General Council for Islamic Banks and Financial Institutions

المجلس العام للبنوك والمؤسسات المالية الإسلامية

CIBAFI

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CIBAFI BRIEFING

"Infrastructure Financing: Investment Opportunities for Islamic Finance"

This briefing aims to shed light on the current challenges of infrastructure financing and how Islamic finance could contribute effectively in this investment opportunity. It investigates the different Islamic finance structures that could be used for infrastructure projects. The briefing also aims to promote the role of Islamic finance through the results of a short survey and the demonstration of industry experiences, discussing the main opportunities and challenges of using Islamic finance in infrastructure financing and providing policy recommendations to overcome these challenges.

1. Introduction: Background and Purpose

The nexus between infrastructure development and economic growth is well established. Infrastructure development is crucially important for a wide range of industries, and a driver to fostering countries' economic growth, prosperity and alleviating poverty. According to the World Bank, a 10 percent increase in the infrastructure investment is positively associated with 1 percent increase in the gross domestic product (GDP)[1].

Infrastructure – social and physical – plays an important role in socio-economic development. It brings together the elements of the economic system, linking production centres, distribution centres, and end consumers. It provides energy, communications, and an educated workforce. But it also meets basic human needs, for example for clean water, sanitation, and healthcare.

Despite the benefits of infrastructure projects, there is an enormous infrastructure investment gap. The investment requirement for global infrastructure development is estimated to be US$ 3.75 trillion per annum and with current global trends of investment, there is a projected shortfall of US$ 596 billion annually until 2040[2].

In this situation, Islamic finance offers both some distinctive funding structures and access to investors for whom ethical issues may be particularly important.

2. Islamic Finance: A Value-Added Proposition

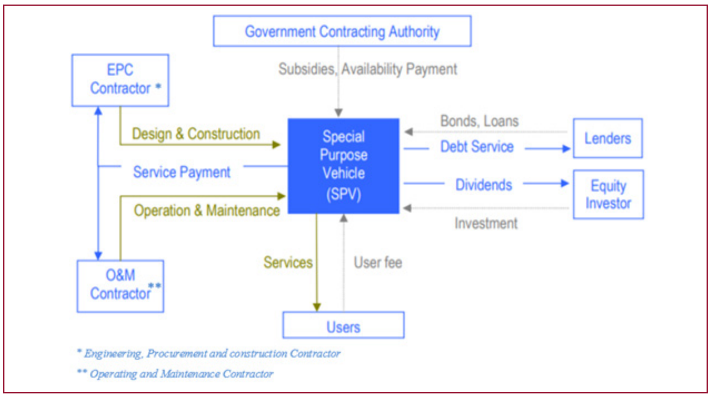
a. Classic approaches of financing infrastructure projects

Traditionally, infrastructure financing has been provided by governments primarily through budget allocation and debt instruments, owing to the large scale, wide breadth and longer duration of infrastructure projects. Nonetheless, with increasing public debt levels and allocation of funds for other needs, governments are facing budgetary constraints and are unable to invest in infrastructure projects to the extent needed.

Partly as a result, the private financial sector is performing an increasingly important role in the development and provision of infrastructure projects. In 2018, the total assets under management (AUM) of global institutional investors were estimated at over US$ 215 trillion. Of these, 39.0 percent are held by banks, followed by asset and wealth management companies (31.6 percent), public and private pension funds (16.6 percent), insurance companies (8.6 percent), sovereign wealth funds (3.4 percent) and private equity with less than 1 percent[3]. In order to tap into the huge potential of private sector financing, governments are encouraging and incentivizing financial institutions to finance infrastructure projects. In some cases, governments provide price support to the private sector by ensuring the supply of inputs and the purchase of output at guaranteed prices.

Governments may also involve the private sector in infrastructure development projects under the framework of public-private partnerships (PPP) whereby, in typical cases, an asset for public use is built and operated by the private sector, sometimes with eventual transfer to the public sector. As illustrated in figure 1, in most PPP contracts, a project company is formed to carry out a specific business operation for a finite period of time, often in the form of a Special Purpose Vehicle (SPV). This separate legal entity raises funds through a combination of equity (typically provided by the project sponsor), loans (typically provided by banks), bonds, or other financial instruments[4].

Figure 1. The flow of funds in a PPP project



Source: PPP Knowledge Lab, 2017

b. The rationale of turning to Islamic finance

Given the global infrastructure financing deficit, Islamic finance can be instrumental in mobilizing financial resources to finance infrastructure projects especially due to its principle of asset-backing and the nature of Islamic finance structures. Additionally, the characteristic of risk-sharing, in principle, makes Islamic finance a natural fit for filling the existing gap in financing infrastructure projects through the framework of PPP.

In 2018, the Islamic financial sector's assets attributable to infrastructure financing were estimated to be close to US$ 120 billion, with the majority of funds (US$ 75.8 billion) coming from the banking sector followed by US$ 39.9 billion from Sukuk issuance. At the international level, the Islamic Development Bank (IDB) is an example of a multilateral development bank that provides Shariah-compliant project financing to the Organization of Islamic Cooperation (OIC) member countries. Since IDB's inception in January 1976 to June 2018, the total distribution of the financing for infrastructure was US$ 64.24 billion of which 68% was allocated to energy sector projects, 19% to the transportation sector, and 11% to water/sanitation , with the remainder going to communications.

Although these amounts are relatively small in global terms, they are significant for the recipient countries.

c. Islamic finance structures for infrastructure projects

The scale, breadth and long timescales of infrastructure projects mean that they require suitable financing structures to meet their specific needs. Innovative Islamic financial structures are great instruments for providing flexible tailor-made financing solutions for specific small and medium projects on one side and large-sized infrastructure projects on the other. There exists a wide spectrum of Islamic finance structures, in the industry, that provides adequate flexibility to developers and investors in selecting an appropriate financing product.

In the Islamic banking sector, banks invest in infrastructure projects either by direct project financing or by buying project securities from the project company. However, the scope to use funds to finance infrastructure projects varies with the size of the bank. Given the large financing required in mega infrastructure projects, Islamic banks typically participate through syndications (based on the Wakala (agency) or Mudarabah structure) whereby a group of Islamic banks come together under a principal bank to meet the project financing needs. Depending on the nature of the infrastructure project, Islamic banks can use different Islamic financial contracts for project financing, for example, bank financing can be given in thethe form of Istisna, Murabahah and Ijarah among others.

On the other hand, Islamic capital markets provide another window to raise funds for infrastructure projects through issuing Sukuk. According to AAOIFI, Sukuk can be based on any of fourteen Islamic financial contracts. While some of these are not suitable for infrastructure financing, several of them are, including Istisna, Ijarah, Mudarabah, Musharakah and Wakalah, and there may be scope for novel approaches using other contracts or new combinations.

Despite the actual support that Islamic finance offers for infrastructure projects there is much scope for innovation and different patterns of risk and return to be offered in order to enhance the role of Islamic finance in supporting infrastructure projects. For example, while Istisna appears at first sight ideally suited to such projects, its use has been inhibited by the difficulty of paying a return to investors before construction is complete.

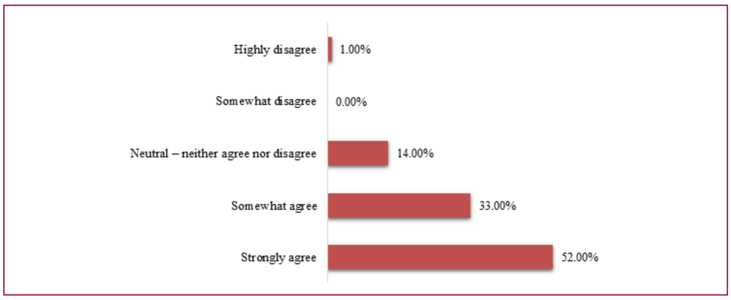
3. CIBAFI Survey and Results

Given the importance of infrastructure financing and its impact on the people's wellbeing and economic growth, CIBAFI conducted a survey to evaluate how far infrastructure finance represents a significant opportunity for the Islamic finance industry, to what extent Islamic financial institutions have been active in this area, and what they see as the main barriers inhibiting this involvement. A total of 106 Islamic banks from 33 countries participated in the survey to express their views on infrastructure financing.

Infrastructure Financing

The majority of the respondents strongly agree with the notion of infrastructure finance as an important opportunity for the Islamic financial industry. Perhaps unsurprisingly, the larger Islamic banks were more likely to agree strongly that there was a significant opportunity, and more likely to be active in this area. The results depict Islamic banks' understanding of the significance of infrastructure financing and its impact on social and economic development in the long run.

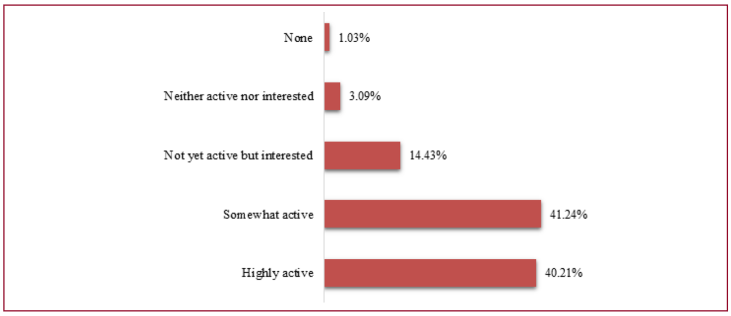
Figure 2. Does infrastructure finance represent a significant opportunity for the islamic finance industry?



Source: CIBAFI

When we asked the respondents about the level of their involvement in infrastructure finance, the majority of the Islamic banks appeared to be active. Around 81 percent of respondents chose either 'highly active' or 'somewhat active' in this question. It appears that most Islamic banks have financial ability and expertise to get involved in some ways in infrastructure projects, though it is possible that some are still in the process of exploring new opportunities for doing so.

Figure 3. Level of activity in infrastructure finance



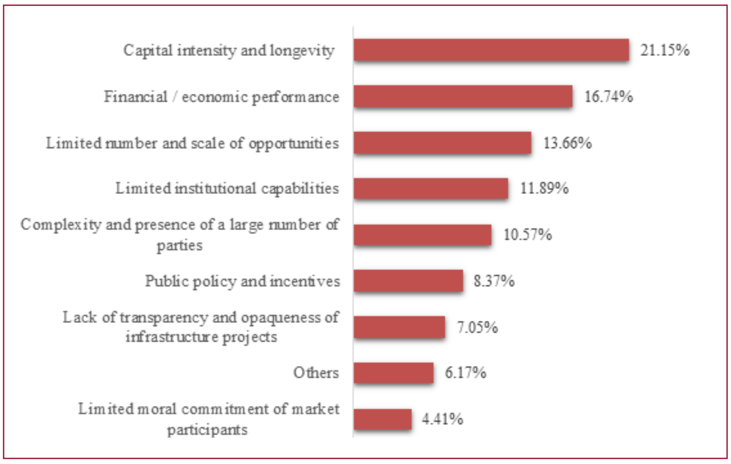
Source: CIBAFI

On the question of barriers faced by Islamic banks in implementing infrastructure financing, the majority identified capital intensity and longevity as the main barrier. This is particularly so when it comes to small-sized Islamic banks that are more sensitive to capital adequacy and liquidity and thus face limitations in investing capital in long-term infrastructure projects. Moreover, Islamic banks consider financial/economic performance as the second most important barrier to financing infrastructure projects. This is, perhaps, owing to the poor economic performance, risks and political uncertainty in different countries.

There are other country-specific barriers. Islamic banks in underdeveloped countries with slower economic growth and higher government borrowing from the banking sector, often lack both infrastructure project opportunities and the free resources to deploy towards them.

The "others" in figure 4 below included the lack of qualified human resources, a difficult security situation, administrative corruption, and the lack of medium and long-term resources to finance infrastructure activities, especially given current liquidity pressures on Islamic banks.

Figure 4. Main barriers to implementing infrastructure financing



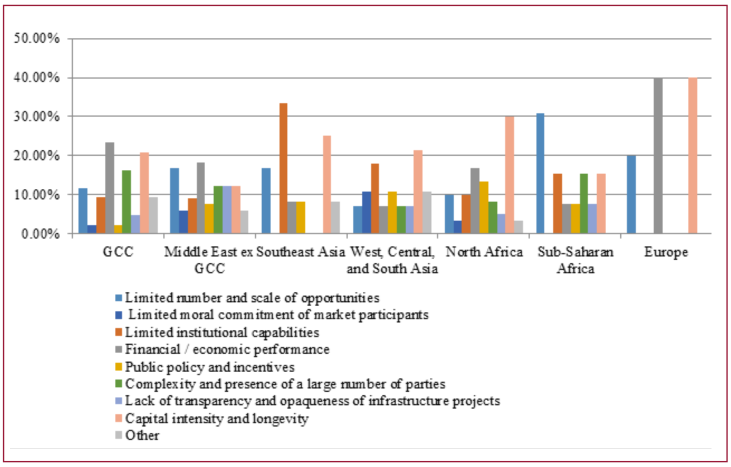
Source: CIBAFI

The regional picture is interesting, although it comes from low response numbers in some regions. The greatest enthusiasm for infrastructure finance came from North Africa and Southeast Asia, with the greatest scepticism in West, Central and South Asia, the GCC, and Europe. Particular regional divergences appeared on the question of the obstacles to infrastructure finance. Financial and economic issues, together with capital intensity and longevity, dominated in the GCC and were generally prominent themes elsewhere. However, the lack of institutional capacity was seen as the main obstacle in Southeast Asia and was also important in West, Central and South Asia, while in Sub-Saharan Africa, the number and scale of opportunities was the leading issue.

Some of these responses may reflect the relatively small scale of Islamic banking in some places, which means that Islamic banks may not be seen as natural partners for infrastructure projects, and project sponsors may not be willing to accommodate the structures of Islamic finance; hints from some comments indicate that this may be the case.

The other key issue that emerges, and which has already been mentioned, is that Islamic banks find it difficult to commit finance for the long periods associated with major infrastructure projects. It is possible that capital market instruments, notably Sukuk, will prove more appropriate for this purpose, and that the key role for banks will be to structure and arrange such financing.

Figure 5. Main barriers to implementing infrastructure financing – regional breakdown



Source: CIBAFI

4. Islamic Finance Industry: Case Studies of Infrastructure Projects

Among the first infrastructure projects in which an Islamic finance tranche was effectively used is the Hub River Power Project with the financing of US$ 1.8 billion in Pakistan in 1994. In this project, a consortium comprising two private Islamic banks, Al Rajhi Bank and IICG Islamic Investment Bank, was formed to provide US$ 92 million bridge-financing facility in the form of Istisna to develop and install power turbines for the project[6].

Today, we have numerous successful examples of Islamic finance participating in infrastructure financing in different regions. In Asia, one example is of Malaysia Airports Holdings that raised RM 4 billion (US$ 1.22 billion approx.) in Sukuk issuance, between 2010 and 2013, to construct the world's largest terminal for budget airlines[7].

In the MENA region, we find similar examples of Islamic finance involvement in infrastructure projects. One case study is from Djibouti where a consortium of three banks entered into a financing agreement, based on four financial contracts of Musharakah, Istisna, Ijarah and Takaful, to develop Doraleh container terminal project. The consortium managed to raise US$ 422 million in 2007, making it one of the first large PPP infrastructure projects that was wholly financed by Islamic syndication[8].

In 2017 the Federal Government of Nigeria raised Naira 100 bn (US$ 328 million approx..) to finance 25 major road projects across the country. This involved transferring land to the SPV, and entering into a Forward Ijarah contract to lease the roads, together with an undertaking to purchase them at the end of the 7-year term.

In 2018, Kuwait Finance House provided KD 124.6 million (US$ 410.29 million approx.) syndicated Murabaha financing facility to facilitate construction works of the new international airport terminal in Kuwait[9].

Most recently in 2020, for the first time, the European Bank for Reconstruction and Development (EBRD) provided an

Islamic financing facility worth US$ 20 million (based on commodity Murabaha contract) to develop two greenfield general hospital projects in Egypt and Morocco[10] .

5. Main Challenges and Opportunities for Islamic Finance in Infrastructure Financing

As Islamic finance sector involvement can improve both the financing and the implementation of infrastructure projects, the crucial role of policymakers and regulatory authorities is to provide the right conditions to reap the financing benefits. The underlying challenges and potential opportunities for Islamic finance in infrastructure financing are as follows:

a. Potential of Sukuk for infrastructure financing

Notwithstanding challenging global conditions, the global Sukuk market demonstrated strong growth of 25.58 percent, with new Sukuk issuances reaching US$ 162 billion in 2019[11]. Sukuk are, arguably, among the best match to finance infrastructure projects and the infrastructure sector is considered to be a large portion of the Sukuk funds raised around the globe. Both Muslim and non-Muslim countries have tapped into the Sukuk market to finance infrastructure projects. In addition to the examples already given, both Indonesia (2019) and Senegal (2016), for example, have issued Sukuk to finance large infrastructure investments.

Sukuk are usually structured to be tradable, and the ability to exit the investment is particularly important for long-term projects. They can also be matched to the requirements of the infrastructure project, as illustrated by the diversity of the examples quoted. For example, although Sukuk can be based on existing assets, they can also be similar to PPP financing whereby investors finance the construction of a set of assets that they initially own, and which are typically transferred to the government at maturity.

Moreover, Sukuk can also offer different risk-return profiles to match project needs and investor demand.

From the investor side, Sukuk allows investors to choose specific investments that are suitable to their own Shariah values, and also priorities for particular types of investment. For example, in 2019, green Sukuk issuances to support sustainable financing goals were prominent, particularly in the Asian and GCC regions, and this trend is expected to grow, as green Sukuk are likely to benefit from favourable demand from asset managers to increase sustainable investments owing to investors' preference as well as regulators' initiatives to encourage sustainability. In this regard, the government of Indonesia has now issued two tranches of green Sukuk (in 2018 and 2019) and, while not all of the proceeds will be devoted to infrastructure, the uses will include renewable energy and waste management projects.

In areas such as these, the nexus between the need for sustainable infrastructure, Sukuk structures, and the values of Sukuk investors creates a highly favourable environment.

b. Legal and regulatory framework

Given the wide breadth and longer duration of infrastructure projects, it is necessary to develop a sound legal and regulatory framework to manage risks appropriately. However, with the implementation of Basel III standards, the regulatory rules are potentially creating disincentives for financial institutions to finance long-term infrastructure projects as these will require higher capital requirements. Liquidity rules, which prior to Basel III were not defined at the international level, can also create problems for investment in long-term and fundamentally illiquid assets, though these are less problematic where the investment is through traded instruments. These requirements are more consequential in case of small and medium-sized Islamic banks that are relatively sensitive concerning capital adequacy and liquidity regimes.

While some banks have argued that the capital adequacy and/or liquidity standards should be changed to encourage investment in infrastructure projects, the primary purpose of these standards is to ensure the stability and soundness of the banking system. Making this case will, therefore, depend on demonstrating that the standards take an inappropriately pessimistic view of the risks associated with infrastructure projects. There is, however, the scope for Islamic banks to work with standard-setters to re-examine the regulatory treatment of infrastructure investment based on a proper economic view of the risks.

Besides the regulatory framework, the legal structure is also important for Islamic financial institutions to consider long-term infrastructure financing. Where the private sector is to take real project risk, as in a PPP project, a legal framework is necessary to define concession contracts (duration, extension and termination of the contract, acquisition of rights of the project, security interests, operation of the project), roles, responsibilities, rights and obligations of different parties, and how both private and public interests will be safeguarded. This legal structure, and confidence that it will be upheld and enforced, are necessary to provide a conducive environment for the banking sector to finance infrastructure projects.

However, scaling up Islamic finance in response to growing demand in infrastructure project financing nevertheless requires overcoming the legal, regulatory, and institutional challenges such as lack of sustainable infrastructure policy framework, insufficient standardization of contracts, inappropriate procurement processes and procedures, inconsistent ruling on Shariah compliance of Islamic contracts and the cost of structuring and executing Islamic infrastructure financing.

6. Conclusion and Policy Recommendations

Islamic finance, thus far, has been successfully employed in financing a variety of infrastructure projects in several parts of the world. However, to tap the full potential of Islamic finance to reduce the infrastructure financing gap in Muslim and non-Muslim countries, multiple efforts are required at the part of governments, regulators, policymakers, investors and Islamic financial institutions.

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Infrastructure Financing: Investment Opportunities for Islamic Finance

An efficient domestic and international infrastructure financing requires a comprehensive regulatory infrastructure finance framework. Therefore, governments and regulators should create a conducive environment with appropriate legal, regulatory, and infrastructure policy frameworks that are supportive of infrastructure projects. One element of this, to tap the potential of Islamic finance, will be to develop frameworks for Shariah-compliant financing, so that these are ready to be drawn upon when needed.

To achieve an integrated framework for financing infrastructure projects, it is recommended that Islamic financial institutions should:

- Develop robust guidelines for the management of their investment portfolios which will allow them to evaluate and support infrastructure projects.
- Devise innovative Islamic financing products and services in collaboration with Shariah scholars, in order that Islamic finance can have a distinctive infrastructure finance offering aligned to the needs of both project sponsors and investors.
- Educate stakeholders and create awareness among investors on infrastructure financing instruments and the related socio-economic benefits.
- Develop systematic means to engage with their external stakeholders to take feedback on issues related to infrastructure financing.
- Through formal guidelines and staff training, equip staff to make realistic assessments of the profitability and risks associated with infrastructure financing.

Islamic financial institutions both individually and collectively (e.g. through trade associations and infrastructure forums) should:

- Engage in advocacy of infrastructure financing within Islamic financial institutions and the ecosystem as a whole.
- Encourage governments to develop and enact appropriate laws and regulations for encouraging investment in infrastructure projects. These should include in particular establishment of a legal and regulatory framework related to PPP which protects the rights of investors in such projects.
- Adaptation of the tax laws in order to facilitate the involvement of Islamic finance in infrastructure projects, in particular to avoid the additional tax burdens that may arise when assets are transferred into Sukuk vehicles and subsequently repurchased.

Standard-setters, principally the Basel Committee but also the Islamic Financial Services Board (IFSB) IFSB, are recommended to work with banks, to examine the data on infrastructure investment and decide whether the capital adequacy and liquidity treatment of such investment correctly reflects the risks associated with it.

Moreover, the national regulators should consider, with the Islamic finance institutions in their countries, the development of a governing framework that can support the activities of Islamic finance for infrastructure projects.

About CIBAFI

CIBAFI is an international non-profit organisation founded in 2001 by the Islamic Development Bank (IDB) and a number of leading Islamic financial institutions. CIBAFI is affiliated with the Organisation of Islamic Cooperation (OIC).

CIBAFI represents the Islamic financial services industry globally, defending and promoting its role, consolidating co-operation among its members, and with other institutions with similar interests and objectives.

With over 130 members from more than 34 jurisdictions from all around the world, CIBAFI is recognised as a key piece in the international architecture of Islamic finance.

Its mission is to support the Islamic financial services industry as the leading industry voice in advocating regulatory, financial and economic policies that are in the broad interest of its members and that foster the development of the Islamic financial services industry and sound industry practice.

CIBAFI is guided by its Strategic Objectives, which are 1) Advocacy of Islamic Finance Values and Related Policies & Regulations; 2) Research and Innovation; and 3) Training and Professional Empowerment.

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