AGENDA FOR A NEW STRATEGY OF EQUITY FINANCING BY THE ISLAMIC DEVELOPMENT BANK

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1. PATTERN OF EQUITY FINANCING BY IDB

Although equity financing was aimed to be the major mode of project financing together with profit sharing by the Bank, in actual practice, over the 17-year period (1396H through 1412H), total equity financing approved by the Bank amounted to ID 229.664 million (US$ 276.121 million) which represented only 10.18 percent of the total project financing approved by the Bank. On a yearly basis, it ranged from 0.42 percent of total financing in 1410H to 55.39 percent in 1396H.

Of this amount, ID 199.249 million was approved for direct equity investments in 47 large projects and ID 30.415 million for 47 small and medium-sized projects through Lines of Equity, administered through various national development banks (NDFIs) in the member countries. In other words, the bulk of equity investments (87.38%) were made directly by IDB. It is important to note that within direct equity investments, non-financial enterprises claimed as much as 96.20 percent, while financial institutions represented by Islamic banks constituted 3.80 percent of direct equity investments by the Bank.

Viewed in terms of the yearly pattern, the approved equity financing peaked around the year 1400H. Thereafter, it started petering out and dropped to a mere trickle, with no direct equity investment in 1406H and only a nominal amount of ID 1.147 million in 1407H. Thanks to the activation of interest in financing the equity of Islamic banks and vigorous scrutiny to sparingly exercise preemptive rights in a handful of highly successful companies, equity financing, as a mode of financing by the Bank, for all intents and purposes, would appear to have been put to a halt.

In terms of number of proposals approved in any single year, the highest number of projects (17) was approved in 1401H; in terms of the aggregate amount, the highest amount (ID 37.949 million) was approved in 1400H. The smallest number of aggregate approvals was only one direct equity project in 1396H and the smallest amount was an aggregate approval of equity investment of ID 1.147 million in 1407H.

Among direct investments in equities, the highest number of projects (8) was approved in 1400H and the highest amount (ID 33.230) million was approved in 1397H. As against this, no

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direct equity investment project was approved in 1406H, while only one project each was approved in 1396H, 1404H, 1407H and 1412H. The smallest amount for direct equity investment in any single year, barring no approval in 1406H, was ID 747,008 in 1407H.

Among Line projects for participation in equity, which started in 1398H, at the lowest end of the scale, no sub-project was approved in 1412H, one sub-project each was approved in 1398H, 1409H, 1410H and 1411H, and in terms of amount, the smallest amount for line financing, barring no approval for 1412H, was ID 43,000 in 1409H. At the higher end of the scale, the largest number of sub-projects, 11 each, were approved under Equity Line Financing in 1401H, 1403H and 1405H. However, in terms of amount, the peak was achieved at ID 5.010 million in 1400H.

Classified by countries, 18 out of 44 member countries have benefitted from direct participation in equity by the Bank, with the largest recipient being Jordan (15.43%), followed by Morocco (13.46%), Pakistan (11.84%), Indonesia (8.31%), Cameroon (6.45%), Senegal (6.43%), Mauritania (5.71%), Niger (5.25%), U.A.E. (5.13%) and Turkey (3.30%).

In the case of Line of Equity financing, out of seven member countries that have benefitted from this facility, Turkey has been on top of the list (40.31%), followed by Tunisia (32.72%), Bangladesh (14.56%) and Pakistan (6.13%).

Again, classified by industrial group, in the field of direct investments in equity by the Bank, bulk of the financing has gone to the cement sector (27.04%), followed by chemicals including petrochemicals (23.3%), textiles (12.12%), mining (8.36%), public utilities (5.25%), and agro-industry (3.32%). Financial sector, represented by the newly emerging Islamic banking fraternity, being the most recent entrant in the field of equity financing, kept the equity mode of financing alive in the asset allocation strategy of IDB. But it constituted barely 3.80% of the cumulative direct equity portfolio of the Bank.

The sectoral distribution in the Equity Line financing, which represents small and medium-sized enterprises, was dominated by agro-based industries (26.25%), followed by construction materials industry (20.98%), electrical industries (11.83%), metals (10.71%), chemicals and pharmaceuticals (9.6%), textiles (8.68%), and health care (8.38%).

Classified by the risk exposure characteristic of the equity portfolio of the Bank, green-field projects, which are, by definition, highly risky, occupied a predominant position with as much as 77.22 percent of the entire equity portfolio of the Bank. The existing projects requiring equity funds for expansion, modernization and balancing, having low risk and high return, were a little over one-fifth of the portfolio.

The exit mechanism characteristic of the portfolio is represented by the concentration ratio of investments in member countries which have the presence of stock exchanges of sorts to serve as the channel for disinvestment. In this respect, the equity portfolio of the Bank enjoys a uniquely favorable position. With as much as 60 percent of the aggregate equity investments in member countries that have stock exchanges, a great challenge and opportunity lies ahead for IDB to perform its role for the reform and development of financial sector, in conformity with *shari'ah.*

2. ANALYSIS OF THE EQUITY PORTFOLIO OF IDB

The analysis of IDB portfolio at the micro level provides useful insights, firstly, for correcting the general impression that the equity portfolio has been a total disaster, and secondly, for drawing lessons from experience to avoid future pitfalls. This analysis will also help in formulating a new strategy for equity financing by the Bank. Applying the criteria of profitability and net worth as the acid test for measuring the performance of the companies in which IDB has made equity investments and taking the latest available data (for the year 1412H) as the basis of analysis, the companies can be classified into four groups: Group A - profitable companies distributing dividends; Group B - profitable companies with no dividends; Group - C loss-making companies with a positive net worth; and Group D - loss-making companies with a negative net worth.

2.1 Group A: Profitable Companies Distributing Dividends

The review of the equity portfolio of IDB shows that, during the year 1412H, 23 companies, representing 42.76 percent of the actual investments of IDB in equities, have performed profitably and have distributed dividends.

Viewed historically, it is observed that the number of companies distributing dividends has been increasing over the years. From only two companies declaring dividends in 1399H, the number rose to 20 in 1409H and indications are that this trend will gather momentum in the future. In terms of dividend yield, measured in equivalent ID terms, which makes full allowance for depreciation in the local currencies in which equity investments are made, the rate of dividend paid by dividend paying companies has ranged between 5.03 percent (1401H) and 9.79 percent.

However, the average dividend yield on the total equity investments is diluted to around

2.8 percent, if the return received from dividend paying companies is spread on the entire portfolio including the three other groups of non-dividend paying and loss-making companies.

In addition to the dividends, except for one company in Morocco, all the other companies in this Group have registered an appreciation in their net worth based on the book value of shares as reflected in their balance sheets. The increase in net worth has resulted from accretions to the retained earnings accompanied with capitalization of retained earnings by way of bonus shares over the years. As a whole, the companies in this Group have registered capital appreciation in ID terms on the amount invested by the IDB, ranging from 5.67 to over 99 percent with the overall capital appreciation averaging around 27.82 percent.

2.2 Group B: Profitable Companies with No Dividends

There are 15 companies in this group, representing 24.51 percent of total amount actually invested by IDB, which have shown net profit from their operations during the year 1412H. These companies have not distributed dividends to the shareholders either because the companies have been following a policy to retain and plough back the profits and show their performance in the appreciation of book values or market values of shares, or are constrained to retain the earnings to write-off the losses accumulated over the previous years. Given the continuation of current trend of rising income in the future years, these companies are potential candidates for dividend distribution and further appreciation in their net worth.

The inherent strength of these companies is demonstrated by the fact that six out of 15 companies in this Group have recorded a net appreciation in their net worth, ranging from 0.37 to 56.9 percent, while the remaining nine companies have yet to recover the losses accumulated over a number of years.

2.3 Group C: Loss-Making Companies with a Positive Net Worth

Seven companies, representing 2.82 percent of the total investments in equities, are incurring losses, although their net worth is still positive. The main reasons for losses sustained by these companies are reported to be problems of varying range and degrees in such fields as marketing, production and finance. In a majority of cases, these difficulties have undermined the financial structure of these companies and made them debt heavy. In fact, in most of the companies, excessive financial charges are claiming as much as 30 percent of the total revenues and are often the chief contributory factor for the progressive increase in losses.

2.4 Group D: Loss-Making Companies with a Negative Net Worth

This Group has 26 companies representing 28.64 percent of the amount actually invested in equities. The nature of problems faced by this group of companies differs in each case. Generally speaking, the nature of difficulties are very complex and relate not only to technical, marketing and financial problems, but also to difficulties stemming from the socio-economic environment in the countries concerned. Some of the companies in this Group are totally bankrupt with no hope of recovery. Adequate provision exists in the balance sheet of IDB to absorb the losses arising from such companies. On the other hand, there are some other companies which still hold promise of a turnaround.

To sum up, the cold statistical facts pertaining to the actual behavior of the equity investments has exploded the myth that equity portfolio of the IDB has been a total disaster. In spite of over-exposure to green field projects, a little over two-thirds of the portfolio is profitable. The dividend yielding companies in the portfolio have not only out-performed the overall yield on IDB assets in the matter of range of return; they have also built-up underlying strength in the net worth of shares which is manifested in the overall appreciation in the book value of shares by 27.82 percent. That is despite the devaluation effect of depreciation of local currencies vis-a-vis ID which is expected to be absorbed over time as the balance sheets of profit making companies build greater strength with accretions to free reserves. More importantly, in its own modest way, equity financing by IDB has performed a catalytic role by lending support to green field projects sponsored by new entrepreneurs which could not have been provided access to market sources of financing without sizeable support to seed capital of the companies by the Bank.

From the standpoint of lessons to be derived from the experience gained in handling equity financing by the Bank, the portfolio provides a storehouse of insights which would form the basis for designing the new equity strategy of the Bank. The insights are provided over the entire gamut of equity financing: spanning from the concept to the strategy; the techniques of evaluation; the methodology of monitoring; response behavior for rehabilitating the problem equity projects; the exit mechanism for rotating the portfolio; technical support to the member countries to create and strengthen the appropriate blend of financial infrastructure for providing the proper environment for capital market development; and the organizational approach within the Bank to deal with the private sector, in general, and equity financing in particular.

3. LESSONS FROM EXPERIENCE OF EQUITY FINANCING BY MULTINATIONAL AND REGIONAL FINANCIAL INSTITUTIONS

A number of insights are obtained by studying the organizational approach, the concepts, the policies, the strategy, methodology and performance of equity financing by other multinational and regional financial institutions.

3.1 International Finance Corporation (IFC)

IFC is a member of the World Bank Group as a legally and financially independent institution, with its own Articles of Agreement, shareholders, management, staff, and financial structure. It combines the characteristics of a multilateral development bank and private financial institution. Like a private financial institution, it charges market rates on financing and seeks profitable returns on its investments. Its share capital is subscribed by its 142 member countries. Most of the funds for the financing operations of IFC are raised through bond flotations in international financial markets. Unlike most multilateral institutions, IFC does not accept government guarantees for its operations. It shares full project risks with its partners. It plays an important catalytic role in mobilizing additional project funding from other investors, either through co-financing, or through syndication, underwriting and guarantees. In addition to project financing and fund mobilization, it offers a full array of advisory services and technical assistance, helping private business in the developing countries to increase their chances of success and encouraging governments to create an environment hospitable to private investment.

Conceptually, IFC performs both a financial and extra-financial function in equity financing. The financial function takes several forms. If significant investment is made in a company's equity capital, the investor assumes the role of a "direct investor" with responsibility in the affairs of the company. On the other hand, if the investment is small, the investor assumes the position of a "portfolio investor" with no other responsibilities except to vote its shares for directors of the company without any effective voice in the affairs of the company. In this distinction between direct vs. portfolio investor, IFC enjoys a unique position owing to multiplicity of roles it plays as an equity investor.

As perceived by IFC, in the conventional mould, the essential financial function of equity is to provide risk capital, which provides a cushion for a business to ride out periods of low income and losses. Such a cushion reduces the risk to lenders, and hence, makes loans possible or available at more favorable rates. Some new ventures may not qualify for loans at all and full equity financing may be the only way to establish them. The contribution to strengthening the financial structure of an enterprise, conceptually associated with equity, is also performed to some extent by a wide variety of instruments, most of which are often subsumed under the term "quasi-equity". These include subordinated loans and income notes and other modes of finance which have in common the feature that the contractual obligation to service them is in some way more flexible than it is for senior debt, i.e. the servicing obligation is not fixed but depends upon the ability of the company to generate the necessary cash flow to service its debt. In exchange for this flexibility, quasi-equity includes income-sharing features offering participation in a project's upside potential.

The extra financial role is provided by addressing the needs and problems of developing countries in connection with financial markets. These are handled by a special unit of IFC called the Capital Markets Department which was established in 1971. It provides comprehensive assistance for the development of financial markets, including advisory services and investment and financial support for local financial institutions and for local companies or entities seeking access to international capital markets. The typical financial market development effort includes technical assistance which is often accompanied or followed by institutional investment. IFC assists government authorities to formulate capital market development plans, establish an order of priorities, create appropriate legal and fiscal framework, improve corporate financial reporting and disclosure and identify the need for market mechanisms and specialized institutions. These specialized institutions may include stock brokerage and money market firms, investment and merchant banks and specialized housing finance and leasing companies, domestic and international mutual funds, equity funds and venture capital companies. Since information is crucial to investment decisions, IFC has been building its Emerging Markets Data Base since 1981. It consists of unique computerized data based on the most actively traded stocks in 20 emerging stock markets. It offers statistics on the performance and size of stock markets, as well as information on stock prices, dividends, changes in capitalization, trading data, price earnings multiples, book values on over 700 of leading companies in developing countries.

The developmental role of equity financing is kept distinct from supporting financially unsatisfactory companies on grounds of developmental considerations. IFC underlines the fact that developmental role cannot be achieved by investing in bad projects or poorly conceived or poorly managed companies. It recognizes that some companies will inevitably fail, but investing in companies that are likely to do so is not the way to promote development. It translates its development objectives by promoting private sector development in countries where considerable work is required to fund, create and structure projects. Although operating in these countries is often less profitable than operating in countries with lower costs and lower risks such financing is justified on developmental considerations. In the case of potential private investment that actually does appear to offer high economic returns but low financial returns due to the presence of externalities or domestic price controls, the investment is made in financially sound companies by restructuring them or their environment so as to capture, for the project itself, the economic benefit inherent in the project.

IFC looks for equity investment opportunities in companies which need its contribution to equity capital to move forward, which are likely to succeed financially and also judged to have significant upside potential, and which are likely to contribute to the development of the host country. Its equity investments aim to strengthen the capital base of enterprises and to put their investment projects on a sound footing. They also enable IFC to play an important extra financial role, bringing in other investors with capital or know-how, facilitating the coming together of major investors that want IFC as a balancing third party, and being the catalyst to promote new activities and new investment ideas.

IFC's equity investments take a variety of forms, including subscription to ordinary (common) shares and preference shares, with or without participation features. It also makes quasi-equity investments such as subordinated loans and income notes which are denominated in US dollars. Such investments rank junior to loans in the event of liquidation, as distinguished from straight equity investments; they do not generally involve a devaluation risk and are returned under agreed-upon schedule, thereby providing to IFC a built-in disinvestment mechanism. Quasi-equity investments are also useful, where the absence of an organized capital market would hinder the sale of equity investments, or where the foreign exchange risk involved in a straight equity investment would be excessive.

In view of the inherently risky nature of equity and quasi-equity investments, each equity investment is justified on its own merits by the desirability of IFC's participation in the ownership of the company and the investment's projected return. As a rule, IFC does not consider an equity investment unless there are reasonable prospects for the eventual sale of the investment and for obtaining a satisfactory return on investment. The threshold issue is particularly sensitive in the case of proposed investment in member countries that do not operate as traditional market economies or have little or no local capital market. In such cases, IFC ensures that adequate alternatives are in place for eventual sale of its investments; for example, an option to "put" the shares to one or more of the project sponsors on the basis of a negotiated formula.

Again, despite being a partner, IFC does not assume the responsibilities of ownership, playing an active role, including ensuring proper management and general direction of the investee company. In fact, its Articles of Agreement prohibit IFC from assuming responsibility for management of investee companies. It restricts its role to overseeing the performance of the company and enhancing the opportunities for divestment. To perform this role, a representative is nominated on the Board where there is a clear need for assistance and IFC has the resources and ability to provide it; where close overseeing appears desirable to IFC; and/or where the stake of IFC in the investee company is substantial. In deciding about the appropriateness of establishing its presence in a company, IFC gives due regard to the cost of providing such assistance and the possibility of obtaining appropriate compensation in the form of fees. In nominating Directors on the Board, IFC ensures that the individuals concerned are aware of their responsibilities and liabilities as Directors under host country laws. Within this framework, IFC is prepared to hold significant minority equity position up to a maximum of 35 percent of share capital of investee companies. IFC, however, avoids being the largest shareholder in any company.

Unlike IDB, IFC does not predicate its decisions on a hurdle rate or minimum *ex ante* rate of return for equity investments. The project's earning ability in dollar terms is the key financial criterion governing equity investment decisions. IFC's projected rates of return for equity investments take into account the long term potential of the concerned enterprises. As a general rule, each equity investment should show a projected rate of return commensurate with the business and foreign exchange risk borne by IFC and should also reflect an appropriate premium over the rate at which a senior loan is made to the same enterprise.

The total amount and composition of IFC's equity and quasi-equity portfolio are guided by several policies designed to diversify and limit the risks associated with various types of investment instruments. In the light of higher risk associated with equity investments, as a matter of prudent policy, the funding of equity investments is done from IFC's net worth, rather than borrowed funds. It observes two policy guidelines to limit the overall level of equity and quasi-equity investments in relation to IFC's own net worth. First, disbursed equity and quasi-equity investments (net of reserves) are not allowed to exceed IFC's net worth. Second, disbursed equity investments (net of reserves) are limited to 50 percent of net worth. From a financial standpoint, IFC is never solely committed to funding equity investments. A substantial portion of Corporation's capital is kept to underpin lending operations and to keep the blended cost of funds and its lending rate at appropriate levels. Finally, equity investments are also subject to maximum single country and single investment exposure with a view to ensure adequate dispersion of the investment portfolio of the Corporation.

As regards the sale of equity investments, IFC is guided by the general principle embodied in Article III, Section 3(vi), which states that, "the Corporation shall seek to revolve its funds by selling its investments to private investors whenever it can appropriately do so on satisfactory terms". In actual practice, the spirit of this Article is fulfilled when three conditions are met: (a) IFC's role in the company is complete; (b) the selling price is commensurate with the investment's intrinsic value and the company's prospects; and (c) the divestiture results in broader local ownership. Once a sale is found to be appropriate, the timing of sale is essentially determined by financial considerations. IFC satisfies itself to ensure that the selling price is commensurate with the intrinsic value of investment, as determined by an evaluation of the company's prospects. IFC prefers to sell its investments through a local stock exchange in a manner that would contribute to a broader local ownership base in the company, provided it is not inconsistent with its financial interest. IFC's investments are frequently illiquid either because they are not appropriate for immediate listing in local markets, or when listed, the trading volume on the stock exchange is small. As a result, sales are often negotiated or spread through an exchange in lots over a period of time. In the event of negotiated block sales, due regard is paid to the identity of the buyer and his acceptability to other shareholders. Negotiated sales are not executed if the sponsoring partners object for valid business reasons.

The financial aspect of the equity sale decision takes into account the realizable sales value vis-a-vis the alternative benefit of holding the investment for future gains. Sector and country concentration is also taken into account. At the administrative level, a corporate management review of the "sell" or "hold" posture for each equity is made periodically, and for significant holdings, at least semi-annually. Sales decisions involving equity holdings costing $1.0 million or less are made by the Vice President. Those exceeding $1.0 million and upto $2.5 million are sold with the approval of Portfolio Committee of the Management and those exceeding $2.5 million are submitted to the Board for approval.

During the fiscal year ending on June 30, 1991, two major developments of far reaching importance took place in IFC. Firstly, following 18 months discussions among IFC's shareholders, the capital stock of the Corporation was increased by $1.0 billion from $1.3 billion to $2.3 billion. This will enable IFC to increase its project financing activities by 11-12 per cent annually throughout the 1990s. In particular, since IFC's equity and quasi-equity investments are funded out of its share capital, an expanded capital base will allow IFC to increase this type of financing which can be used by private companies in developing countries to finance new investments without increasing their debt burdens. Secondly, the role that each institution in the World Bank Group should play with respect to private sector development was also reviewed in the debate stimulated during discussions about the capital increase of IFC. It was reaffirmed that the World Bank should retain the primary role in policy dialogue with governments; however, in the future IFC will make a greater contribution to developing private sector strategies based on its experience as a financier of projects. While IFC will continue to focus on specific transactions, the World Bank will help governments create a macroeconomic environment in which private enterprise can prosper, through structural adjustment programs, financial sector reform, and improvement in infrastructure, education and health. Multilateral Investment Guarantee Agency (MIGA) will encourage private investment by insuring investors against political risks.

In terms of performance, on an equity investment of US$829 million as at 30 June 1991, IFC earned a dividend income of US$31.6 million giving an overall yield of 3.81 percent. In addition, the Corporation also realized a capital gain of $112.9 million by rotating the equity portfolio, yielding a further return of 13.62 percent on investments held at the end of fiscal 1991. As a proportion of total portfolio, after an experience of 35 years, in 1991, the risk-oriented component of IFC's investments represented by equity financing constituted 15.66 percent, while the risk-averse component of investments represented by dollar denominated loan portfolio constituted 84.34 percent.

3.2 Asian Development Bank (ADB)

As in the case of IFC, equity financing operations in ADB are considered a part of private sector operations and comprise indirect assistance through financial intermediaries and direct assistance to private entities without government guarantees. The Bank took a major initiative for directly assisting the private sector in member countries by introducing an equity investment facility in March 1983. The Equity Unit was established in the then Industry and Development Banks Department (IDBD), under the direct supervision of the Director of the Department. The Unit was responsible for identifying, promoting and evaluating suitable proposals, drawing where necessary, on the resources of other departments, particularly the Office of the General Counsel (the counterpart of Legal Department of IDB), on all matters outside its expertise. The Unit also took charge of portfolio management. Another important milestone for supporting the private sector in member countries was the decision taken in November 1985 to provide financial assistance to the private sector without government guarantees. In March 1986, the Private Sector Division was established in IDBD to facilitate direct private sector investment. In August 1989, the Private Sector Division was upgraded to the level of Department and the Development Finance Division was merged into this Department and the IDBD was renamed as Private Sector Department (PSD).

ADB has provided significant amount of "indirect assistance" to private enterprises in member countries since 1968 through individual credit lines to development finance institutions (DFIs), e.g. "apex loans" which use an institution like the central bank of a member country to receive the loan and distribute it to participating DFIs on the basis of a pre-determined allocation or on a first-come-first-served basis; and the "umbrella credit line approach", where a group of participating DFIs and/or commercial banks are allocated a Bank loan for on-lending to sub-projects. The Bank has also used the "program loan modality" in connection with the sector development approach while supporting the balance of payment adjustment needs of member countries. The credit lines to DFIs and program loans have led to extensive dialogues with the governments of member countries on issues relating to reforms and institutional developments in both the financial sector and the capital markets.

As on 30 September 1990, ADB provided 116 loans under indirect "assistance activities", including 110 credit lines to DFIs and six program loans for a total amount of $3.750 billion. The DFI lines have included six apex loans for $295.0 million and ten umbrella credit lines for $920.0 million. The DFI lines have been spread between 52 DFIs and 23 member countries. The six program loans for an amount of $455.0 million have been provided to Indonesia, Laos and Sri Lanka. A large proportion of the Bank's indirect assistance has gone to Pakistan (25.5%) followed by Republic of Korea (21.2%), India (12.5%), Philippines (11.9%), Indonesia (7.7%), Peoples Republic of China (5.3%), Thailand (3.7%) and Bangladesh (3.6%).

The Bank's direct assistance to the private sector has involved equity investment in and underwriting of, non-financial enterprises, financial intermediaries and regional as well as country-specific mutual funds. The Bank has also extended unguaranteed loans in the form of currency-specific and pool based loans, either independently or jointly with equity participation to non-financial enterprises and financial intermediaries. Equity Lines, which are fee-based cooperative arrangements, are extended to local financial intermediaries to facilitate relatively small investments by the Bank in enterprises selected, appraised and co-financed by recipient intermediaries.

Before making equity investments or private sector loans in a member country, the Bank seeks certain general assurances from the member country's government on the basis of a "framework agreement". The agreement relates *inter alia*, to tax exemption for any income resulting from dividends or the sale of proceeds in connection with the Bank's equity investment and any principal repayments, interest or other charges relating to private sector loans. The framework agreement also provides the Bank with access to convertible currencies and the freedom to repatriate such currencies any time. On the basis of these assurances the Bank is in a position to carry out both equity investments and private sector loan operations.

Since the commencement of direct private sector operations in 1986 up to the end of September 1991, cumulative loans and equity approvals to the private sector (net of cancellations) amounted to $495.2 million. The composition of private sector financing sheds useful light on risk management techniques implicit in the asset allocation strategy of ADB. It is observed that bulk of the financing of the Bank to private sector was allocated in the form of loans (59.44%), which are less risky, while more risky financing in the form of equity constituted only 40.56 percent. Of nearly 41 percent allocated for equity financing from the total portfolio, only 17.52 percent was invested directly in the equities of non-financial enterprises. The remaining 82.48 percent of equity financing was channelled through member country financial institutions in various forms including direct investment in the equity of financial institutions to the extent of 44.5 percent, 20.8 percent by way of equity underwriting and only 17.5 percent through Lines of Equity. Furthermore, direct equity investment in large scale non-financial enterprises was more or less equal to equity financing for small and medium enterprises through Lines of Equity.

As of 30 September 1991, direct equity investment in financial intermediaries for an aggregate amount of $89.2 million was spread over 28 projects in financial intermediaries. These comprised ten venture capital companies and two regional venture capital funds for $24.3 million, five leasing companies for $2.7 million, one insurance company for $330,000, two securities companies for $2.4 million, one commercial bank for $10.3 million, three development banks for $2.7 million, three merchant banks for $36.2 million and three mutual funds for $10.2 million, of which two were regional funds and one country fund. The largest direct equity investment by the Bank so far has been in a merchant bank amounting to $35.0 million and the smallest in a mutual fund in Pakistan amounting to $30,000. A majority of other equity investments ranged between $1.0 million to 3.0 million, with two regional funds accounting for investments of $5.0 million and $5.2 million respectively.

Again, it is observed that ADB has directed its investments to non-traditional financial intermediaries with the main objective of diversifying the financial sectors of its member countries. It directed its equity investment support to intermediaries, which were either finding it difficult to raise adequate equity capital due to the nature of their business or were experiencing a clear funding gap in raising such resources through domestic and foreign investors. Through provision of its supplementary equity investments, the Bank catalyzed a variety of financial intermediaries with investments of a much larger magnitude from other domestic and foreign investors.

The Bank assumed underwriting commitments for an amount of $41.6 million for six mutual funds, three of which were regional mutual funds and three country funds. In undertaking the underwriting commitments, the Bank played the role of co-lead Manager and primarily lent its name and prestige to attract foreign investors to invest in these funds. One of the primary aims in promoting and underwriting a portion of the share issue of these funds was to help recycle investible funds from capital-rich countries to member countries and help promote securities market development through transfer of fund management technology.

The Line of Equity mechanism is an arrangement under which the local financial institution identifies, appraises and recommends to the Bank equity investments in relatively small-sized private enterprises to be taken up by the Bank in its own name and at its own risk. The local financial institution takes a parallel, though not necessarily a matching, stake in the investee private enterprise and assists the Bank in investment supervision and its eventual disposal. The Lines of Equity are routed by the Bank through a variety of financial institutions such as venture capital companies, commercial banks and DFIs.

The Bank made direct equity investments in 15 enterprises amounting to about $35.1 million. These enterprises covered four companies in textiles, five in chemicals and fertilizers, two in metal industries, one in food processing, one in a cement factory and one in electricity generation. The largest equity investment in manufacturing was $10.0 million and the smallest $500,000.

As regards rotation of the portfolio, the Bank tries to sell its equity investments at a fair price as soon as it is ascertained that its catalytic role has been achieved. To fulfill this objective, the Bank requires public listing of shares of the investee company or enters into a buy-back arrangement with the project sponsors. The Bank prefers to sell its shareholdings to nationals or institutions of member countries and consults and coordinates, as far as practicable, with major partners to ensure that divestment does not lead to undesirable destabilization of the management of controlling interest or unduly depress the market price of the shares of the concerned enterprises. As for Line investments, the Bank largely relies on the initiative of DFIs for sale of its investments.

At the operational level, the Private Sector Department (PSD) is responsible for taking the initial decision to carry out divestment, either in its entirety or partially, after establishing that the Bank has achieved its catalytic role. The PSD seeks approval of the management to carry out the divestment exercise in one of the following ways: (i) to sell to the principal sponsors; (ii) or sell to the general public in the stock exchange through designated stockbroker(s); (iii) or to sell to other institutions.

In the last three years, ending 30 June 1991, the overall yield on the equity portfolio of ADB, including realized capital gains, has ranged between 0.76 percent (1989) and 2.97 percent (1990) per annum.

3.3 Asian Finance and Investment Corporation Ltd (AFIC)

AFIC was established in August 1989 on the initiative of ADB to supplement, both at micro and macro levels, the Bank's own private sector operation. As the largest shareholder, ADB holds 30 percent of AFIC's present paid-up capital of about $115.04 million. The company is domiciled in the rapidly growing financial center of Singapore. To facilitate close coordination with the Bank, AFIC's regional headquarters are located in Manila. The other 25 shareholders, based in nine countries across Asia, Europe and America, include some of the world's largest commercial, investment and trust banks, and securities, insurance and leasing companies.

AFIC's main objective is to assist private sector enterprises in the developing countries of the Asia Pacific region in implementing viable new projects and expansion plans. Its equity participation not only provides additionality to the limited institutional equity finance available to enterprises in the region but also augments their capacity to mobilize long term borrowings for financing development. Its equity investments, with the exception of direct purchase of shares in the stock market, are made in a variety of ways such as:

(a) participation in the equity of new enterprises/projects and those undergoing expansion;
(b) venture capital type of equity financing;
(c) participation in the equity of enterprises under privatization or in a turn-around situation;
(d) packaging of equity investment with other forms of assistance (such as loan/guarantee) to an enterprise;
(e) underwriting and placements;
(f) investment in quasi-equity instruments such as convertible bonds; and
(g) equity investment through the wholesale approach, i.e. investment in country funds, venture capital funds and regional funds and other institutions established to underwrite and invest in equities.

Apart from its underlying developmental objectives, the main thrust of AFIC's equity investment is on the growth potential. For its equity investments, AFIC typically selects those enterprises, which have good prospects for growth, but need fresh capital injection to realize growth. AFIC would like to see the value of its investment growing with the growth of the investee. AFIC's investees cover a broad spectrum, from start-ups to those at an advanced stage of expansion. Its investment horizon is essentially that of a medium to long term investor. All investee projects must pass through the usual tests of market, technical and financial viability and be soundly managed. While potential for capital appreciation is a key factor in reaching investment decisions, the long term feasibility of the investee's business remains the basic criterion. More often than not, AFIC would take equity position in companies which have the potential and plans for listing on the stock market. However, other exit mechanisms such as private placement/sale and buy-backs, are also considered.

In the appraisal of equity investments, AFIC takes the following factors into account:

(a) feasibility of the underlying project/operations;
(b) managerial capability and track record of the main sponsors;
(c) evaluation of the capital market where the investee's shares would be listed -- number and frequency of listings, market capitalization, turnover, price earnings ratios, etc;
(d) estimation of dividend stream and price earnings ratio of the investee shares, and projection of its divestment value;
(e) calculation of internal rate of return.

In the monitoring of its equity investments, AFIC adopts the following methodology:

(a) periodic analysis of progress/performance reports and financial statements of the investee;
(b) follow-up visits to investee projects on the basis of felt need;
(c) weekly monitoring of published stock market quotes (where investee's shares are already listed);
(d) periodic monitoring of net asset value per share and book value per share, etc., in the case of investments in unlisted shares; and
(e) in general, following closely the laws, regulations (including those relating to taxation), and trends applicable to capital markets in various countries.

AFIC essentially remains a minority partner in its investee companies. AFIC's policy limits its equity investment in an enterprise to 25 percent of the total paid-up capital, though, in practice, this limit has not been reached in any of its investments so far. As a rule, AFIC is required to keep its total equity investments, at any given time, well within its own equity. To provide support to the sponsors in gaining credibility and respect, and in shaping the policies of the investee company, AFIC requires or accepts, as the case may be, representation on its Board. Board representation, however, is not essential in each case and is based on felt need.

AFIC's cumulative equity investment operations as at 30 September 1991 amounted to $36.14 million. At this level, it constitutes about 30 percent of its cumulative total commitments. All direct investments of AFIC are in enterprises in the industrial sector. Out of the total commitment of $26 million in mutual funds, AFIC has placed about one half with other institutions. The total equity investments approved for AFIC's own account, therefore, presently stands at $23 million.

More recently, AFIC has taken a new initiative to launch a regional fund, called the **AFIC Fund**. The Fund is envisaged to be an offshore regional fund for mobilizing resources from investors in capital-exporting countries for investments primarily in growth-oriented unlisted companies in developing Asian Pacific countries. The Fund would be managed by AFIC with the assistance and cooperation of selected financial institutions in those countries, and perhaps with one or more internationally known fund management firms. The proposed AFIC Fund would be an off-balance-sheet operation for AFIC, and would thus avoid the problems that AFIC might face in mobilizing a similar volume of funds by way of its own equity or debt. AFIC would not directly run the risks associated with the Fund investments, but would assume fund management responsibility to the investors to ensure that the investments prove profitable and yield satisfactory returns.

4. AGENDA FOR A NEW STRATEGY

The preceding review of the equity financing activities of the IFC, ADB and AFIC helps us to set the perspective from which to draw up a pragmatic agenda for a new strategy for equity financing by the IDB.

4.1 Overall Strategy

Before delineating the specific items of the agenda, a few general observations are worth making. For example, the overall performance, measured by the cold yardstick of average yield on the portfolio has not been unsatisfactory on a comparable basis: at 2.8 percent annual yield by way of dividends, IDB stands in good stead vis-a-vis 2.97 percent yield inclusive of dividend and realized capital gains achieved by ADB, and 3.80 percent dividend yield achieved by IFC. It is now more or less axiomatic that equity financing is one element in the multidimensional environment of the market economy. Unless a well integrated strategy is evolved to deal with the private sector as a whole (for instance, covering the economic environment in totality consisting of a reasonably developed physical infrastructure, a set of policies conducive to the growth of private sector and an appropriate legal and institutional framework of financial sector) the ground will not be hospitable for financing of risk capital at the institutional level. This is typically epitomized in the re-definition of the role of the World Bank, the IFC and MIGA, as it emerged after 18 months of stimulating debate on increase in the share capital of IFC. It is also axiomatic, as distilled by the experience of IBRD and ADB, that equity financing can be handled efficiently solely in a market oriented culture of independent legal entities such as IFC, AFIC, which must be kept separate from development financing by the parent institutions which assign greater weight to economic rates of return, as opposed to financial rates of return. In fact, in this respect ADB showed great vision and maturity in two ways: (a) it took the bold step to encourage the creation of an institution, where instead of owning 100 percent, it kept its stake to 30 percent so as to ensure the commercial character of the new entity; and (b) it went a step further to physically distance AFIC from its noncommercial culture and locate it in the burgeoning financial center of Singapore.

There now appears to be a general consensus in the fraternity of multilateral and regional financial institutions that a wide variety of tools need to be developed and applied to reduce the normal hazards associated with equity financing. These tools include (a) a judicious distribution of assets between risk oriented and risk averse components of the institutions' portfolio; (b) choice of the right blend of investment vehicles, e.g. equity versus quasi-equity, direct versus line of equity, diversification in terms of sectors and countries; and (c) timely response to difficulties encountered by projects.

4.2 Conceptual Strategy

We come now to a consideration of specific items of the agenda for a new strategy of equity financing by IDB at the conceptual level. Not only did the Bank backtrack in the field of equity financing, which was conceived in the initial years to be closest to the tenets of *shari'ah*, it is now confronted with a historic challenge to re-establish the very purpose of its creation by offering practical solutions towards establishing a truly Islamic financial system. Equity, in its present form, has been pronounced to be unIslamic. This pronouncement was contained in a verdict by the Council of the Islamic *Fiqh* Academy during its seventh Session held in Jeddah, from 7 - 12 Dhul Qa'da 1412H (9 - 14 May 1992). According to the Resolution passed by the Council relating to "shares in companies", it was stated that:

(a) As transactions originally deal with what is permissible, the establishment of a joint stock company with lawful objectives and activities is something which is permissible. (b) It cannot be disputed that it is not lawful to participate in companies whose basic objectives are unlawful, like dealings in usury or production of, or trading in, unlawful things. (c) It is originally unlawful to participate in companies dealing sometimes in unlawful things, like usury, etc; despite the fact that their activities are basically lawful".

The verdict can be taken either as a challenge to innovate or as an escape-hatch to abandon financing of equities in non-financial enterprises until the millennium of zero leveraged corporate structures ushers in the real world of business. If the latter course is adopted, it will run counter to the spirit of the Articles of Agreement incorporating the Bank. Taken as a challenge, a two-pronged strategy may be launched. Firstly, in the case of companies in the existing portfolio of IDB, where IDB has substantial stake and the companies are running profitably, their capital structure could be cleansed by substituting (either singly or preferably jointly with other Islamic financial institutions) all interest-based financing with lease/instalment sale financing in respect of fixed assets and *murabaha* financing or profit-sharing arrangements in respect of working capital. As regards companies experiencing financial difficulties, provided they have a reasonable chance of turning around, the switchover to a wholesale Islamic mode of financing may be used as an incentive for making available financial assistance for their restructuring and rehabilitation. Secondly, and more fundamentally, a planned program may be chalked out to design and introduce new instruments of Islamic finance. These could include: venture capital companies for financing start up projects; venture capital funds for start up companies; securitised leasing with conversion options; quasi equities such as leasing/instalment sale contracts denominated in ID/US$ with the servicing obligation contingent upon the ability of the company to generate the necessary cash flows with income sharing features or stock options; offering participation in the project's upside potential.

The viability of private sector financing, in general, and equity financing, in particular, hinges on the maturity and health of incorporated corporate structures. These, in turn, depend, internally, on the quality of entrepreneurship and adoption of modern corporate practices of auditing and disclosure and, externally, upon the investment climate created by fiscal and corporate laws and the stage of development of financial sector. For these reasons multilateral and regional development financing institutions are increasingly addressing themselves to these issues as a key activity in their development financing functions. In fact in 1971, IFC created a special unit called the Capital Markets Department to focus solely on this aspect of its operations. The need to address the Bank's efforts in this area is crucial for IDB for more than one reason. Firstly, as the premier Islamic financial institution of the *ummah,* IDB is mandated to innovate efficient products of Islamic finance and play a catalytic role for financial intermediation in all possible ways to promote the development of capital markets in the member countries. Secondly, the function of developing financial markets (consisting primarily of technical assistance, product development, token participation in the equity of financial institutions so as to lend the prestige and name of IDB, underwriting of new issues, syndication etc...) is cost effective and efficient. Thirdly, the establishment of a network of satellite institutions would be mutually advantageous for the mobilization of resources and recycling them for financing productive economic activities in the member countries. This may feature as one of the items on the agenda for new strategy of equity financing by the IDB. Finally, at the conceptual level, the strategy generally followed by multilateral and regional development finance institutions in the matter of giving primacy to commercial as opposed to developmental considerations, needs to be incorporated as the central element in the agenda of new strategy being articulated by the Bank.

4.3 Institutional Strategy

It will be observed from various models of institutional strategy evolved by multilateral and development finance institutions for dealing with equity financing that, in situations where it is handled within the parent institutions, case in point being ADB, it is centralized in a full-fledged Private Sector Department (PSD). For example, as against the fragmented structure of private sector financing, including equity financing, in existence in IDB, giving the responsibility of private sector financing to various departments of the Bank, the strategy followed by ADB, provides useful insights for adopting a scientific institutional approach in this field - until such time the Bank graduates to the concept of setting up an independent legal entity for this activity. It is interesting to learn from the experience of ADB as to how it transformed its Equity Unit, which started as a small segment in the Industry and Development Banks Department (IDBD), into a full fledged PSD absorbing IDBD itself within its fold in the process of reorganization.

At the level of creating an independent entity, two distinct models have emerged so far: (1) AFIC with minority shareholdings together with physically distancing the institution from the core Bank by locating it in the heart of an emerging financial center and the conventional model of IFC and (2) Inter-American Investment Corporation (IIC) having common shareholders for the parent and subsidiary institutions. It is for IDB to choose the model that best suits its environment.

4.4 Asset Allocation Strategy

If the experience of other similar institutions could serve as a guide for redefining the asset allocation strategy, the safe limit for equity exposure in the assets of IDB could be conservatively put at a maximum of 20 percent of the equity of IDB. Based on the audited accounts of the Bank for the year 1412H, this ratio will work out at ID 432.40 million against the actual exposure of ID 229.66 million at present. The exposure may be reviewed from time to time, keeping in view the strength of the Bank's balance sheet, the injection of resources from the market and the behavior of the portfolio. The element of conservatism built into this proposal may be seen in the context of the ratio of 50 percent fixed by IFC. At the micro level, in actual operation, risk-averse financing represented by dollar denominated loans predominates in the asset allocation strategy of all other similar institutions: 84.34 percent for IFC; 59.56 percent for the private sector portfolio of ADB; which would blow up to a percentage larger than IFC, if the ratio is seen in the context of financing by ADB as a whole; 70 percent for AFIC and 81 percent for IIC. IDB should follow a strategy no less dissimilar to other identical institutions, and set this target at 60 -70 percent of its total assets for lease and instalment sale financing, which is IDB's counterpart for loan financing by similar other conventional development finance institution. Again, within equity financing, bulk of the financing should be allocated to financial institutions. This is borne out by the behavior of similar other institutions. For example, as against 3.8 percent of the direct equity investments allocated by IDB to financial sector out of 88 percent allocated to this category in the overall equity portfolio of IDB, for one thing, while similar other institutions allocate a much smaller proportion to direct equity financing for non-financial enterprises compared to IDB, the proportion allocated for participation in the equity of financial institutions is diversified over a wide spectrum of different types of financial institutions: merchant banks, security houses, commercial banks, leasing companies, housing finance companies, venture capital companies and funds and Country and Regional mutual funds. The underlying policy appears to be to keep to the minimum direct equity exposure in non-financial enterprises, and within this category, to route financing to green field non-financial projects via a wide variety of financial intermediaries. There are many lessons for IDB to learn from this strategy while reformulating its asset allocation strategy at the microlevel. As regards single project exposure limits, the policy pursued by IDB appears to be more or less in line with the strategy followed by similar other institutions and does not call for any change for the time being. Finally, it is significant to note that, unlike IDB, no other similar institution has any hurdle rate of dividend yield to serve as the benchmark for antiselection of projects to be considered by the institution.

4.5 Portfolio Management Strategy

One of the chief lessons to be learnt from the strategy followed for identification, appraisal and monitoring of equity projects by all other similar institutions is that, firstly, it is not commingled with development financing functions and is strictly restricted within the closed confines of private sector market oriented environment of the institution, irrespective of whether it is handled within the framework of development financing environment (e.g. PSD in the case of ADB), or dealt within the all pervasive private sector environment of specialized subsidiaries such as IFC, AFIC and IIC. Secondly, in every similar institution engaged in equity financing, a comprehensive system of project identification, appraisal and monitoring appears to have been evolved with a decisive bias in favor of appraisal of corporate aspects of equity financing, such as the maturity and experience of entrepreneurship, the quality of corporate management and practices, as well as the efficiency of capital market institutions such as the stock markets, securities houses, etc., to provide easy exit routes for the roll-over of the portfolio. A critical review of appraisals of equity projects undertaken by the IDB so far, highlights the weakness in these areas of appraisal. This is thrown into sharp focus when attempts are made to revolve the portfolio. The techniques used by IFC, AFIC and PSD of ADB in this sphere will provide a storehouse of experience for adoption by IDB when it embarks upon the new strategy for equity financing.

4.6 Portfolio Roll-over Strategy

Experience of other institutions suggests that the preconditions for taking a decision to sell or hold have been defined most unambiguously. For example, IFC has evolved a system to ensure that, prior to taking a decision to divest any equity investment from its portfolio, its role in the company is complete, the selling price is commensurate with the investment's intrinsic value and the company's prospects, and divestiture will result in broader ownership. Similarly, a wide measure of flexibility is given to the management to take decisions to divest the portfolio without seeking the prior approval of the Board for every case. For example, in IFC, decisions to sell equity holdings upto $1.0 million or less are delegated to the Vice President incharge of portfolio management. Decisions for sale of equities for investments, from $1.0 million upto $2.5 million, are assigned to the Portfolio Committee of the Management. It is only the decisions for portfolio roll-over exceeding an amount of $2.5 million that are required to be submitted to the Board for approval. The agenda for new strategy for equity financing may use the systems adopted by similar other institutions in this field as guidelines for introducing operational flexibility in the decision making processes of the Bank both for roll over of portfolio and exercise of preemptive rights in existing projects.