



# MOBILIZING ISLAMIC FINANCE FOR INFRASTRUCTURE PUBLIC- PRIVATE PARTNERSHIPS

REPORT 2017





## OVERVIEW

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Muslims constitute a vast majority of the population in emerging market and developing economies (EMDE) in Asia and Africa. The 57 members of the Organization of Islamic Cooperation (OIC) have a combined population of more than 1.6 billion people (for a list of OIC members, see appendix A). These countries, along with many non-OIC member countries, are facing years of pent-up deficits in infrastructure, inhibiting their ability to exploit their full development potential. In the face of limited public finance, these countries need to attract private capital to build and maintain the critical infrastructure that is essential for sustained economic development. Public-private partnerships (PPPs) have been used successfully to channel private capital for infrastructure investments globally. Many developing countries have implemented PPP schemes to deliver core infrastructure projects and services.

Over the past two decades, Islamic finance has emerged as one of the important sources of finance for a wide variety of infrastructure projects, through both public sector and PPP schemes. Amidst the dearth of conventional infrastructure financing, Islamic finance

offers the prospect of widening the sources of financing needed to meet the massive infrastructure investments in developing countries, including but not limited to Muslim-majority countries.

This report is an attempt to discuss and disseminate information on how Islamic finance has been applied in infrastructure projects through PPP schemes, what the structural challenges and solutions are, and what could be done to deepen and widen the use of Islamic finance for this purpose. This report has two broad dimensions. The first is enhancing the understanding of Islamic finance building blocks as they relate to financing infrastructure PPP projects. Second, and perhaps less well understood, the report explores how the building blocks of Islamic finance can fit within a PPP context, paving the way for providers of the Islamic finance capital to become partners for infrastructure development and thus contribute to its overall global financing pool.

The global need for infrastructure is huge. It extends across all regions, giving rise to a massive deficit in infrastructure investment. Chapter 1 explores the

infrastructure deficit in major regions of the world. It is particularly acute in the region where a vast majority of Muslim population lives—which is one of the contributing factors to the low income level of many of those countries. Many of these countries have started tapping into private capital by introducing PPP projects. Islamic finance can provide a complementary source of financing to these efforts. As noted in a study by the McKinsey Global Institute, while PPPs “account for only about 5 percent to 10 percent of total investment, they are unlikely to provide the silver bullet that will solve the funding gap” (Woetzel et al. 2016). Accordingly, the conditions must be set for PPPs to constitute a much larger share of total investment. This can be done if the readiness of developing countries for PPPs can be improved, and additional sources of finance, such as Islamic finance, can be marshalled for the infrastructure projects.

Chapter 2 provides an overview of the state of global Islamic finance. The Islamic financial market has been growing rapidly around the world. Over the past six decades, the market has reached nearly \$2 trillion, with annual growth nearly at double digits, as reported by the Islamic Financial Service Board (IFSB 2016). The chapter also focuses on the state of Islamic finance among OIC’s 57 members. In tandem with the growth of Islamic finance, a number of supporting institutions have evolved that are playing important roles in setting standards, regulations, policies, and guidelines. These institutions form part of the global Islamic finance ecosystem. This chapter introduces these institutions. As OIC economies continue their above-average growth rates, accentuated by their relatively young yet rapidly growing populations, the volume of the *shari’ah*-compliant financial assets will also grow. The report discusses these motivations as a platform for understanding the potential roles Islamic finance can play for infrastructure PPP projects.

Chapter 3 presents the basics of Islamic finance within the context of a PPP framework.<sup>1</sup> A common feature of all structures of Islamic finance is that no interest can

be charged. Rather, the financier charges a mark-up, leases out an asset, or shares in the profits of the venture by undertaking one of the following trading activities:

- ◆ Entering into sales and purchase transactions
- ◆ Entering into leasing arrangements
- ◆ Participating in equity investments.

While applying Islamic finance instruments to infrastructure PPP projects, financiers need to enter into any or a combination of these three transactions, at the same time creating a structure that aligns with the conventional debt or equity structure. The former ensures compliance with *shari’ah* requirements. The latter conforms to the existing financing frameworks that are being used to finance infrastructure PPP projects, thus allowing Islamic finance to seamlessly integrate with the rest of the capital providers coming from conventional sources.

Several standard Islamic finance instruments are being used to meet the financing needs of infrastructure PPP projects (for definitions, see glossary). These instruments are used, either in isolation or in combination with multiple instruments, to tailor bespoke financing solutions for PPP projects.

*Istiṣnā’* and *ijārah* are the most common forms of Islamic finance instruments for large, longer-term financing arrangements, such as financing for power projects, infrastructure, and transport equipment. These two instruments are used in combination most of the time—*istiṣnā’* for the construction and procurement stage, and *ijārah* for the operation stage. Many power, water, and transport projects have been financed through a combination of *istiṣnā’* and *ijārah* structures. *Istiṣnā’* financing is suitable when it involves construction of assets (such as civil works), whereby the finance parties take construction risks as opposed to sales-based or *ijārah* structures, where the suppliers, not the financing parties, take the risk in constructing or manufacturing assets. Though the Islamic financiers pass the construction risks back to the project company

through an agency arrangement, many Islamic financiers still prefer not to take on direct exposure to construction risks, and follow an *ijārah*-only structure.

Under the *istiṣnāʿ*, the borrower of an infrastructure PPP project agrees to procure/construct assets by a certain date, on behalf of the Islamic financier. The contract price payable by the Islamic financier must be fixed and is paid to the borrower in stages, to match payment obligations that the borrower might incur by any back-to-back construction contracts, such as an engineering, procurement, and construction (EPC) contract.<sup>2</sup> Title to the assets being manufactured or constructed is transferred to the Islamic financier at the end of the construction period. As mentioned earlier, *istiṣnāʿ* is often combined with a forward *ijārah* or a *murābahah* sale.

Under a forward *ijārah*, the project company (as lessee) and the Islamic financier (as lessor) contemporaneously with the *istiṣnāʿ* agreement enter into a lease agreement to lease the assets under construction. During the construction phase, the lessee pays advance rentals to the lessor with respect to the asset that is under construction. The size of these advance rental payments is based upon the drawn-down that has occurred under the *istiṣnāʿ* agreement. Thus during the early stage of project construction, when relatively fewer funds have been drawn on, the advance rental payment will be lower. This payment will continue to increase as the accumulated draw down increases. This approach means that the lessee is, in effect, servicing the advanced funds that have been made available under the *istiṣnāʿ* agreement before the assets are constructed. During the operational phase of the project (the period following delivery of the assets according to the *istiṣnāʿ* agreement) until the final maturity date of the facility, the nature of the lease changes. The forward lease converts into the leasing of the actual assets that have now been delivered. The lease rentals are calculated by aggregating a fixed element (equivalent to principal, in conventional facilities) and a variable element, generally on the basis of a reference such as six-month LIBOR (London Interbank Offered

Rate), plus a margin (equivalent to the applicable margin under the conventional facilities).

Lease rentals can be structured to be made at the same frequency as equivalent repayments under conventional facilities. This is the most common schedule, given that big infrastructure PPP projects tend to be financed by both Islamic and conventional finances.

The majority of transactions using *istiṣnāʿ* and *ijārah* are structured to be on the balance sheet of the Islamic financier. From a risk mitigation perspective, there is a need to ring-fence the liabilities of Islamic financiers. In instances in which insurance is not considered a sufficient mitigant for this risk, it is possible to structure the arrangements so that the Islamic financier acts through a special purpose vehicle (SPV), using structures that are familiar in structured financing transactions.

***Murābahah*** is another fairly common form of Islamic finance instrument (although more commonly used in shorter-term financings). This structure involves a contract between the Islamic financier and the client for the sale of goods on a cost-plus mark-up basis —either as a percentage of the cost price or a lump sum. The Islamic financier will purchase the goods as requested by its client and will sell them to the client with an agreed mark-up. The client pays back the Islamic financier over a defined period of time; hence the justification for the mark-up. The profit mark-up must be agreed upon by the buyer and seller before the deal closes and cannot be changed. This conforms to another principle of Islamic finance that there cannot be any uncertainty in Islamic finance transactions.

***Mushārahah*** is a partnership between two or more parties that provide capital toward the financing of new or pre-existing projects. The parties share the profits on a pre-agreed ratio, with losses being shared on the basis of equity participation. While used by Islamic financiers in certain countries such as in Malaysia and Pakistan to finance infrastructure PPP projects,

this mode is not very common in other countries for infrastructure PPP projects.

**Sukūk** (sometimes loosely referred to as Islamic bonds) have emerged as one of the most promising developments in the area of Islamic finance. Their application for PPP projects, however, has been limited for the same reasons as any conventional project bonds have also been limited application in infrastructure projects. Essentially, *sukūk* involve the issuance of certificates in the collective legal or beneficial ownership of the asset. The certificate holders receive income derived from the assets of the project. *Sukūk* can be placed on top of any Islamic structure, but traditionally has been combined with the *ijārah* structures. In the context of infrastructure PPP projects, *sukūk* resemble conventional project bonds.

Islamic credit enhancement is an emerging topic and more so in the context of infrastructure PPP projects. Islamic insurance, otherwise known as *takāful*, is based on the principles of mutual insurance, which involves a group of people/parties agreeing to insure one another against given risks. Only a handful of institutions offer *takāful* products for infrastructure PPP projects. The Islamic Corporation for the Insurance of Investment and Export Credit (ICIEC), a member of the Islamic Development Bank Group (IsDBG), is a pioneer and leading the efforts in offering insurance service for infrastructure PPP projects based on *takāful* principle. While the use of *takāful* is recommended, *shari‘ah* scholars allow conventional insurance to be used in infrastructure PPP projects that are financed wholly or partially by Islamic “finance” if Islamic insurance products are not available or are not economically feasible.

Chapter 4 reviews evidence from nine case studies in six countries (Pakistan, Djibouti, Turkey, Saudi Arabia, Jordan, and Malaysia) that illustrate the flexibility of Islamic finance in putting together *shari‘ah*-compliant solutions across different countries and sectors. These cases span power, airports, seaports, health care, and

roads. The countries covered by these case studies vary greatly in terms of their macroeconomic environments, readiness to support PPPs, and institutional maturity vis-à-vis Islamic finance. Yet all of them have applied Islamic finance to infrastructure PPP projects and many of these projects have been financed by both conventional and Islamic financiers. The cases demonstrate that the practitioners were able to create Islamic finance structures that are aligned with the debt financing structure of conventional finance, while complying with *shari‘ah*. This flexibility in structuring various *shari‘ah*-compliant Islamic finance instruments also allows Islamic finance and conventional finance to coexist seamlessly in the same infrastructure project, on equal footing. Although the two facilities are documented separately, the terms and conditions incorporated into the two sets of documents are structured in a way that ensures that both sets of financiers (Islamic and conventional) benefit from the same or very similar commercial terms.

Chapter 4 further illustrates the flexibility and innovation of Islamic finance solutions for infrastructure PPP projects by presenting a number of examples where Islamic finance was deployed in innovative and tailor-made solutions. Some examples are country specific, while others relate to the integration of Islamic and conventional finances in the same infrastructure PPP project.

Overall, the report delves into why and how PPPs can benefit from Islamic financing. The asset-backed nature of Islamic finance structures and their emphasis on shared risks make them a natural fit for infrastructure PPPs. A wide variety of Islamic finance structures are available to provide sufficient flexibility to practitioners to select appropriate financing vehicles. This is a key takeaway from this research and the cases reviewed. The success of PPPs in using Islamic finance has motivated project sponsors (equity investors) in countries such as Bangladesh, Djibouti, Indonesia, Kazakhstan, Malaysia, Mali, Morocco, Nigeria, Pakistan, Saudi Arabia, Turkey, and Uzbekistan to continue to seek Islamic finance, along

with conventional finance, in undertaking future PPPs. The Islamic Development Bank Group (IsDBG) has been pioneer in offering Islamic finance for infrastructure PPP projects. In addition, other multilateral development banks and international financial institutions, including the International Finance Corporation (IFC), the Multilateral Investment Guarantee Agency (MIGA), and the Asian Development Bank (AsDB), have started deploying Islamic finance instruments to support infrastructure projects, thus providing much-needed confidence to commercial lenders to follow suit. For each transaction that takes place, innovations in the structures used contribute to the body of knowledge and experience, and pave the way for future transactions.

Yet Islamic financing is not routinely used in PPPs. More knowledge about Islamic finance is needed within countries seeking infrastructure finance and ways to facilitate the use of Islamic finance instruments to mobilize private investment in infrastructure through PPPs. Given that many stakeholders, including project sponsors and commercial banks, have relatively modest understanding of the application to Islamic finance to infrastructure PPP projects, there is significant room for awareness and knowledge building in this area. This report serves an important milestone in meeting

that goal: as a basis to understand the environments where such transactions have occurred, how those transactions can be structured, and ways they can guide the mobilization of Islamic finance to help bridge infrastructure gaps in many developing countries.

As the chapters that follow will explain, a key feature of Islamic finance is the flexibility of *shari'ah* structures to accommodate needs specific to the country, sector, and project, thus allowing providers of Islamic finance to craft the most appropriate solution. However, this often requires innovative and new structures to be created, within the boundary of *shari'ah* tenets. This may slightly increase costs and the time to deploy them. As more of these deals are undertaken, the additional costs related to structuring the Islamic tranche tend to diminish and even disappear, as practitioners become familiar with the structures and can use past transactions as precedents.

The report ends with a set of recommendations to facilitate the deployment of Islamic finance for infrastructure PPP projects, thus serving both to help developing countries overcome their infrastructure challenges and to further develop Islamic finance within each respective market.

