

Funding Infrastructure Development through Islamic Finance: Issues and Challenges

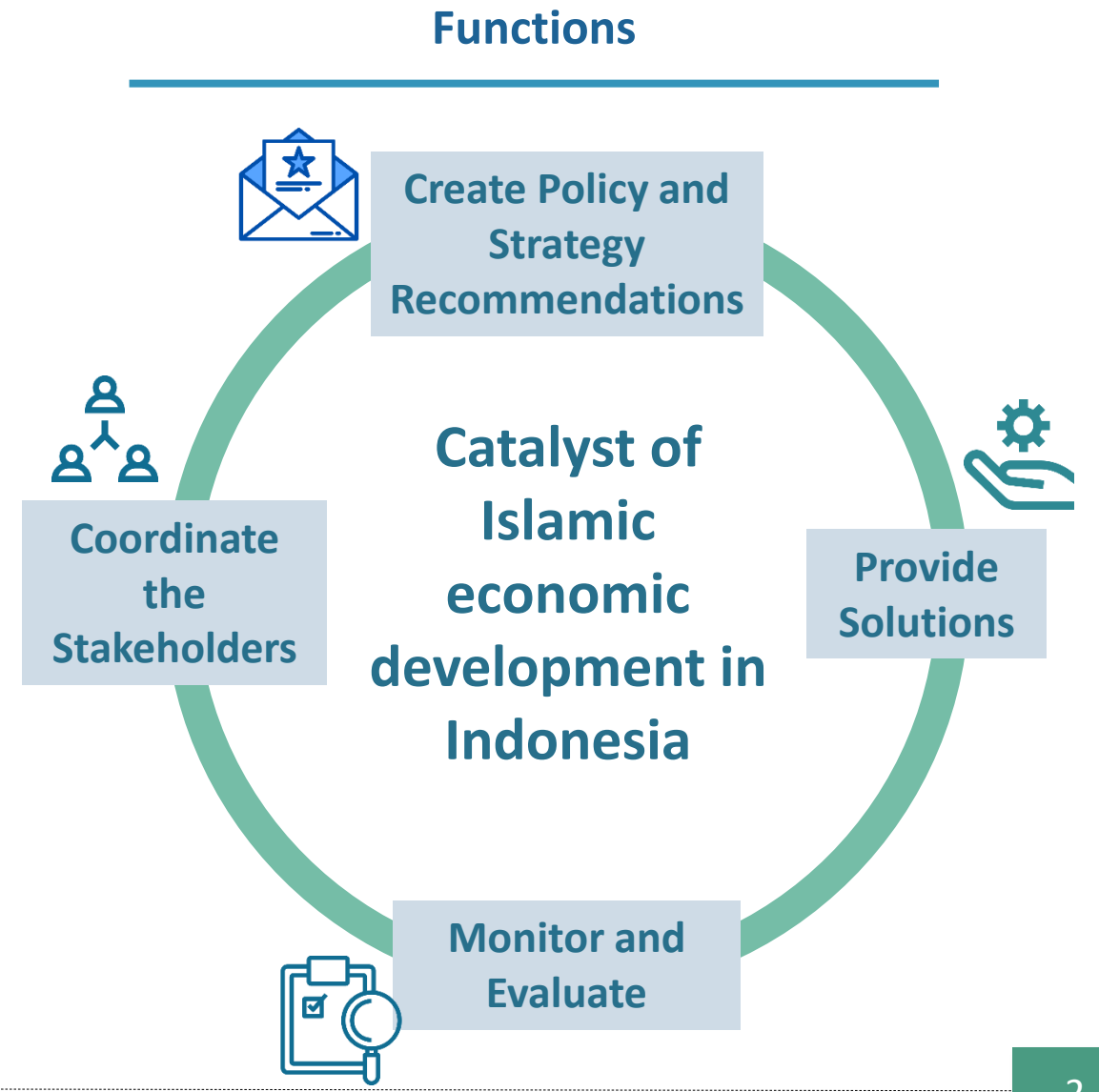
Ronald Rulindo, Ph.D.

(Director of Islamic Finance Product Innovation, Financial Market Deepening and Infrastructure Development of KNKS)

Delivered on BI-ADFIMI-KNKS joint CEO seminar on *“Islamic Structured Finance: Cases of Infrastructure Project Finance in IsDB Member Countries”*



National Islamic Finance Committee is established to enhance the impact of Islamic finance on national economic development



- 01** The need for infrastructure development
- 02** Islamic Finance and Infrastructure Financing
- 03** Funding Infrastructure through Islamic Finance: Case of Indonesia

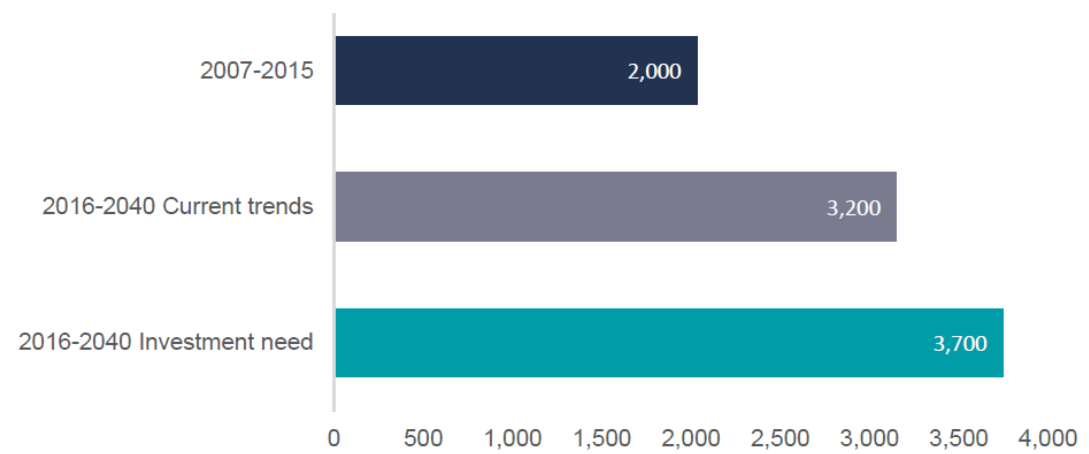
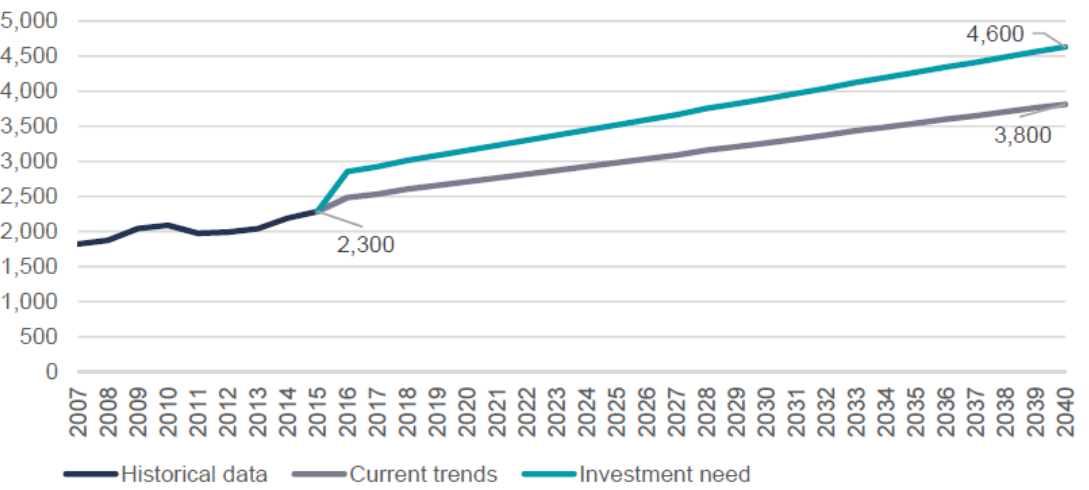
Komite Nasional Keuangan Syariah

01 The need for infrastructure development

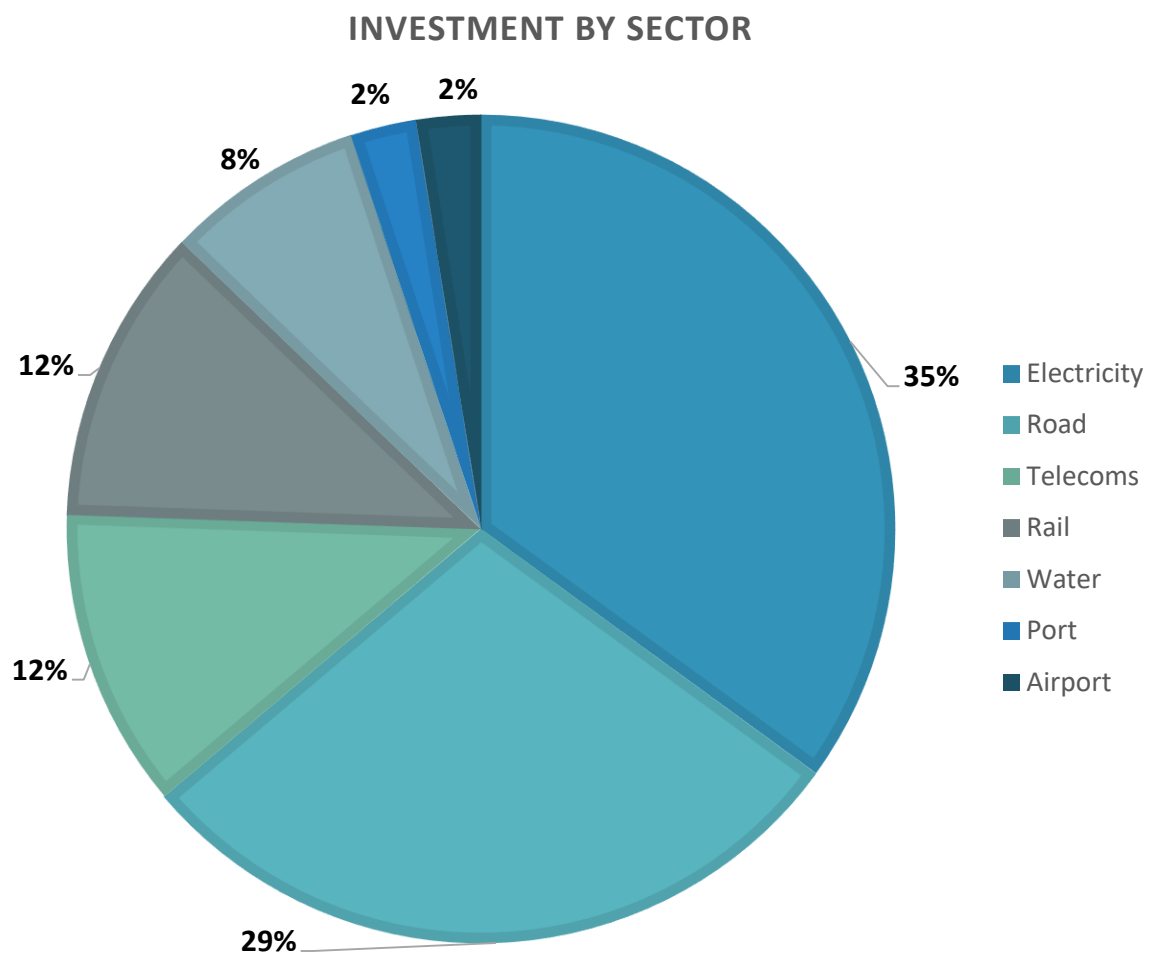
Global infrastructure spending trends shows continuous improvement in terms of budget allocation across countries, dominated by electricity and road sectors

Global infrastructure spending, 2007-2040

Billion US\$, based on 2015 prices and exchange rates



Average annual investment by sector, 2007-2015



Source: Oxford Economics

How can the world bridge its infrastructure gap other than government spending?

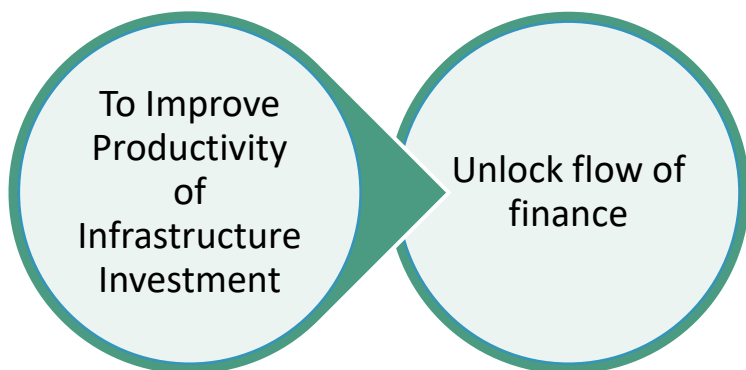


The world invests \$2.5 trillion annually in transport, power, water, and telecom as of today

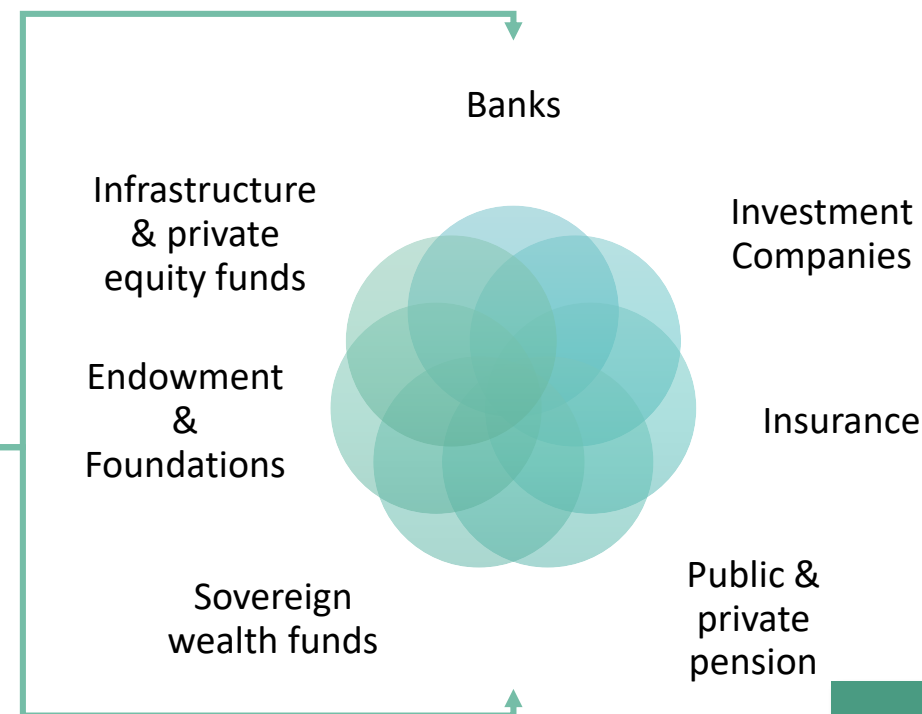


The world needs to invest \$3.3 trillion annually just to meet growth forecast by 2030

Find a way to attract more alternative financing sources

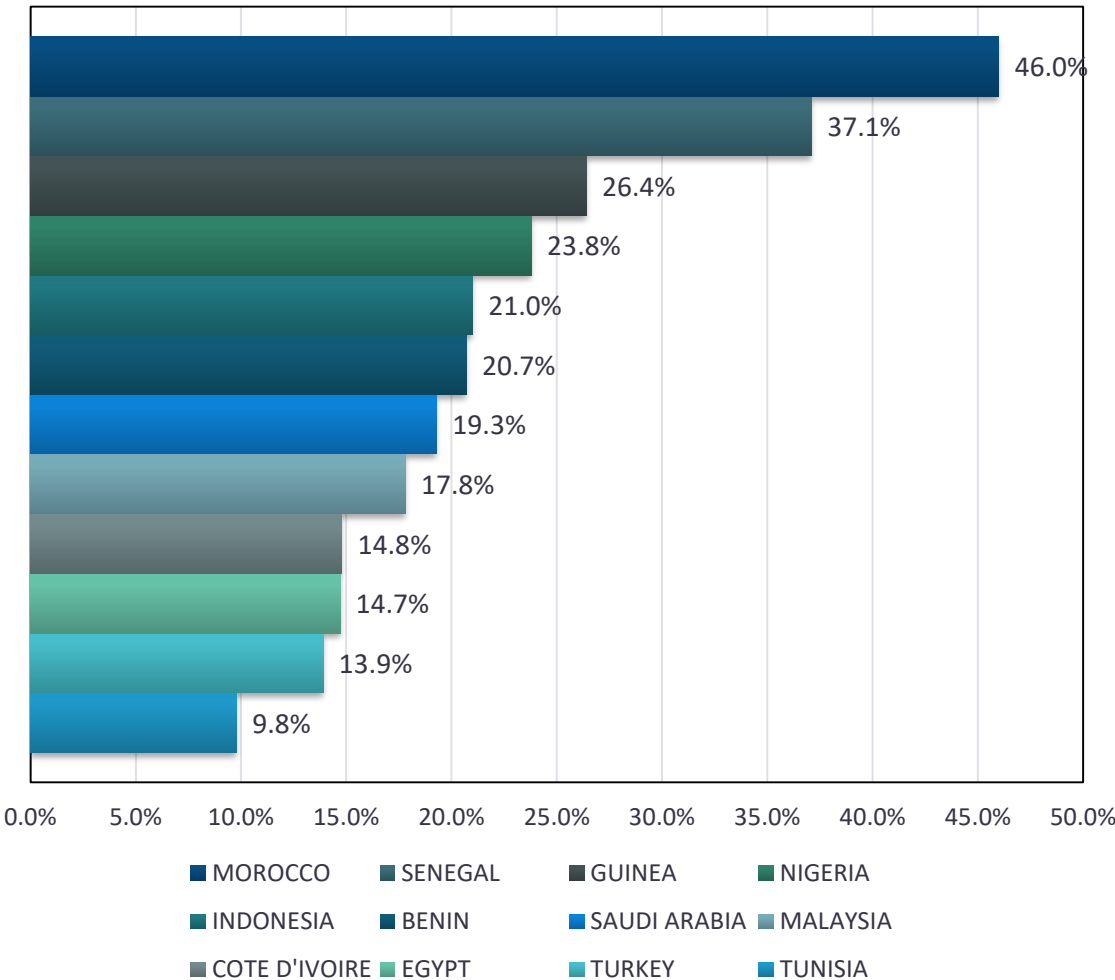


\$120 trillion funds under management of

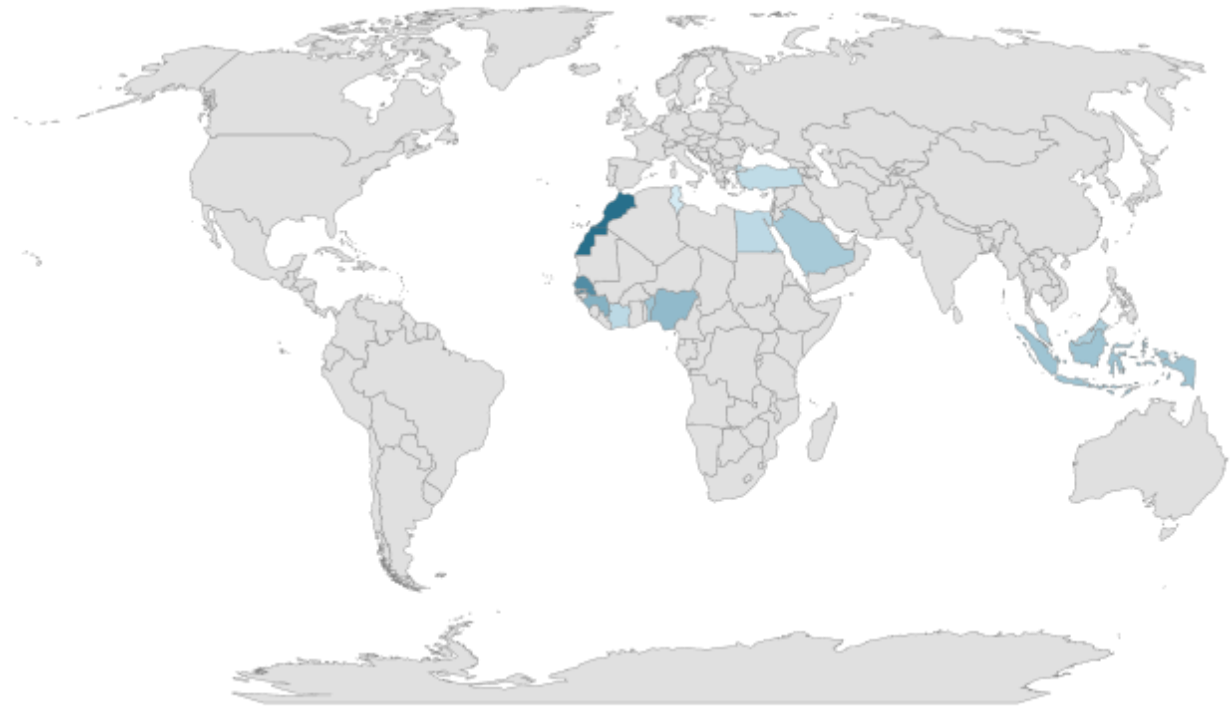


The State of Infrastructure Investment in OIC Member Countries varied from one to another

**Total Infrastructure Investments Contribution towards GDP
(Total Infrastructure Investment - %GDP)**



**Total Infrastructure Investments Contribution towards GDP
(% in Selected OIC Member Countries)**

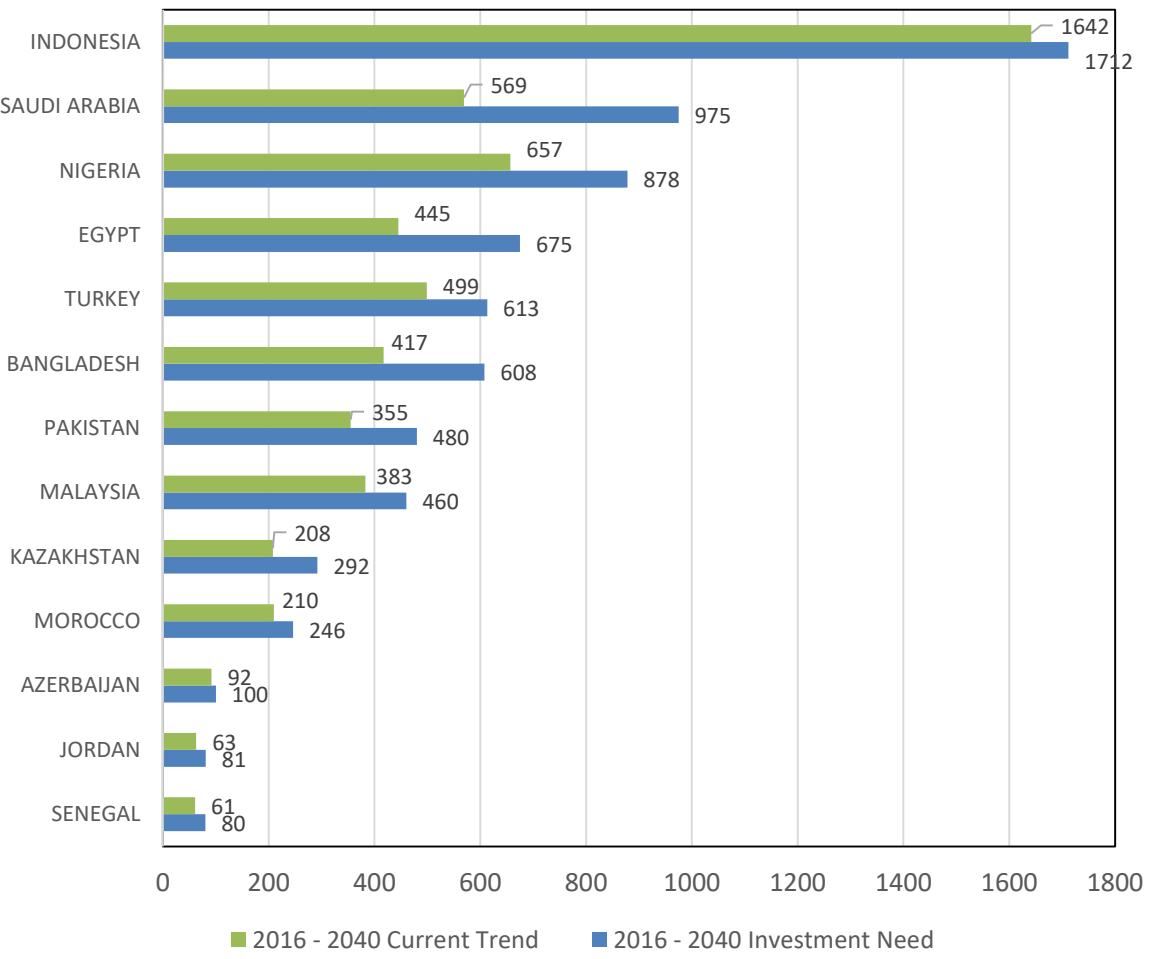


National Islamic Finance Committee

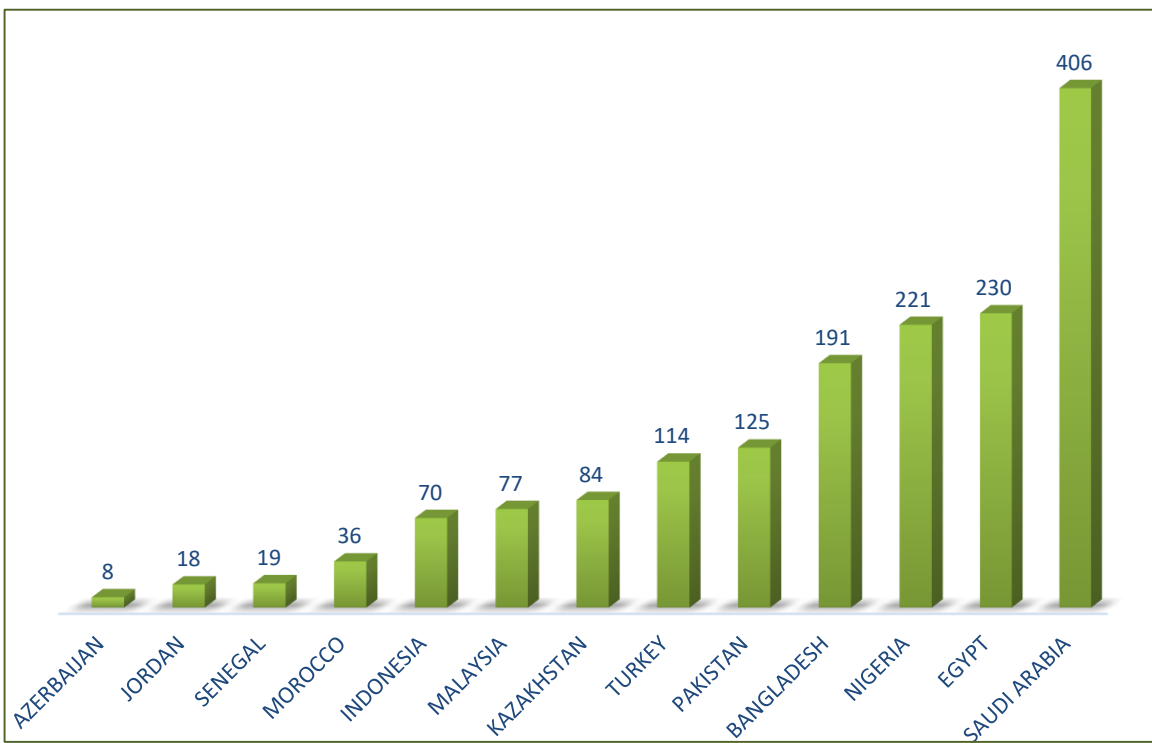
Source: https://infracompass.gihub.org/compare_countries. COMCEC OIC

Infrastructure spending needs and the funding gaps in several OIC Countries years ahead demonstrated the demands for more investments

Infrastructure Spending Needs 2016-2040 Cumulative in Selected OIC Countries (USD billion, 2015 prices and exchange rates)



Infrastructure Gap in Selected OIC Countries 2016-2040 (USD billion 2015 prices and exchange rates)



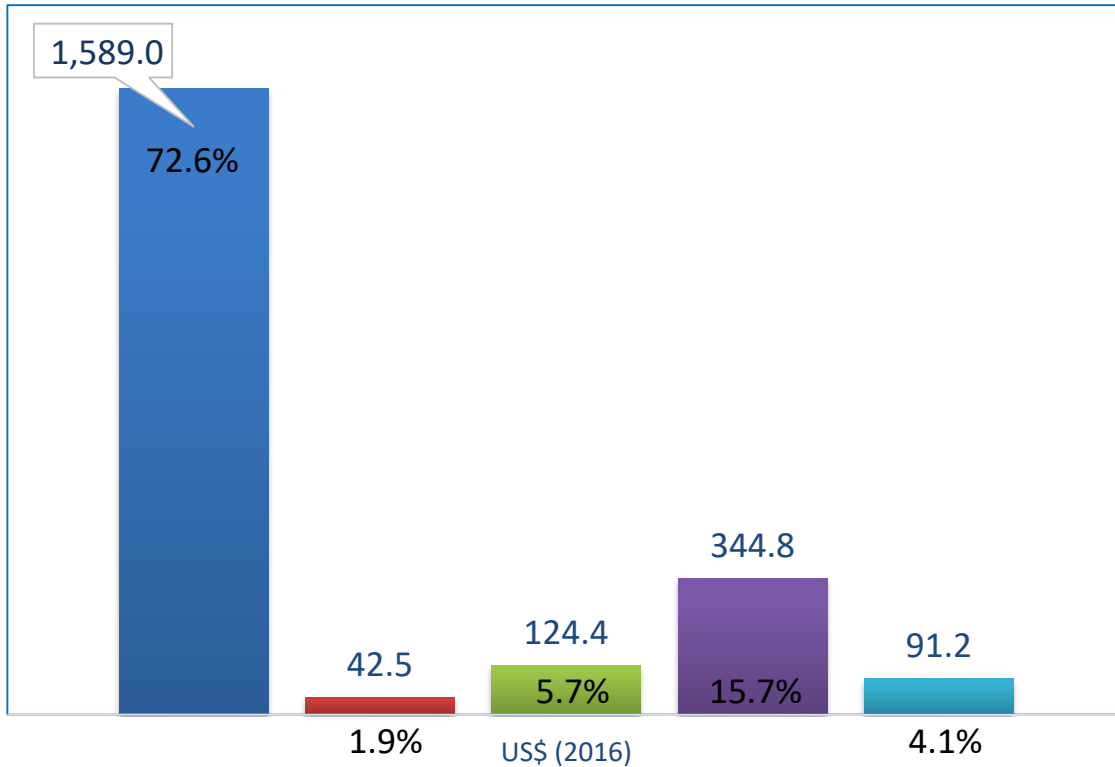
Total Investment Needs till 2040: US\$ 7,200

Total Infrastructure Gap till 2040: US\$ 1,599

Source: GIH and Oxford Economics (2018), Global Infrastructure Outlook, Infrastructure investment needs 50 countries, 7 sectors to 2040. COMCEC OIC

Global Islamic Financial Sectors Size (USD billion & Percentage)

■ Islamic Banking ■ Takaful ■ Other IFIs ■ Sukuk ■ Islamic Funds



Total Value of Islamic Financial Industry: US\$ 2,438 billion

Total Islamic Finance Investments in Infrastructure Sector (2017-2018, USD Billion)

Sectors	Total assets (USD billions)	Percentage going to Infrastructure	Infrastructure Investments by Islamic Finance (USD Billion)
Islamic Banking	1,598.90	4.74%	75.8
Takaful	42.5	2.00%	0.9
Sukuk	344.8	11.57%	39.9
IDB Project Financing			3.12
Total			119.7

- 01** The need for infrastructure development
- 02** Islamic Finance and Infrastructure Financing
- 03** Funding Infrastructure through Islamic Finance: Case of Indonesia

Komite Nasional Keuangan Syariah

02 Islamic Finance and Infrastructure Financing

Principles of Islamic Finance

Returns should be linked to the profit/earnings and derived from commercial risk taken by financier

Islamic financiers become partners in the project

Transactions should be free from speculation or gambling (*maysir*)

Existence of uncertainty in a contract is prohibited

Investment relating to prohibited goods and activities are not permitted

Infrastructure Project

Infrastructure projects allow risk to be shared among the parties involved in the project, including financiers (in PPP)

Infrastructure projects allow Islamic financiers to become a party to the project, not only as a lender

Infrastructure projects, by nature, should be free from speculation or gambling

Project contracts are generally well defined with certainty

Infrastructure projects mainly exclude the areas of the prohibited goods

Islamic finance contracts vis-à-vis conventional for infrastructure financing

Islamic Finance Contracts for Project Financing

Musharakah

- Partnership financing method in which all parties jointly contribute and bear losses

Mudarabah

- Profit and loss sharing-contract based

Istisna

- Manufacture or build assets based on terms specified by the buyer, at agreed price, within a certain time

Ijara

- A lease for a specific rent for a specific period

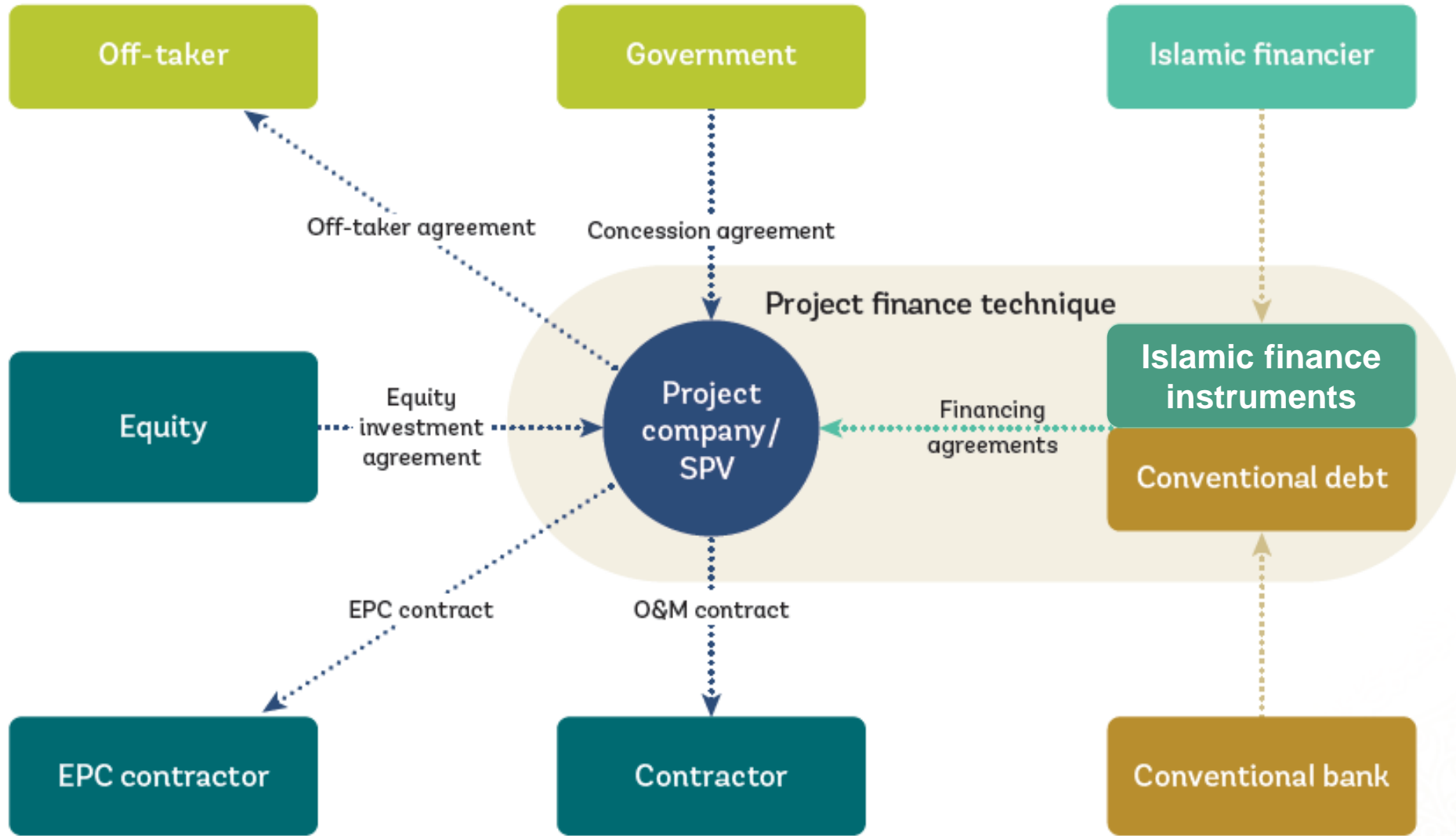
Wakala

- Agency contract whereby a principal appoints an agent to perform an act on its behalf

Conventional and Islamic Finance Contracts for Infrastructure Financing

Contract Categories	Conventional Finance	Islamic Finance
Equity	Equity provided by sponsors (ownership shares in the SPV)	Equity provided by sponsors (ownership shares in the SPV) —can take the form of <i>musharakah</i> or <i>mudarabah</i>
	Infrastructure Equity funds	Infrastructure equity funds—the fund manager works as an agent (<i>wakil</i>) to manage the funds
Debt	Loans with interest Interest-based bonds	Sale-based instruments (<i>murabahah</i> and <i>istisna</i>)
Hybrid	Various structures such as convertible bonds, preferred shares, mezzanine financing, etc.	While certain features such as convertibility of debt to equity are allowed, other structures such as preferred shares are not permissible. Structures combining various contracts such as <i>istisna-ijarah</i> , <i>wakala-ijarah</i> , etc.

Project financing and implementation of Islamic finance contracts for Infrastructure PPP Projects



Note: EPC = engineering, procurement, and construction; SPV = special purpose vehicle; O&M = operations and maintenance

Possible challenges of Islamic project financing implementation in infrastructure projects

01

Understanding of Islamic financial transactions (contracts, shariah structure & compliance)

02

Financial institution capability in conducting project finance

03

Investor behavior and characteristics (risk and return appetite)

04

Government policies and regulations

05

Government support, guarantee and commitment (incl. incentives and level playing field for Islamic finance-related projects)

06

Mismatch in the duration between Islamic finance transaction maturity and infrastructure project financing need

07

Project preparation and readiness (Feasibility studies)

08

Financing scheme and process

09

Understanding of infrastructure project financing

10

Cost of Islamic finance fund (source of fund)

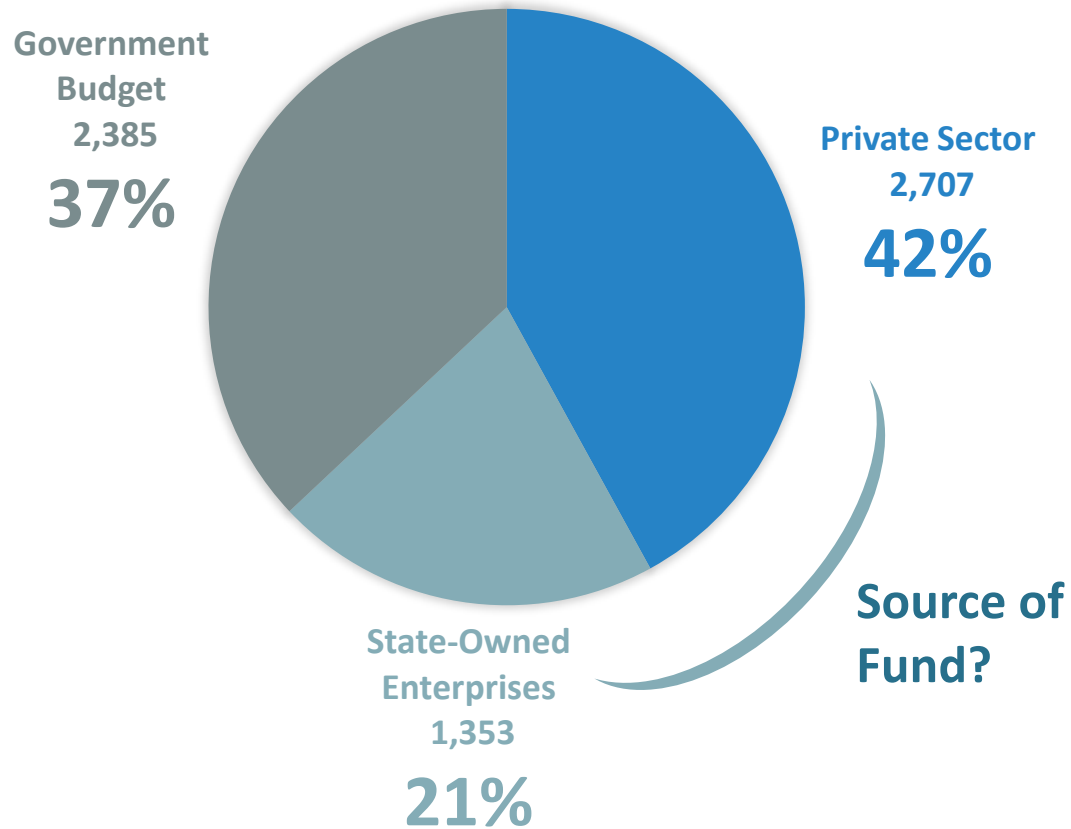
- 01** The need for infrastructure development
- 02** Islamic Finance and Infrastructure Financing
- 03** Funding Infrastructure through Islamic Finance: Case of Indonesia

Komite Nasional Keuangan Syariah

03 Funding Infrastructure through Islamic Finance: Case of Indonesia

INVESTMENT TARGET 2020-2024

Rp6.445 trillion
(trillion Rp)



ISSUES



Insufficient state and regional budget



Lack of managerial skills of project owner

Current issue in State-owned Companies



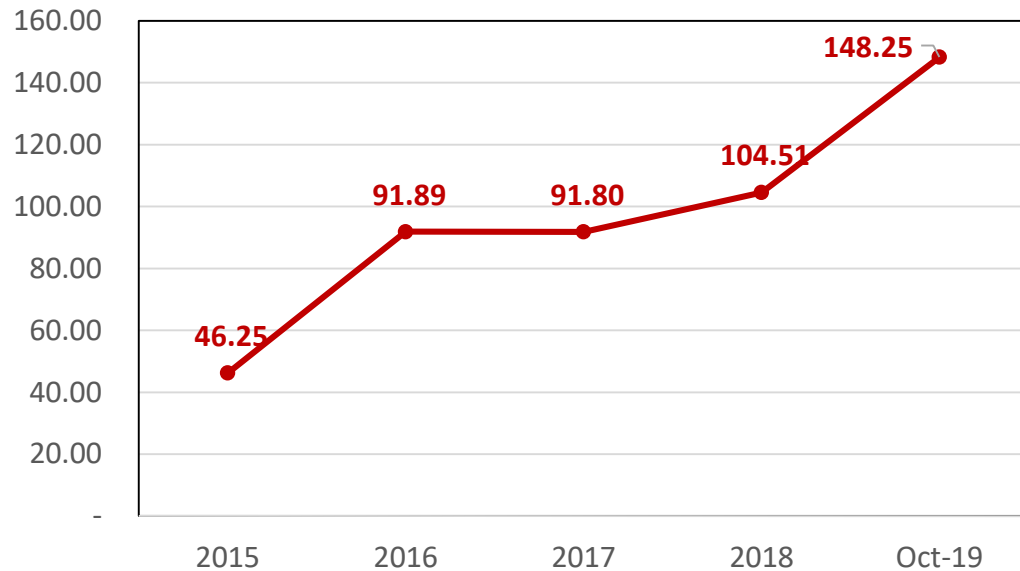
Increasing level of government debt



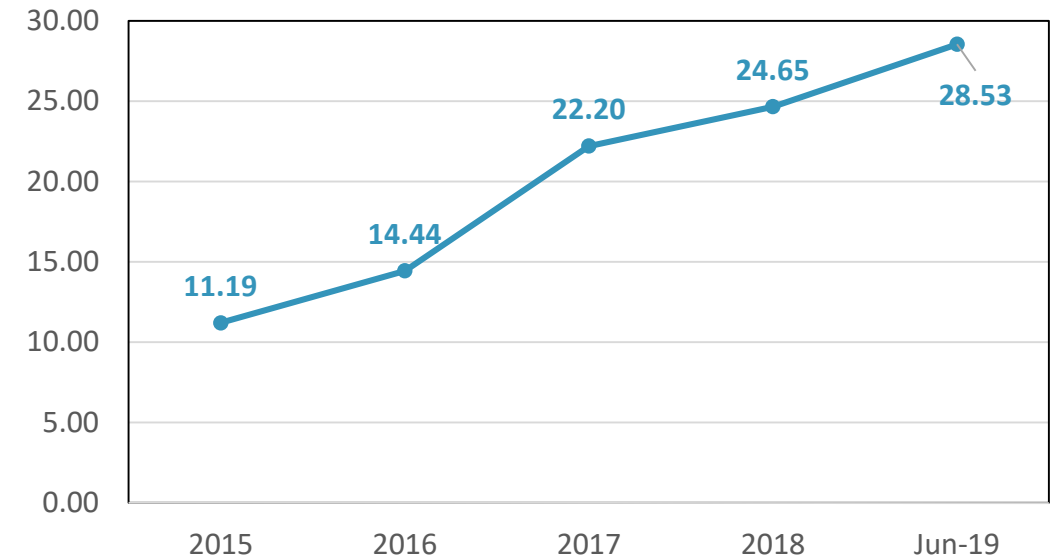
Increasing debt to equity ratio of the industry

Infrastructure financing from Islamic financial institutions

**Surat Berharga Syariah Negara (SBSN)
Project Based Sukuk Issuance
(trillion Rp)**



**Financing to Construction Sector by Indonesia's
Islamic Banking Industry
(trillion Rp)**

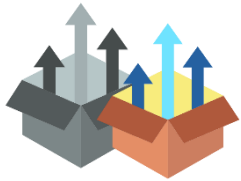


**Infrastructure financing from Islamic banking and capital market is increasing.
However, the size of infrastructure financing from Islamic bank in Indonesia is lower than Islamic capital market (Sukuk).**

ADVANTAGES



Public demand for sharia compliant transaction is increasing



Uniqueness of sharia compliant products that could address specific financial requirements and financing diversification



Several support and incentives from the government have been given to the Islamic finance industry



Investor diversification from local and international

SUPPORTING FACTS

- **Anti Riba Movements**
- **Critics on Debt**

- **Partnership**
- **Sale and Lease Back**
- **True Sale**
- **Blended Finance**

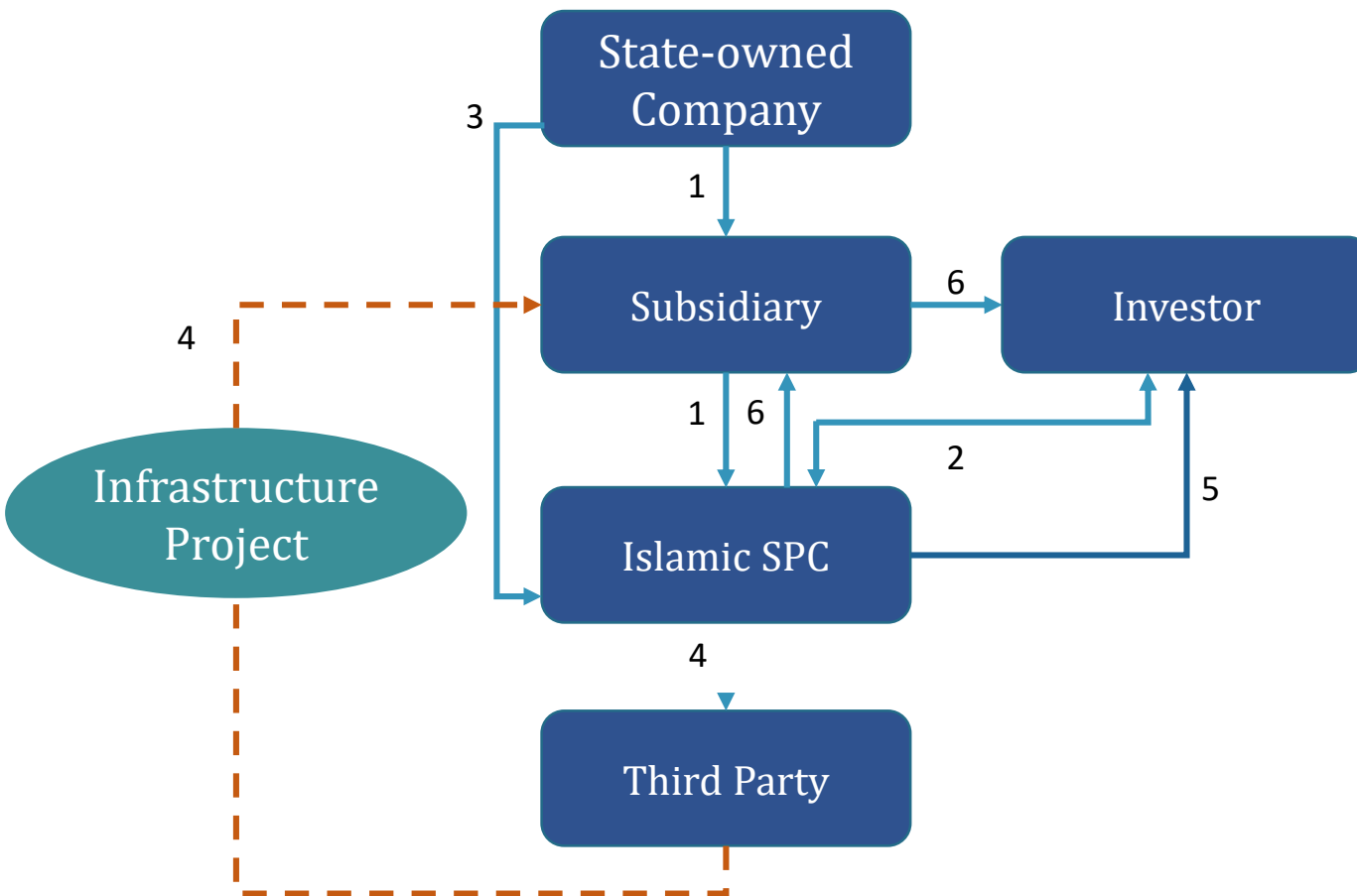
- **Tax incentives on murabahah financing transactions**
- **Lower cap of sukuk issuance fee**

- **Listed in sharia index stocks**
- **Wider access to Middle-Eastern/Islamic investors**
- **Wider access to green/impact investors**

Implication of Islamic financing schemes on Public Private Partnership

Unlike in conventional system where the price of lending money is interest rate, in Islamic financial system, money is not treated as a priced commodity. Every transaction should have real underlying assets and the contracts/*aqad* used are specialized based on the transaction characteristics.

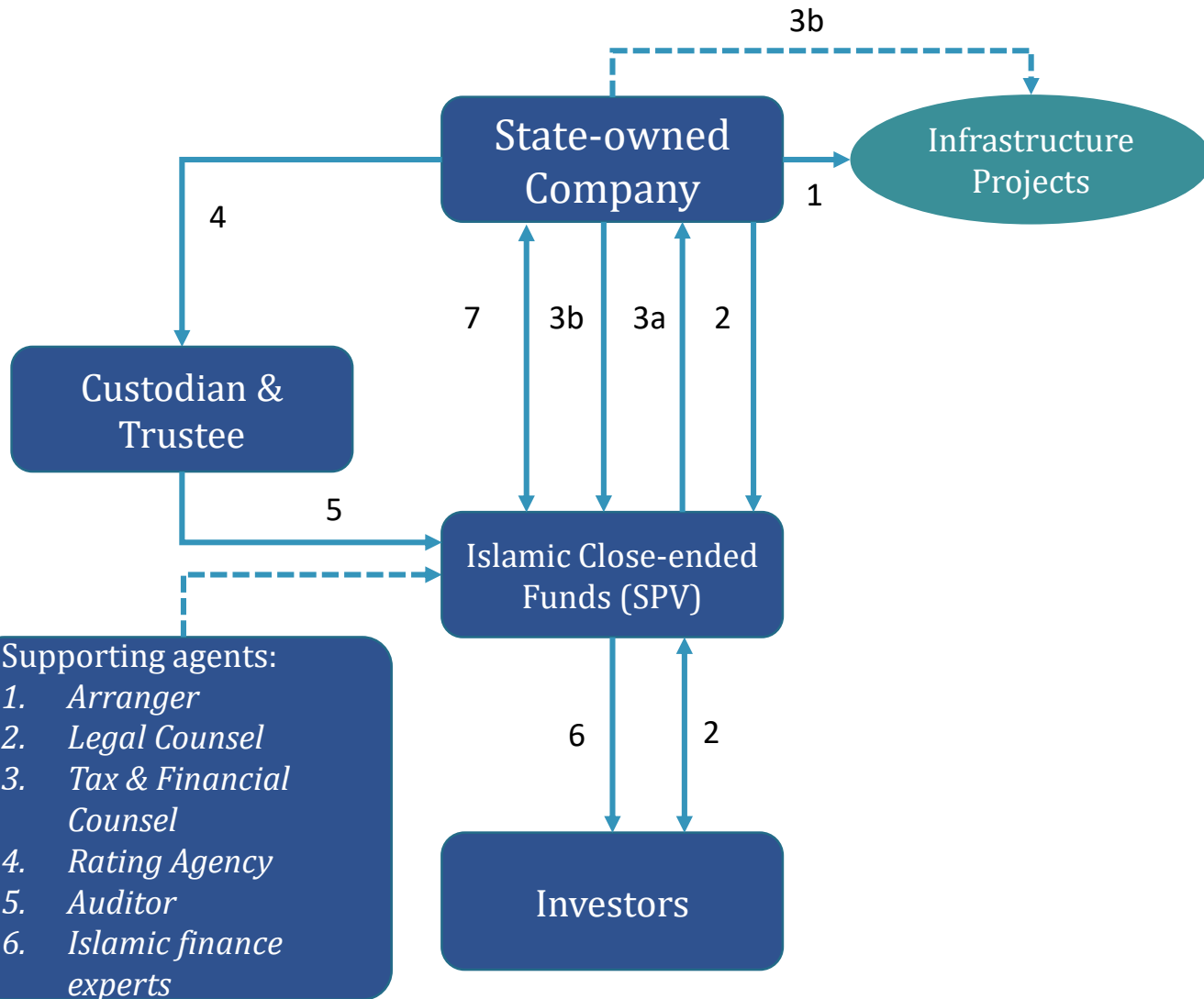
	Conventional Loan	<i>Murabahah</i> and <i>Istishna</i> financing (Sales contract)	<i>Mudharabah</i> and <i>Musyarakah</i> financing (Partnership contract)	<i>Ijarah</i> financing (Leasing contract)
Business model	Loan/credit	Bank/financier builds the asset (eg. housing, infrastructure projects) before transferring the ownership to the government/private sector entity. After the construction, the asset could be refinanced through KIK EBA	Bank/financier and the private sector entity will establish a partnership to build the asset.	Leasing of assets with purchase options (eg. housing, infrastructure projects)
Accounting treatment	Bank records interest income and asset Customer records interest expense and liability	Bank/financier book the asset as inventory (including during construction) before selling it to government/private sector entity. Customer do not need to book the asset before the purchase and after the purchase it could be securitized (off balance sheet)	Asset during construction will be booked as inventory by the bank. After the construction, the asset could be refinanced through KIK EBA so Badan Usaha do not need to book as liability	Assets are booked by lessor (bank/financier). Lessee (government/private sector entity) records rental expense in income statement, not booked as a liability
Taxation	Refer to accounting treatment	No VAT charged in asset ownership transfer in <i>murabahah</i> financing	Income tax for investors of profit and loss sharing product is lower than income tax for deposit investors	No VAT charged in rental payments and sale of assets at the end of leasing period



1. Establishment of an Islamic Special Purpose Company (SPC).
2. The Islamic SPC issue Sukuk *Musharakah* to the investors, the proceeds recorded as the Temporary Shirkah Funds at the Islamic SPC.
3. The State-owned Company orders the project to the Islamic SPC with *Ijarah Maushufah Fi Dzimmah* – upfront leasing (in *Ijarah Muntahiyah Bi Tamlik-financial lease*) and pay the rent.
4. The Islamic SPC orders the construction of the project to the third party with *Istishna'*, and then the SPC delivers to the The State-owned Company.
5. The Islamic SPC disbursed the profit to the investors.
6. At the maturity, the Islamic SPC execute purchase undertaking of the investor's portion (the principal).

Note: SPC = Special Purpose Company

Islamic Close-ended Funds as an alternative source of infrastructure project financing (for State-owned Companies)



- 1 :** Project identification by the state-owned company (originator) as the underlying for the issuance of Islamic close-ended funds
- 2 :** Appoint Asset Manager to create Islamic close-ended funds (specified for infrastructure; based on the underlying project; inviting investor's participation,
- 3a :** The funds disburse the collected proceeds to the the state-owned companies .
- 3b :** The state-owned company or their subsidiary issue common shares to the funds.
- 4 :** Paying out dividen to the Custodian & Trustee.
- 5 :** the Custodian & Trustee deliver dividen to the funds.
- 6 :** The funds disburse to the investors.
- 7 :** At the time of funds dissolvent, the originator undertake shares' buyback *at par*.

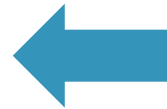
Islamic Bank's balance sheet illustration when implementing SRIA for Islamic PPP

Islamic Banks

Assets	Liabilities
Cash	Deposits
Financing	<i>Profit-Sharing Investment Account (PSIA)</i>
Underlying Asset SRIA (Specific Financing)	Investment Account SRIA
Other Assets	Equity
Total Asset	Total Liabilities and Equity



Islamic Public Private Partnership



Global Investors



Islamic PPP Guarantee Facilitator



Government Guarantee



PT Penjaminan Infrastruktur Indonesia



The Islamic Corporation for the Insurance of Investment and Export Credit

Islamic financial industry is relatively new and still facing various challenges

However, it has a huge potential in contributing to Indonesia's infrastructure development

Government of Indonesia continues to encourage Islamic financial industry's contribution to infrastructure development

We are open to collaborate with various stakeholders with relevant expertise and interest in supporting infrastructure development through Islamic finance

Thank You

