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Islamic Finance: Opportunities and Challenges for Infrastructure Financing

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Roadmap

I. Overview of Infrastructure Financing

II. Regional Perspective

III. How Islamic Finance Can Bridge the GAP?

IV. Going Forward

I. Overview of Infrastructure Financing

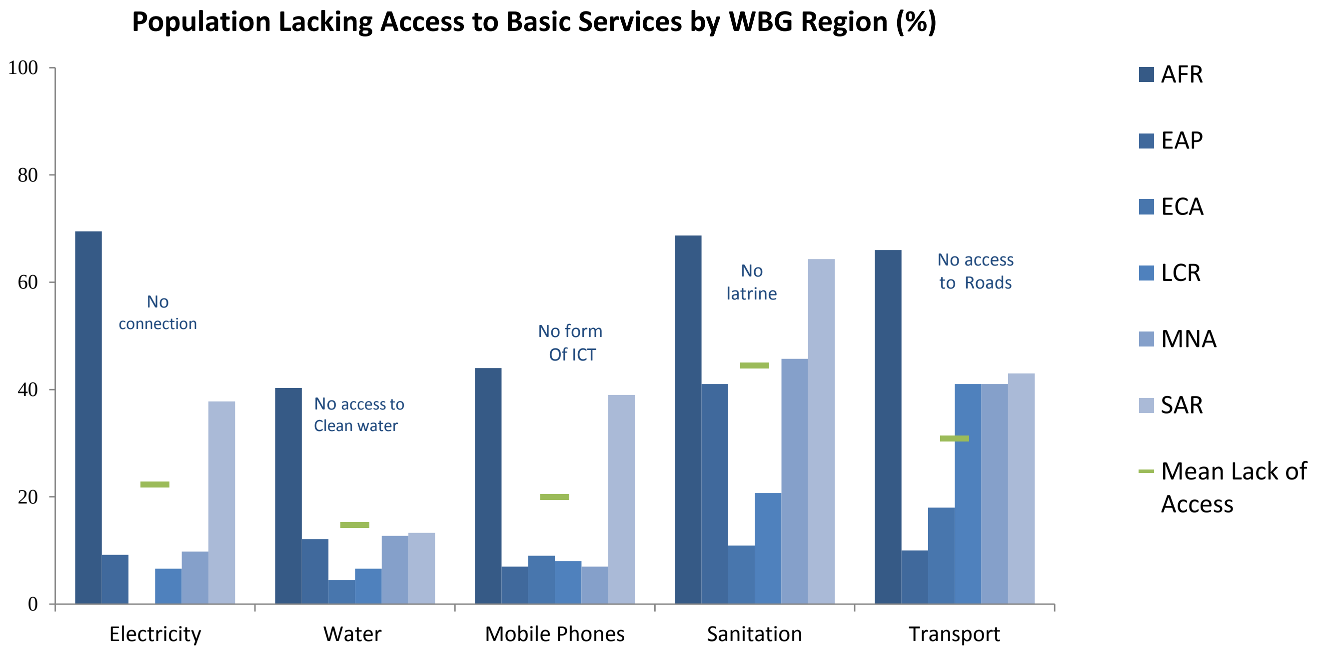
Growing demand for infrastructure financing

- The need for long term funding to finance long term investment especially in emerging markets has been an increasing matter of concern across both international platforms and academic circles in the recent years.

- Public and private investments in infrastructure such as **transportation, power, water, and telecommunication** are positively related to sustainable economic development.

- The need for infrastructure financing:
  - **$57 trillion** infrastructure investment is required to achieve the projected global GDP growth from 2012 to 2030 (Mc Kinsey, 2013)
  - **$14.4 – 15.7 trillion** USD infrastructure investment need from 2008 to 2020 for EM (Bhattacharyay et al., 2012)
  - Nearly **$1 trillion** USD infrastructure investment is required for MENA region from 2013 to 2020 (Estache et al., 2013)

Potential for long-term financing

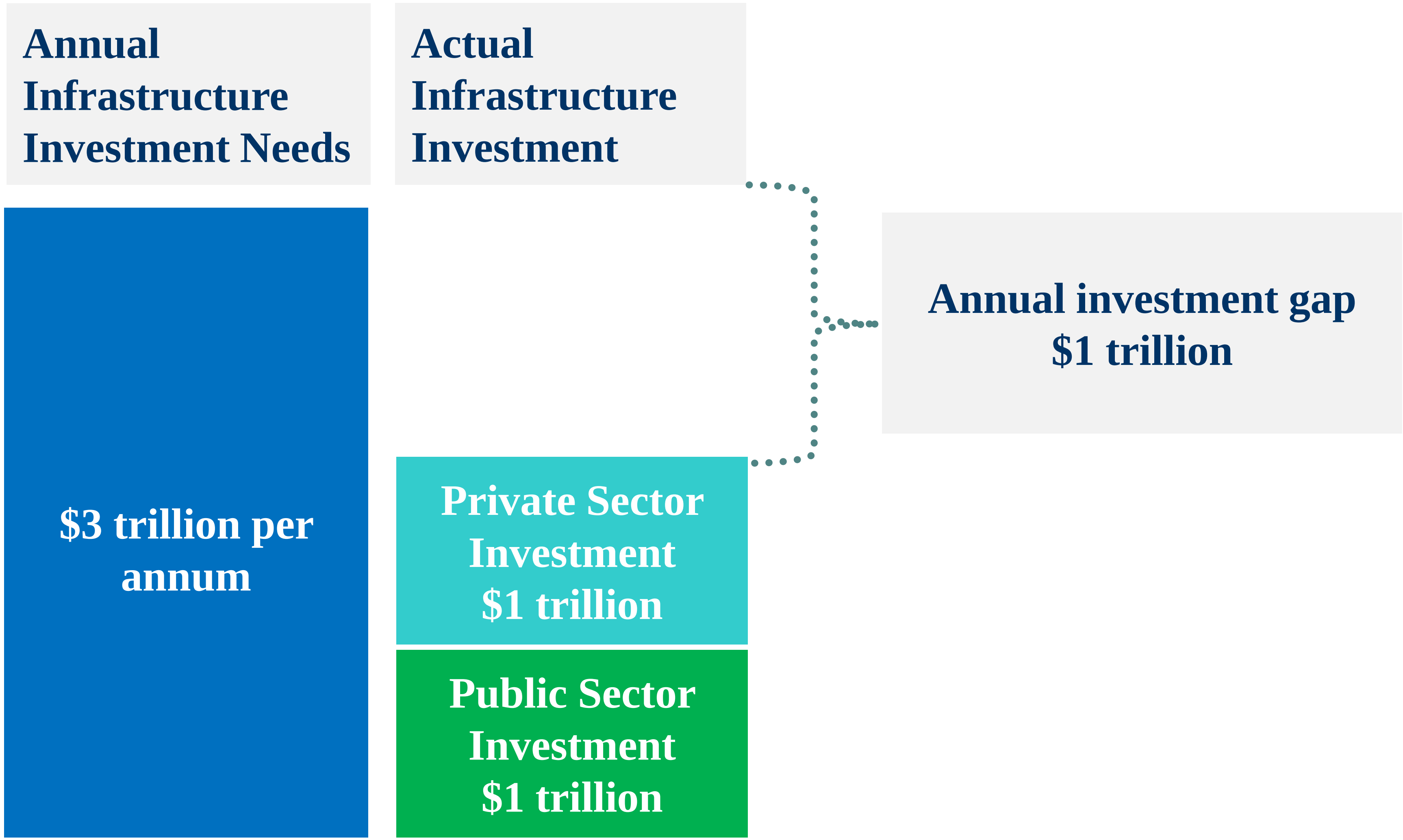


Transport Data: Rural Access Index, 2007
Remaining Data: Regional Action Plans, Infrastructure Strategy Update 2012

- Estimations for 9 countries[1] (%60 of global GDP) show that they need annual investment of US$18.8 trillion in real terms by 2020.
- It is estimated that MENA region alone needs to invest between $75 and $100 billion in infrastructure annually for the next 10-15 years.

[1]Brazil, China, France, Germany, India, Japan, Mexico, the United Kingdom, and the United States.
Source: "Long -Term Finance and Economic Growth"; Group of Thirty; 2013.

Global Infrastructure Needs (2010-2030)



Source: OECD

Gaps and constraints for long-term financing is evident

- **Constraints on the future supply of long-term finance**
  - Long-term investors are increasingly becoming constrained in their ability to provide financing.
  - Long-term financing in many countries rests on a narrow range of instruments.
  - Cross-border capital flows have been driven by short-term, volatile lending.

- **Trends on the horizon are not supportive**
  - Bank deleveraging and new regulation (such as Basel III)
  - Fiscal consolidation
  - Aging populations

Infrastructure as an Asset Class

- Essential Services
- Long Life
- High barriers to entry
- Inelastic demand and inflation protection
- Steady and predictable cash flow
- Low correlation with other asset classes

What makes infrastructure finance challenging?

- **Financial versus social returns.** Project may not be economically feasible but could have significant social benefits.

- **Complexity** of cashflow patterns, nature of projects, and number of different parties (financiers, suppliers, constructor, operator).

- Initial phase, i.e. construction phase has **high risk** as the project may not generate any cashflow.

- **Regulatory barriers.** New regulatory framework to market-based valuations and risk-based solvency standards is indirectly affecting the ability of institutional investors such as pension funds and insurers to invest in infrastructure and other alternative asset classes.

- **Monitoring challenges**. Lack of objective, high quality data on infrastructure and a clear and agreed benchmark, making it difficult to assess the risk in these investments to understand correlations with other assets.

Source: OECD, 2014. "Private Financing and Government Support to Promote Long-term Investments in Infrastructure", Analytical Report. Paris, France

The Need for More Private Investment

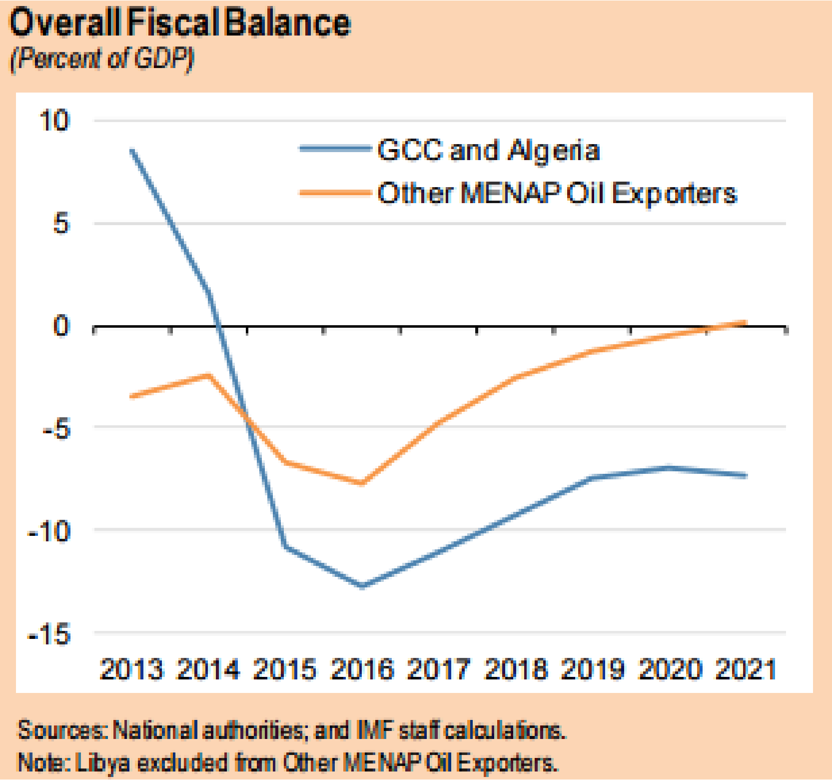
- Closing the $1 trillion investment gap requires significantly higher contributions from both public and private sources

- Fiscal pressures have reduced the contribution of traditional, public sources of investments, creating the need to explore private sources more vigorously

- Islamic financial institutions can contribute to both private and public sources of infrastructure investments

II. Regional Perspective

Overall Fiscal Balance is deteriorating



The oil price drop since mid-2014 has been spectacular: prices **have fallen nearly 70 percent to about $40 a barrel**. Futures markets anticipate oil prices to recover only modestly to $50 a barrel by the end of this decade, though much uncertainty surrounds this forecast.

The outlook for lower oil prices implies weak oil revenues for years to come, dramatically reducing the capacity of governments to spending.

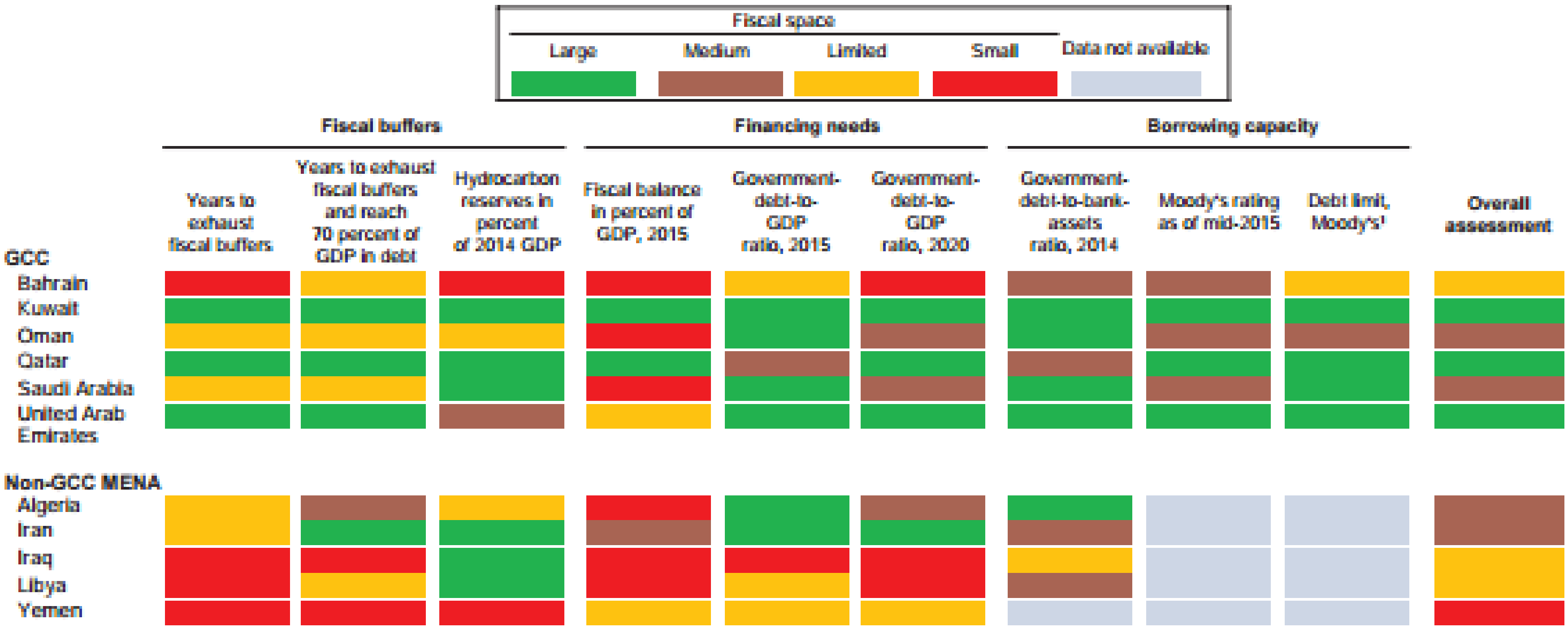
Mirroring the large loss in export receipts, fiscal balances have deteriorated considerably.

The ample surpluses of the GCC countries and Algeria have turned into significant deficits, projected to average 12¾ percent of GDP in 2016 and remain at 7 percent over the medium term, despite the implementation of sizable deficit-reduction measures. For other MENAP oil exporters—those generally less reliant on oil but with smaller fiscal buffers—the combined deficit is projected to average 7¾ percent of GDP in 2016, and gradually close by the end of the decade as oil output increases and conflicts are assumed to ease.

Source: IMF (2016), *Regional Economic Outlook Update.*

Fiscal Space in MENA and GCC – Increased Vulnerabilities

Alternative Measures of Fiscal Space.

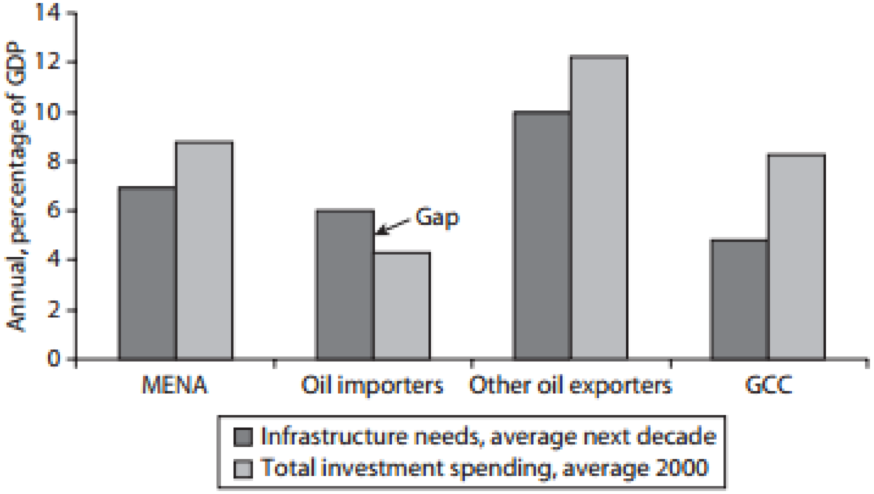


Source: IMF (2015), ***Regional Economic Outlook Report.***

The large and sustained drop in oil prices has increased fiscal vulnerabilities in MENA.

According to the table above, Kuwait, Qatar and the United Arab Emirates have a high degree of fiscal space. Countries with limited or small fiscal space include Bahrain, Iraq, Libya, and Yemen.

Infrastructure Needs and Financing



Source: The World Bank (2013), *Infrastructure and Employment Creation in the Middle East and North Africa.*

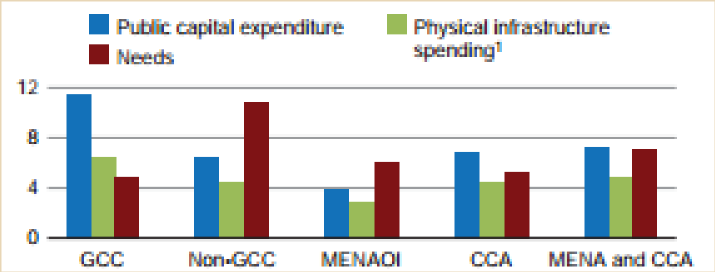
MENA's infrastructure investment and maintenance needs through 2020 at about **US$106 billion** per year or 6.9 percent of the annual regional gross domestic product (GDP).

Electricity and transport are each estimated to account for about 43% of total infrastructure needs in MENA, followed by information and communication technology (9%) and water and sanitation (5%).

Fulfilling the electricity need alone would require approximately 3% of the annual regional GDP, or US$46 billion, of which US$10 billion will be spent in OICs and around US$36 billion in OECs.

Public Investment and Physical Infrastructure Needs, 2014–19

(Percent of GDP)

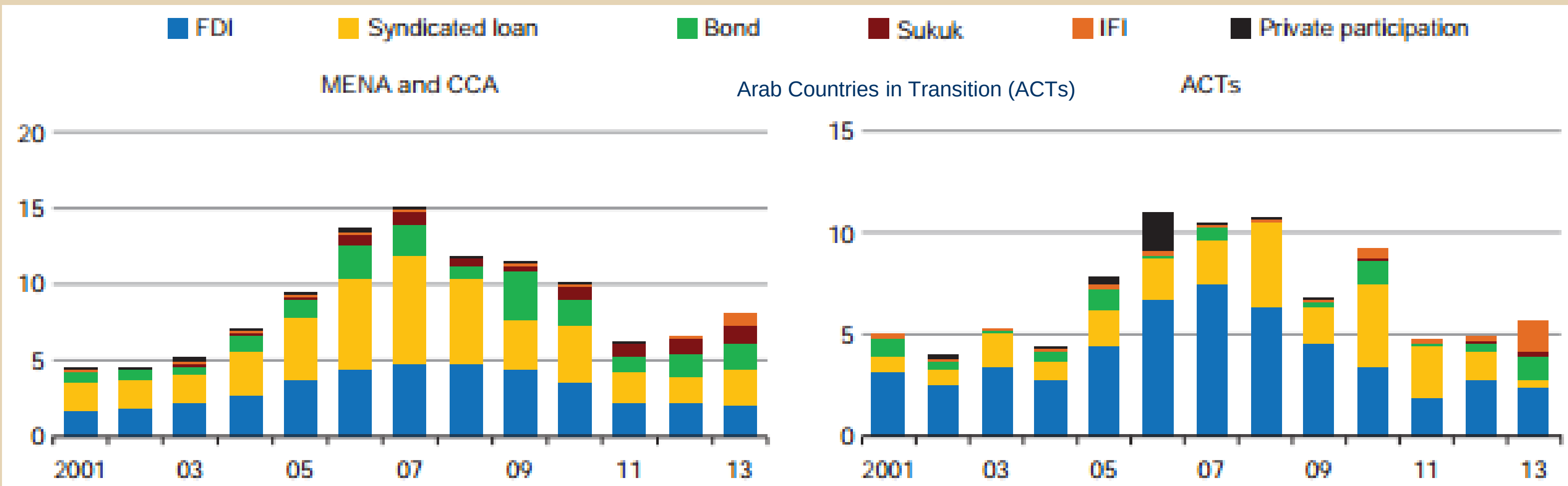


Sources: IMF, World Economic Outlook database; Ianchovichina and others (2013); the Multilateral Development Bank Working Group on Infrastructure (2011); and IMF staff estimates.

[1]Estimates of infrastructure spending are based on the information from countries' budget laws, when available, and IMF staff assessment. In the absence of estimates for a country, regional averages of infrastructure spending to total public capital spending ratios were computed to obtain total infrastructure spending.

Infrastructure Financing Driven by Syndication…

Financing for Infrastructure and Other Investments
(Percent of GDP)



Source: IMF staff calculations.
Note: Includes also financing not directly used for infrastructure spending (e.g., certain FDI, bonds, and loans directed to noninfrastructure investments). FDI = foreign direct investment; IFI = international financial institution.

Financing capacities vary sharply across the region. Hydrocarbon exporters have generally stronger fiscal positions and easier market access than hydrocarbon importers. **Sukuk are an increasingly popular financing option**, especially in the GCC, but conventional financing through syndicated loans and bond issuances have fallen substantially since the global financial crisis.

Public-private partnerships (PPPs) continue to play a marginal role in the region.

Source: IMF (2016), *Regional Economic Outlook Update.*

III. How Islamic Finance Can Bridge the Gap?

Why is Islamic Finance Suitable for infrastructure?

- Emphasis on tangibility
- Partnership- and equity-style financing
- Profit and loss sharing
- Socially responsible investments

Forms of Islamic Infrastructure Investment

- Third party equity in project companies
- *Sukuk* issuances by project companies
- *Sukuk* issuances by public sector
- Loan syndications
- Sharia compliant guarantees

Potential Role of *Sukuk*

The risk-sharing aspect of *Sukuk* gives them a clear advantage as a funding instrument for infrastructure.

- *Sukuk* are designed from the outset to spread the risk more broadly because all investors share in the same manner.

- *Sukuk* can also be used more flexibly over time because payments are tied to underlying returns rather than to fixed schedules.

- *Sukuk* resemble Public-Private Partnership (PPP) financing whereby investors finance the assets, own them—leading to true securitization— and then transfer them back to the government at maturity.

Source: IMF (2015), *Islamic Finance: Opportunities, Challenges, and Policy Options.*

IV. Going Forward

G30 Working Group on Long-term Finance – Policy Recommendations

- I: Ensure investors are better able to take a long-term horizon in their investment decisions.
- II: Create new intermediaries and instruments geared toward the provision of long-term finance.
- III: Develop debt and equity capital markets in order to promote a broad spectrum of financing instruments.
- IV: Ensure that cross-border flows support the efficient global allocation of capital to long-term investment.
- V: Strengthen systemic analysis when setting future regulatory policy.

Leveraging Islamic Finance for Long-term Financing

- Islamic banks acting as asset managers or specialized fund managers managing portfolio of infrastructure projects.
- Enhancing risk-sharing and asset-based financing through development of capital markets and securitization markets.
- Provide liquidity through tradeable shares or securities of specialized funds.
- Attracting conventional and Islamic institutional investors, i.e. pension and insurance funds through development of new product meeting their risk-return requirements and enhancing liquidity.
- Developing enabling environment for robust financial intermediation through enhanced transparency, governance, and regulatory environment.
- Financial awareness and literacy of core principles of risk-sharing financing, i.e. Islamic finance.

Issues for Discussion - I

- Composition of financing
- Rights, benefits and protection of parties
- Transaction costs
- Tax considerations
- Risk allocation and risk management

Issues for Discussion - II

- Legal and regulatory issues
- Need for Standardization
- Development of Islamic NBFIs
- Infrastructure planning
- Project preparation

Thank You

For your further questions please contact:
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