the Naya Pakistan Housing Authority (NPHA) there are plans to add 5 million housing units. 80% of these houses will be constructed in urban and rural centres, while 1 million units will be built in peri-urban areas. Dormant land parcels under the federal and provincial governments will also be used and developed under the PPP model.

The NPHA plans to roll out units with sizes ranging from 650-900 sq. ft. constructed at a cost of PKR 600,000 – 700,000 for the rural areas. Bigger units will be constructed in the peri-urban areas. These are estimated to cost PKR 2.6 million, and will be subsidized to cover half of the cost. Units in urban centres will target the middle-income segment with no subsidies. Since its inception in 2017 the Pakistan Mortgage Refinance Company (PMRC) has disbursed PKR 8 billion. The increase in the policy rate (currently at 13.25%) has impacted affordability at the borrower/owner level, yet housing finance has retained its share at 15-17% of consumer financing. Going forward PMRC expects demand to increase, as interest rates have peaked. The company plans to issue fixed rate bonds for financing as well. PMRC is also working with regulators and NPHA to develop targeted products for the lower and middle-income segments.

It is also recommended that a rent replacement model be explored for the domestic housing market. Replacement cost is the amount of money required to replace an existing asset with an equally valued or similar asset at the current market price. Globally, real estate investors are increasingly looking at replacement cost as a method of establishing pricing parameters. Replacement rent is a function of replacement cost, the required return on costs (or risk premium), and an adjustment to acknowledge some level of expected vacancy and expenses.

PRIVATE PUBLIC PARTNERSHIPS AND ASSOCIATED CHALLENGES

PPPs, as a modality for infra financing, have been in existence for long. PPPs share in infrastructure development and finance constitute 20-30% in a few key Asian economies. Drawing lessons from models, it is clear the PPP requires strong leadership backed by strong PPP centres or units equipped with right expertise, best practice policy, legal, regulatory and institutional frameworks and risk mitigation and management approaches. Relative to public projects, PPPs typically require greater scrutiny, coordination, effective analysis of risks and an assessment of who bears what risk, how its priced and clarity of risk mitigation frameworks. So while cost of structuring and expertise required are high, if effectively managed and operated, in the longer run, these are offset by efficiency gains.

For PPPs to thrive in the country, strengthening of institutional capacities both at the federal and provincial levels, with enhanced harmonization is required. Within the country there is scope to strengthen the Financial advisory services and deepen competition. To be able to effectively structure and negotiate PPP, it is important for public sector entities to have adequate capacity.

After the Infrastructure Project Development Facility (IPDF) was merged into the Public Private Partnership Authority (PPPA) via the PPPA Act 2017, it is now chaired by the Minister of Planning. Other members on the board include representatives from the Ministry of Finance, the Board of Investment (BOI) and some experts from the private sector. The Government has allocated PKR 250 billion for PPP projects but the weaknesses in legislation and laggard operationalization of the new body has held back the momentum of federal PPPs. Independently over the period, the Government entrusted the Power Infrastructure Board to promote IPP ventures and PPPs; the National Highway Authority (NHA) has also structured a few PPP road deals.

While the provinces have established PPP cells, the achievements in some of the provinces have been more effective than in others. Ideally the policy boards of these provincial PPP cells should be headed by the respective chief ministers, which is now the case in both Sindh and Punjab. In addition to showing strong political buy in, such an arrangement would provide confidence to private investors. However, a sustainable and predictable policy environment and efficient incentive framework is imperative to attract interest from the private sector. A new PPP law has been passed in the Punjab province, whereby the Policy Board will be headed by the Chief Minister. The Board has two provincial ministers and three private sector experts (Finance, Law and Engineering). Punjab has PPP projects worth of PKR 400 billion in the pipeline, while PKR 20 billion worth of projects have been approved by the Policy Board. In addition, a number of sectors (education, renewable energy, tourism, value added textile sectors) are being explored for PPPs as they can have meaningful impact on job creation and augment export receipts. There is also need to have a sustainable regulatory environment. Presently, the private sector is wary of increased scrutiny and this has hampered investors' trust and confidence.

According to the Asia Infrascope 2018 publication by the Economist, Sindh was ranked 6th in the world on its PPP-based performance by sub-national governments. The ranking is supported by the fact that the Government of Sindh has demonstrated significant improvements in: i) its regulatory environment (especially its PPP selection criteria and the fairness and openness of bids and contracts), and ii) its institutional environment, including the stability of its PPP agency, the resourcing of project selection and implementation, and institutional transparency and accountability.

Sindh revised its PPP policy framework in 2010 to include the establishment of a PPP policy board to develop strategic goals and monitor PPP implementation, as well as a unit located within the finance department which, when approved by the policy board, works with contracting agencies to identify and prepare projects. Sindh's regulatory framework also provides clear procedures for dispute resolution and for dealing with unsolicited bids. In addition, the province has its own infrastructure plan. Example of local successful PPPs in the province include the Sindh Engro Coal Mining Company, Hyderabad-Mirpurkhas Dual Carriageway, and Performance Based Contracts for Education Management Outsourcing.

Punjab has historically undertaken projects under the PPP mode; including in the transport (orange train, BRTs) and education (PEF, PEMA) sectors. Notably these projects were outside the ambit of the PPP Act. As an endeavour to streamline the PPP ecosystem and enable better ownership, the PPP Authority has been formed. As stated above, the newly formed PPP Board is now headed by the Chief Minister. The Board has two provincial ministers and three private sector experts (Finance, Law and Engineering). Punjab has PPP projects worth of PKR 400 billion in the pipeline, while PKR 20 billion worth of projects have been approved by the Policy Board. In addition, a number of sectors—infrastructure, water conservation ,waste treatment, value added textile sectors–are being explored for PPPs as they can have meaningful impact on job creation and augment export receipts. There is also need to have a sustainable regulatory environment. Presently, the private sector is wary of increased scrutiny and this has hampered investors' trust and confidence.

In Balochistan, there is need to strengthen the PPP cell; the department is in very early stage of development. Specialized risk management departments at the federal and provincial PPP cells are critical to assess the projects' risks and viability to better manage associated contingent liabilities. Specialized risk management function will also help in more informed budgetary allocations. Going too fast on the PPP agenda can result in accumulation of unsustainable public liabilities and with the significant implications for fiscal deficit. Hence, the pace and sequencing of large development projects need to be carefully weighed. While it is important that all risk is not passed on to the private sector, merely depending on public sector financing and guarantees will not be enough. Innovative solutions, including Viability Gap Funds are required to keep the government's contingent liabilities in check. To promote PPP systematically, a strong pipeline of bankable projects is required. Enhancing bankability of projects calls for exploration of innovative financing methods (covered above).

REGULATORY STRUCTURES AND IMPEDIMENTS

The regulatory framework governing the infrastructure activity in Pakistan is confusing. Multiple laws govern the same sectors, both at the federal and provincial levels, making compliance a costly and time-consuming affair. Foreclosure laws and contract enforcement are big issues. To mitigate the issue of information asymmetry, digitization of land titles and records is imperative. In comparison, in India digitization of land records has been achieved more successfully. The complexity of the legal and regulatory environment has not only affected domestic investors but it has also been a vital factor in the failure to attract consistent Foreign Direct Investment (FDI). Foreign investors prefer to invest in South East Asia or within South Asia in Bangladesh and India because of more consistent and structured policies.

Fragmentation of data is currently a real issue as government agencies operate in silos. With enhanced usage of API based systems, interaction between different datasets can be developed and effective dissemination of information can facilitate decision making. Due to double taxation and difficult exits, Private Equity funds prefer to get registered offshore. SECP has tried to introduce improved legislation with less restrictive measures. The State Bank of Pakistan needs to introduce policy measures which will ensure less cumbersome exit for these funds.

Along with FDI, domestic savings are principal avenue to finance the country's long-term financing needs. Domestic savings in India are 3x more than Pakistan. Improved financial inclusion and literacy can play a role as more people keep their savings with formal entities. Fintechs also have a role to play; Pakistan needs to develop models that encourage retaining of cash in the system, rather than just offering cash-in and cash-out solutions. Another example is of Japan, where 200 years ago, for better and sustainable economic development, the concept of savings was embedded in the schooling system to encourage the younger generations to save. By allowing young people to experience the benefits of saving, the Japanese people learned and with time imbibed the habit of saving which nurtured an institutional investment industry. Commercial banks, insurance companies and pension funds operating in the Asian region do not have enough avenues to invest their assets for longer tenure and channel their funds to foreign markets. With more developed instruments in place and deepened capital markets, capital raised from Asia can be used to fund domestic projects.

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Chairperson Karandaaz & Former Governor of State Bank of Pakistan and Finance Minister

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ANNEX A: DAY 1: APPLYING INNOVATIVE FINANCE SOLUTIONS TO DEVELOPMENT CHALLENGES (NOVEMBER 25, 2019)

FINAL AGENDA

Time	Agenda Item	Guest/Panel
Registration | 08:30 AM		
09:30 AM	**Welcome Remarks** *(on behalf of the forum hosts)*	**Dr. Shamshad Akhtar** *Chairperson Karandaaz Pakistan and Former Governor State Bank of Pakistan*
09:50 AM	**Opening Address from the Government of Pakistan**	**Dr. Hafeez Shaikh** *Advisor on Finance and Revenue, Government of Pakistan*
10:10 AM	**Keynote Address** *Infrastructure Financing Needs in Developing Asia and Pakistan*	**Ms. Ingrid van Wees** *Vice-President for Finance and Risk Management, Asian Development Bank (ADB)*
10:30 AM	**Audience Q&A**	
10:40 AM	**Presentation 1** ***Introducing Private Financing into Infrastructure Investment and the Achievement of Economic Growth*** *Applying infrastructure spillover effects for increased tax revenues to augment rate of return.*	**Prof. Naoyuki Yoshino** *Dean, Asian Development Bank Institute (ADBI)*
Group Photo and Tea Break | 11:10 AM		
11:30 AM	**Panel Discussion A** ***Innovative Infrastructure Finance for Market Growth in Pakistan*** *Governments across Asia, and particularly developing Asia, struggle to maintain the rate of investment necessary to meet present and future infrastructure needs, creating a significant gap, which impedes growth. Pakistan also faces insufficient investment in both conventional and social infrastructure. This poses a major challenge to growth and development, as well as to greater engagement with other economies. Since government sources are not sufficient to bridge the gap, it is essential to look for innovative sources of finance.*	*Moderator:* **Mr. Waqas ul Hassan** *Senior Financial Sector Development Expert, Department for International Development, Pakistan* *Panel Members:* **1. Mr. Aamir Khan** *Chairman, Securities and Exchange Commission of Pakistan (SECP)* **2. Dr. Salman Shah** *Advisor to the Chief Minister of Punjab; Former Finance Minister, Government of Pakistan* **3. Mr. Asim Siddiqui** *Country Managing Partner, Ernst & Young Ford Rhodes Pakistan* **4. Mr. Salim Raza** *Former Governor, State Bank of Pakistan*
12:15 PM	**Audience Q&A**	
12:30 PM	**Panel Discussion B** ***PPP Models for Conventional and Inclusive Social Infrastructure*** *In Asia, PPPs are an important source of infrastructure finance and are widely used to deliver economic infrastructure, notably in transport, energy, and urban sectors. Evidence shows that PPPs experience lower failure rates than projects with conventional financing. If well-structured, PPPs can also deliver innovations in design and construction, achieve significant risk transfer away from governments, and deliver better services more sustainably than traditional procurement methods.*	*Moderator:* **Mr. Sheharyar Chughtai** *Office of Public Private Partnership, ADB* *Panel Members:* **1. Dr. Shamshad Akhtar** *Chairperson Karandaaz Pakistan and Former Governor State Bank of Pakistan* **2. Brig. Ihsan Ullah Khan** *Naya Pakistan Housing Authority (PM Sect)* **3. Mr. Khalid Mehmood Shaikh** *Director General, Public Private Partnership Unit, Finance Department, Government of Sindh*

Time	Agenda Item	Guest/Panel
12:30 PM	*However, PPPs may involve long lead times and higher transaction costs, and generally require strong and effective governance frameworks. This panel looks at the experience of Pakistan with PPPs, the suitability of various PPP models for financing the country's infrastructure needs - both conventional and inclusive social infrastructure, and the potential for scaling up.*	**4. Dr. Farrukh Naveed** *Project Director/Head, Public Private Partnership Cell, Government of Punjab*
01:15 PM	**Audience Q&A**	
	Lunch Break | 01:30 PM	
02:30 PM	**Panel Discussion C** ***Toward a More Robust and Viable Project Pipeline for Private Sector Investment: Challenges and Opportunities.*** *While previous panels have discussed potential sources and modalities of innovative private finance, one of the biggest hurdles faced by the Asia-Pacific region to attracting more private investment in infrastructure is an overall lack of bankable, sustainable deals. This is partially a function of the limited capacity of governments to prepare projects to the standards required by private sponsors and financial investors. In this respect various facilities exist to assist governments, for example: ADB and ADBI are involved with a G20 initiative designed to address the shortage of quality infrastructure pipelines in emerging markets and developing economies. This panel looks at what can be done to ensure a steady flow of well-prepared and well-structured projects to attract private investment in Pakistan.*	*Moderator:* **Ms. Sana Masood** *Senior Project Officer (Financial Sector), Pakistan Resident Mission ADB* *Panel Members:* **1. Mr. Usman Hameed** *Head Project Finance and Infrastructure Advisory, Habib Bank Limited (HBL)* **2. Mr. Nasim Beg** *Arif Habib Group* **3. Mr. Ashruff Hasan Rana** *Director, Bridge Factor* **4. Mudassir H. Khan** *Managing Director/CEO, Pakistan Mortgage Refinance Company*
03:15 PM	**Audience Q&A**	
	Tea Break | 03:30 PM	
04:00 PM	**Panel Discussion D** ***What are the Key Legal and Regulatory Impediments to Attracting Private Sector Investment in Pakistan?*** ***Credit enhancement and de-risking instruments for improving the financial feasibility of infrastructure projects.*** *Private investment in infrastructure in developing countries responds positively to the presence of effective legal and regulatory frameworks, which provide security and credibility to private investors. Achieving such frameworks in developing economies often involves extensive and long-term reform processes. Meanwhile, unresolved legal and regulatory impediments remain, creating strong barriers to private investment. It is often necessary in developing economies, therefore, to incentivize private investment using various credit enhancement and de-risking instruments. This panel looks at existing legal and regulatory frameworks in Pakistan, potential for reform, and use of guarantees for attracting private investment.*	*Moderator:* **Mr. Rabel Akhund** *Founder and Managing Partner, Akhund Forbes Hadi* *Panel Members:* **1. Mr. Ali Asgher Khan** *Managing Partner, Ali Khan Law Associates* **2. Mr. Ali Sarfraz Hussain** *CEO, Karandaaz Pakistan* **3. Mr. Shahid Mustafa** *Financial Sector Specialist and Former CEO of Telenor Bank* **4. Mr. Ali Ibrahim** *Head Corporate Sustainability, Jazz Telecom*
04:45 PM	**Audience Q&A**	
5:00 PM	**Fireside Chat**	**Dr. Shamshad Akhtar** *Chairperson Karandaaz Pakistan and Former Governor State Bank of Pakistan* **Prof. Naoyuki Yoshino** *Dean, Asian Development Bank Institute (ADBI)*
5:30 PM	**Thank You Note**	**Ms. Xiaohong Yang** *Country Director, Pakistan Resident Mission, ADB*
5:45 PM	**Closing Remarks**	**Mr. Asad Umar** *Minister for Planning, Development and Reform, Government of Pakistan*

About Karandaaz

KARANDAAZ PAKISTAN, a not-for-profit company established in August 2014, promotes access to finance for small and medium businesses through a commercially directed investment platform and financial inclusion for individuals by employing technology enabled digital solutions. The company has financial and institutional support from leading international development institutions, principally the United Kingdom's Department for International Development (DFID) and the Bill & Melinda Gates Foundation.

Karandaaz Digital

Focuses on expanding the poor's access to digital financial services in Pakistan by working across the ecosystem with all stakeholders.

Karandaaz Capital

Provides wholesale structured credit and equity-linked direct capital investments to micro, small and mid-size enterprises (MSMEs) that demonstrate compelling prospects for sustainable business growth and employment generation in Pakistan.

Karandaaz Innovation

Manages the Innovation Challenge Fund and Women Entrepreneurship Challenge, providing risk capital and grants to partners with the aim to generate innovative solutions in areas of financial inclusion and entrepreneurship.

Knowledge Management and Communications

Supports the company's core financial inclusion goal by developing and disseminating evidence based insights and solutions.

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