STRUCTURING INNOVATIVE SUKUK FOR INFRASTRUCTURE FINANCING

1ST ANNUAL ISLAMIC FINANCE CONFERENCE:
SUKUK FOR INFRASTRUCTURE FINANCING AND FINANCIAL INCLUSION STRATEGY

17 MAY 2016
JAKARTA, REPUBLIC OF INDONESIA

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Menteri Keuangan, Republik Indonesia
Islamic Development Bank
Other Generous Sponsors
• Consider select issues relating to issuance of innovative sukuk for infrastructure financing.

• Two areas of focus:
  • Private sector issuances.
  • Fundamentals of infrastructure finance.

• Synergy point: use infrastructure finance innovations to assist in the development of other aspects of sukuk markets.
INNOVATION FOR AN EXISTING SUCCESS STORY?

• Remarks today relate to innovation – to change – to an area of Islamic finance that must be characterized as an existing “success story”.

• The growth in sukuk issuances since 2002, and throughout the economic downturn, has been inspiring.

<table>
<thead>
<tr>
<th>Total Global Sukuk Issuances</th>
</tr>
</thead>
<tbody>
<tr>
<td>2002-2008 (November 7)</td>
</tr>
<tr>
<td>2009</td>
</tr>
<tr>
<td>2014</td>
</tr>
</tbody>
</table>
2014 Total Global Issuances

<table>
<thead>
<tr>
<th>Issuer</th>
<th>Percentage</th>
</tr>
</thead>
<tbody>
<tr>
<td>Sovereign</td>
<td>67%</td>
</tr>
<tr>
<td>Quasi-Sovereign</td>
<td>16%</td>
</tr>
<tr>
<td>Corporate</td>
<td>22%</td>
</tr>
</tbody>
</table>

Are these allocations credible?

Source: Zawya Islamic Sukuk Quarterly Bulletin, Issue 20, Q4 2013
## SECTORS - INFRASTRUCTURE

<table>
<thead>
<tr>
<th>Sector</th>
<th>Percent in 2014 (rounded)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Governmental</td>
<td>46</td>
</tr>
<tr>
<td>Financial Services</td>
<td>18</td>
</tr>
<tr>
<td>Transport</td>
<td>12</td>
</tr>
<tr>
<td>Telecommunications</td>
<td>10</td>
</tr>
<tr>
<td>Power and Utilities</td>
<td>5</td>
</tr>
<tr>
<td>Construction</td>
<td>4</td>
</tr>
<tr>
<td>Real Estate</td>
<td>4</td>
</tr>
<tr>
<td>Other</td>
<td>2</td>
</tr>
</tbody>
</table>

Source: Zawya Islamic Sukuk Quarterly Bulletin, Issue 20, Q4 2013

**Are these allocations meaningful?**
What drove this shift in issuances?

Increase in murabaha issuances seems to correlate with sovereign infrastructure financing. Need to explore further.

### SHARI‘AH STRUCTURES

<table>
<thead>
<tr>
<th>Structure</th>
<th>Percent in 2014 (rounded)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Murabaha</td>
<td>59</td>
</tr>
<tr>
<td>Murabaha – Mudaraba</td>
<td>3</td>
</tr>
<tr>
<td>Murabaha - Musharaka</td>
<td>1</td>
</tr>
<tr>
<td>Murabaha - Musharaka</td>
<td>63</td>
</tr>
<tr>
<td>Ijara</td>
<td>11</td>
</tr>
<tr>
<td>Musharaka</td>
<td>10</td>
</tr>
<tr>
<td>Bai Bithaman Ajil</td>
<td>8</td>
</tr>
<tr>
<td>Wakala</td>
<td>3</td>
</tr>
<tr>
<td>Al-Istithmar</td>
<td>4</td>
</tr>
<tr>
<td>I Wakala-Bel-Istithmar</td>
<td>1</td>
</tr>
<tr>
<td>Salam</td>
<td>1</td>
</tr>
<tr>
<td>Mudaraba</td>
<td>1</td>
</tr>
</tbody>
</table>

Source: Zawya Islamic Sukuk Quarterly Bulletin, Issue 20, Q4 2013
GAPS IN THE SUCCESS STORY

• Those statistics are both reassuring and disquieting.
  • Much progress has been made, to be sure.

• But these statistics also point to some gaps in the sukuk story, to areas in which we have made insufficient progress.
CONCLUSIONS FROM STATISTICS

• Significant **under-reporting of “sovereign” credit.**

• Focus should be the **ultimate credit**, not issuer identity.
  - Designation as a “corporate” issuance, tells us nothing of who owns the corporate or what the ultimate credit is. Corporate leases or sales to a sovereign?

• **Government share of risk is too high**: adverse effects on private sector.

• **Sukuk al-murabaha issuances increased** dramatically.

• Are we **favoring convenience over correspondence to underlying fundamentals of infrastructure finance?**
• Why are there so few private sector issuances?
• What matters need to be addressed?
WHY NO RATED PRIVATE SECTOR CREDITS?

• Private sector issuances cannot be easily rated.

• Of the five key rating categories, the most significant in terms of precluding ratings are legal and regulatory.
  • Special purpose vehicles: difficulties in formation and ensuring bankruptcy remoteness.
  • Bankruptcy and insolvency: true sale; substantive consolidation.
  • Collateral security.
  • Systemic legal factors and mechanisms.
  • OIC jurisdictions: not possible to get satisfactory legal opinions, which means no ratings.
TRUE SALE

• Transfer of the securitized assets from the asset originator to the SPV issuer: is this really a “true sale”?
  • If yes: creditors of the asset originator cannot reach the transferred assets in a bankruptcy of the asset originator.
  • If no: creditors of the asset originator will reach the transferred assets; sukuk holders deprived of cash flows and assets.

• No (or exceedingly few) sukuk satisfy true sale requirements: repurchase obligations; rights of originator in residual value; etc.

• Result: no ratings.
COLLATERAL SECURITY

- Some, if not most, sukuk transactions involve collateral security interests.
  - Sometimes the cost of transferring the assets (title) is prohibitive (fees, taxes, notification costs, other costs and expenses, type of property, etc), and a security interest structure is the only realistic structure.
  - Other times, collateral security laws are mandatorily applicable to the assets.
    - In most OIC jurisdictions, it is difficult, if not impossible, to say that the security interests are “first prior perfected security interests”.
  - Result: no rating.
REFORM IS ESSENTIAL

• **Substantive legal reform and systemic reform** is necessary with respect to all the aforementioned factors.

• **Islamic finance should take the lead**; shape the outcome from inception rather than making piecemeal amendments to principles designed for interest-based finance.
  - **Examples**: UNCITRAL, World Bank, EBRD and IFC initiatives in the areas of collateral security and bankruptcy.

• **Suggestion**: Sukuk issuances on assets in jurisdictions that do not have these infirmities (e.g., the US) to build the markets (primary and secondary) and participation with non-Islamic institutions.
• Why are governments involved?

• What risks are to be allocated and how?

• What sectors will take risks and finance?

• What techniques are appropriate and will be used?
WHAT IS INFRASTRUCTURE FINANCE?

• Finance of ownership, design, construction, operation and maintenance of large capital-intensive enabling assets: assets with some public purpose.

• Often monopolistic, single-purpose (single-location) assets.
  • Electricity.
  • Transportation.
  • Telecommunication.
  • Water.
  • Oil and gas.
  • Petrochemicals.
  • Mining.
  • Other natural resources.

• Roads.
• Bridges and tunnels.
• Airports.
• Railways.
• Other transportation.
• Waste water and sewage.
• Hospitals and health care.
• Schools.
FINANCING CHARACTERISTICS

• Large, capital intensive projects.
• Cash flows necessitate long tenors for payout.
• Expropriation risks are high.
• Post-closing renegotiations are commonplace (incomplete contracts).
• Banks are reluctant to finance infrastructure.
WHY AND WHO?

• Three critical, and interrelated, inquiries in determining when and how to innovate, particularly as to risk allocations:

  • **Why** is the infrastructure project being financed in a particular manner? What is the **motivation**?

  • **Who owns** and **who operates** the infrastructure project, and what blends of ownership and operation risks are appropriate for a given project?

  • **Who finances** the infrastructure project?
• The answers to those questions determine:
  • **Objectives** of structure.
  • **Risk allocations and participations** among participants.
  • **Financing structure**, including:
    • Capital elements.
    • Organizational elements.
    • Contractual elements.
WHY?

- Government Motivations:
  - Enhance public services?
  - Accelerate economic growth?
  - Supplement revenues?
  - Achieve cost efficiencies?
  - Political considerations?
  - Fiscal rule constraints?
  - Accounting considerations?
  - Other non-economic considerations?

- Many of these factors introduce economic inefficiencies.
  - Neither good nor bad; but must be recognized and accommodated.
WHO OWNS AND WHO OPERATES?

• Who owns and who operates?
• How much regulation and how much outsourcing?
  • These questions must be separately analyzed.
  • Depends upon the “why”.
• Government.
• Public sector - private sector combinations.
• Private sector.
WHO FINANCES?

• What sector(s) will take risks and finance?
  • Depends upon the “why” and “who” answers.
  • Government.
  • Private corporate.
  • Mixed: public-private partnerships (PPP).
  • Project finance: a structural methodology.
DISTINCT CONCEPTS FOR INFRASTRUCTURE

• **Infrastructure**: defined by asset type.

• **Project finance**: defined by the degree of recourse available to the financiers.

• **PPPs** (public private partnerships): defined by the entities involved (public and private) in sharing project risks.

• Some, not all, infrastructure projects are project financed.

• Some, not all, infrastructure projects involve PPPs.

• Some, not all, project financings involve infrastructure.

• Some, not all, PPPs involve infrastructure.
Project finance is **financing** of an economic unit in which the **lenders/financiers** look to:

- **operational cash flows**, and
- **collateral** (cash flows and project assets).

Defined from financier/lender vantage.

- Isolate risks and then **reallocate** risks:
  - greater efficiency and certainty.
PROJECT FINANCING OF INFRASTRUCTURE

• Collateral availability importance increases where asset is a monopolistic public good - infrastructure.
  • Cannot move the asset.
  • Monopolistic off-taker.
  • Limited operators.
  • Political risks (expropriation, direct and creeping).

• Must structure remedies that allow collateral realization.
WHAT IS A PUBLIC-PRIVATE PARTNERSHIP?

• Many (and diverse) definitions and conceptions.

• Generally:
  • collaboration between public and private sectors,
  • with risk sharing as between each sector.
MOTIVES, INVOLVEMENTS, RISK ALLOCATIONS

• Motivations and involvements influence risk allocations.

• Consider the fundamental elements:
  • **Operational** elements: who has operational risks for design, construction, operation, management, maintenance, etc.?
  • **Ownership** elements: who has ownership risks at each stage?
  • **Regulation** motives: government control, decision-making and cash-flow rights.
  • **Outsourcing** motives: private investor gets control, decision-making and fees and/or profit sharing.
  • **Incentives/disincentives relative to each.**
WHO - ULTIMATELY – PAYS?

• **Who, ultimately, pays** for the infrastructure project?
  • The public?
    • Taxpayers? Which taxpayers?
  • The private sector?
    • Users?

• **And how do they pay?**
  • Broad-based taxation?
  • Targeted taxation of groups or geographies?
  • General fees?
  • Direct usage fees?
  • Tariffs?
STRUCTURES

• Analysis of these factors will determine much of the structure:
  • Government build and operate
  • Concession: private build and operate
  • Public-private partnerships rubric encompasses, among others:
    • Build, own, operate, transfer (BOOT) or design, build, finance, operate (DBF))
    • Build, operate, transfer (BOT)
    • Build, own, operate (BOO)
    • Build, lease, transfer (BLT), or design, build, operate, maintain (DBOM)
    • Build, transfer, operate (BTO)
  • These are all quite different in terms of risk allocations.
  • These all use Shariʿah-compliant contracts.
PRIVATE RISK PROGRESSION

Public Private Partnerships

- Works and Service Contracts
- Management and O&M Contracts
- Leases; Affermage Agreements
- Concessions, BOT, BLT, BOOT, DBFO(T)
- Joint Ventures, Divestitures and Privatizations

Private Sector Risk

Generalized progression: each structure can vary significantly depending upon structure and negotiated terms.
Ownership and Operational Risk

Ownership – Operation Risks

- Divestiture
- Joint Venture
- BOOT, DBFOT
- Concession
- BLT
- BOT
- DBFO
- Leases
- Affermage Contracts
- O&M Contracts
- Management Contracts
- Service Contracts
- Corporatization

Generalized progression: each structure can vary significantly depending upon structure and negotiated terms.
RISK-REWARD CONTINUUM

Generalized progression: each structure can vary significantly depending upon structure and negotiated terms.
CONCLUSION
OPPORTUNITIES EXIST
CONCLUSION

• Structure to infrastructure finance fundamentals and focus on deliberate risk allocations.
  • Motivations – why
  • Distribution of ownership and operational risks - who
  • Transactional involvements - who

• Move to development of private sector issuances.

• Take the lead in fundamental structural reforms:
  • SPVs
  • Bankruptcy and insolvency
  • Collateral security
  • Systemic legal structure and functioning.
SUGGESTION: DATA AND STATISTICS

• Our data and statistics are a significant limitation on our ability to innovate and progress.

• Classification schemes (for all categories) are poorly defined and inconsistent.

• The data and statistics are:
  • not publicly available.
  • not rigorous or consistent.
  • not transparent.
  • lacking in inter-correlative depth.

• Must improve our classification, collection, management and dissemination in every regard.
MUCH ADO ABOUT NOTHING ... BASED OR BACKED

• In Islamic finance: much ado about whether an arrangement is “asset backed” or “asset based”.

• My view: much of that discussion is misinformed and misguided: further, more nuanced, consideration is needed.

• For a transaction that is not a true sale, but is subject to a first prior perfected security interest, the asset transfer is delayed pending default or another trigger event.

• Asset-based then becomes asset-backed.

• A strong first prior perfected security interest may transfer essentially all indicia of ownership even before asset transfer.
THANK YOU