Mobilizing Islamic Finance for Long Term Financing: Lessons From Conventional Finance
The Context: Gaps in long term finance

**Infrastructure**
- Financing gap estimated at USD $1 - 1.5 trillion of annual investment in low income and middle income countries to 2020

**Housing**
- While mortgage depth averaged 40% in high income countries, it averaged 5%-10% for middle income and less than 1% for most low income countries

• Traditional funding sources will not be able to fill this gap
  - EMEs governments have fiscal constraints
  - There are also concerns that long term finance could be affected by the implementation of Basel requirements (for some EMEs changes in Basel II, while the larger are also expected to implement Basel III). However, is still early to assess.
The context

- Institutional investors in EMEs are growing rapidly
- However, growth has not been even across region and countries within regions

Source: Official sources and J.P. Morgan
The context

- Sovereign Wealth Funds (SWFs) held roughly US$ 6.3 trillion in assets under management (AUM) as of March 2015.
- Funds based in Asia and the MENA regions represent almost 80 percent of total AUM, and almost half of all SWFs worldwide

Source: Preqin
The opportunity

Theoretically infrastructure investment matches the profile of institutional investors (*):

• It matches the long term duration of pension and insurance companies’ liabilities and provides duration hedging.
• It provides attractive yields in excess of those obtained in the fixed income market although with potentially higher volatility.
• Investments in infrastructure assets linked to inflation could hedge pension fund liabilities that are also linked to inflation.

WBG-IMF-OECD Report to the G20 on “Capital Market Instruments to Mobilize Institutional Investors to Infrastructure and SME Financing in Emerging Markets” provides an overview:

• of current size and importance of institutional investors in EMEs
• Their current level of investment in infrastructure,
• their investment potential, and
• key challenges and recommendations to realize such potential.

* Presentation focuses on “traditional” institutional investors in EMEs; however many observations are also applicable to SWFs
Institutional investors’ investment in infrastructure: Key observations

Current investment is very limited

- Average of 1% of AuM in industrialized countries; much less in EMEs (in both cases with exceptions)
- But increased attention/interest from institutional investors in both industrialized and EMEs in infrastructure investment in EMEs

Different vehicles are being used

- Majority of the investment done via listed companies and fixed income products
- But investment through unlisted instruments, mainly equity, has increased over time
  - Most investments done through unlisted equity funds
  - Only largest institutional investors use direct investment and co-investment
- After the crisis, more interest in debt instruments (both project bonds and debt funds)

In general appetite focuses on “high-quality” investments

- Mostly brownfield
- Highly rated securities (for fixed income products)
Factors affecting their appetite: Demand side

<table>
<thead>
<tr>
<th>Liability structure and mandate</th>
<th>Constraints on the regulatory front</th>
<th>Capacity issues</th>
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</table>
| • This largely explains focus on brownfield, given higher uncertainty of construction risks in greenfield investment | • Rigid investment limits and sometimes prohibitions to invest in certain asset classes (equity, alternative assets, etc)  
• In the case of pension funds, sometimes provisions that require them to guarantee a minimum return, have been a disincentive for long term investment  
• For insurance companies, potentially solvency requirements can affect | • Many have limited in-house capacity to analyze risks beyond financial risks (i.e. construction risks)  
• Or to analyze complex products (i.e. effects of tranching on rights) |


Factors affecting their appetite: Supply side

<table>
<thead>
<tr>
<th>Lack of high quality assets in which to invest</th>
<th>Challenges in the frameworks for the instruments themselves</th>
<th>The economics of the transactions</th>
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<tbody>
<tr>
<td>• In most EMEs, main critique is the lack of a pipeline of investable projects</td>
<td>• In some countries, lack of robust securitization frameworks which underpin many fixed income products for infrastructure financing (project bonds but also sukuk); and sometimes also of frameworks for funds</td>
<td>• In many cases, to make investment attractive to the private sector the government would need to retain certain risks that in turn could affect the value for money</td>
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<td>• Compounded in many countries by problems on the PPP frameworks (legal, procedures, trust in the fairness of procedures) – these issues are mentioned as a key obstacle to invest in EMEs by foreign institutional investors</td>
<td>• In some countries, offering regimes do not adequately cater to institutional investors</td>
<td>• And/or credit enhancements would need to be included that could affect the overall costs of the transaction</td>
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<tr>
<td></td>
<td></td>
<td>• However, some costs might diminish overtime</td>
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Factors affecting their appetite: Mechanisms to align risk-return appetite

<table>
<thead>
<tr>
<th>The structures used</th>
<th>Risk sharing mechanisms</th>
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<tbody>
<tr>
<td>• Lack of simple, transparent and comparable structures</td>
<td>• In many countries, the fiscal position of governments affect their ability to provide credit enhancements and other risk-sharing mechanisms</td>
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</table>
Factors affecting their appetite: The enabling environment

In some countries, a lack of a robust enabling environment is the first stumbling block for institutional investment in infrastructure

- Macroeconomic stability
- Respect for the rule of law and investors’ rights
- Sound regulatory and supervisory regime for securities markets
- Deep and liquid markets (including a deep government yield curve to use as reference point for investment in fixed income instruments)
- Robust market infrastructure (including services such as credit rating agencies and research analysis)
- Taxation
Institutional investors’ investment in infrastructure: Key lessons so far

Bank lending remains a key source of infrastructure financing

- Bank lending remains better suited for greenfield financing due to the nature of risks involved (construction risk mainly) vis-à-vis the profile of institutional investors

But institutional investors can complement such funding

- Given the importance of greenfield in EMEs, the key will be in finding ways to use fixed income instruments as a vehicle to offload bank loans (take out facility) and free capital
- For brownfield, project bonds, infrastructure bonds and sukuk can already be used
- The development of guarantees and other risk sharing mechanisms will be key to align institutional investors’ appetite

The role of capital markets is greater in middle income countries

- Where an institutional investor base has already developed (including SWFs in MENA)
- And basic preconditions (macroeconomic stability, a well developed government bond market, etc) are in place
- But no pre-defined size
Key recommendations: Role of Governments

**Key leadership role**

- Developing policies and strategies to address infrastructure financing gap
- Ensuring public and private sector participation in the design of such strategies,
- Leading policy and institutional reforms
- Participating actively in the design of risk sharing mechanisms to align the risk-return appetite of institutional investors

**Key component is the development of actions plans to mobilize institutional investors**

- Ensure that plans are well articulated into a broader strategy for capital markets development
- Appoint a champion
- Constitute high level committee with representation from key stakeholders
- Make the plans public and report periodically on their progress
Key recommendations: Development of action plans

**Enabling environment**
- Continue to develop the government yield curve, and money markets
- Continue encouraging the development of basic market infrastructure and information related services
- Continue to ensure macroeconomic stability, a clear and stable tax framework, creditors’ rights and quality of regulation and supervision

**Supply**
- Continue to develop pipeline of “high quality” projects
- In tandem work on key underlying preconditions
  - Legal and institutional arrangements for public-private partnerships (PPPs), including bidding processes that allow for capital markets financing
  - Develop legal frameworks for the instruments; mainly securitization and funds
- Develop offering regime for institutional investors

**Demand side**
- Reform investment frameworks of institutional investors to (i) allow them to invest in alternative assets, and (ii) reform provisions that operate as a disincentive for long term investment such as performance benchmarks, and rules that allow changes between funds
- Impose strong risk management requirements and encourage capacity building
- Work on developing clear, simple and transparent structures
- Work on developing risk sharing mechanisms, including guarantees, under robust framework to ensure their sustainability

For low income the priority is on the enabling environment.

Middle income countries with a “robust” investor base should work in tandem to address both supply and demand side challenges to accelerate mobilization of institutional investors.
Key recommendations: Role of MDBs

MDBs should be able to provide integrated solutions to EMEs

Advisory services
  - Both capital markets issues (enabling environment, supply and demand side challenges)
  - As well as “sectoral” issues (such as the framework for PPPs in connection with infrastructure financing)

“Transaction” work, including designing risk sharing tools, and participating as investors in catalytic transactions
  - As part of such work they should continue to explore mechanisms to optimize use of both banking and capital market solutions
Country case: Colombia
Financing of toll roads

The Challenge

- A USD 26 bn pipeline of toll roads and other growing infrastructure needs
- Insufficient funding from domestic banks
- Shallow corporate bond market (5.6 % of GDP)
- Large but very concentrated pension fund industry:
  - USD 80 billion (20 % of GDP), 4 pension funds of which 2 hold 80 % of assets.
- High risk averse institutional demand below AA+
Country case: Colombia (con’t)

The Solution: A proactive set of coordinated policies

- Standardization of public-private partnership (PPP) contracts
- Changes to infrastructure fiscal support to toll road program
  - From 15 to 30 % availability payments in USD
  - More frequent payments to compensate for traffic shortfalls
- Capital markets support
  - Creation of a development bank, Financiera de Desarrollo Nacional (FDN), to support market-based financing solutions with emphasis on capital markets: guarantees, take out facilities
  - New regulations for the offering of issuances to institutional investors to make the offering more efficient
  - Policies to address current misalignment of incentives in pension fund regulation: including a review of minimum return rules and investment regulations
- WBG support included:
  - Supporting the infrastructure agency, Agencia Nacional de Infraestructura (ANI), in contract standardization and quality control of project structuring
  - Investment in equity of FDN by IFC
  - Supporting FDN in design of guarantees, standard project bonds and capacity building,
  - Supporting the financial supervisory agency, Superintendencia Financiera de Colombia (SFC) and the Ministry of Finance on the development of a set of regulation including regulations for the offering regime, regulations for mutual funds and project finance regulations.
Country case
South Africa: Pilot initiative in renewable energy sector

The Challenge

- Installed capacity needs to grow by 40,000 megawatts (MW) in the next 20-25 years to meet current and forecast demand
- South Africa’s commitment to reach 43% of generation installed capacity in renewable energy by 2030
- State monopoly utility Eskom supplies about 95% of South Africa’s electricity
- Issues of trust in public sector planning and procurement processes
Country case: South Africa (con’t)

The Solution

- **Renewable energy sector selected as a pilot to build trust in PPPs**
  - A separate administrative unit responsible for the independent power producer (IPP) procurement program was ring fenced from traditional procurement entities and from main identified obstacles
  - A well designed procurement policy and a highly efficiency team with demonstrated ability to meet deadlines in planned bidding processes
  - Incentives to developers through high returns, particularly in first rounds.
  - Eskom guarantees purchase of electricity from IPPs at a pre-agreed price (in auction): the National Treasury guarantees the electricity purchase if Eskom is unable to do so

- **Has delivered good results**
  - Electricity prices have come down for solar and wind by 68% and 43% respectively
  - First contracts adjudicated around 2011 are entering into the operational and maintenance phase

- **WBG support**
  - WBG is currently supporting the Treasury in the enabling environment so that IPPs can refinance their bank debt through project bonds

<table>
<thead>
<tr>
<th>Results as of June 2015</th>
<th>Total MW adjudicated</th>
<th>No of Projects adjudicated</th>
<th>Total Investment (USD)</th>
<th>Total Debt to be refinanced (USD)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Total</td>
<td>7494</td>
<td>77</td>
<td>12Bn</td>
<td>8Bn</td>
</tr>
</tbody>
</table>
The Challenge

• Government is trying to implement a strict fiscal adjustment, reducing the role of the public development bank in infrastructure financing, seeking greater private sector participation.

• Domestic market for infrastructure bonds is incipient and illiquid. Dominated by retail investors with negligible participation of domestic and international institutional investors.

• The Ministry of Finance requested the WBG to develop a new infrastructure bond to attract institutional investors and become a benchmark for an ambitious infrastructure program.
Country case: Brazil (con’t)

The Solution

- **Designed the Standardized Infrastructure Bonds with two innovations:**
  - Bond holders receive interest payments during the whole life of the bond (including the construction period!)
  - Guarantee based on a government bond collateral (adaptation of Brady Bond model)
  - Interest payments during the construction phase are paid by Banks: relieving negative carry to the concessionaire and crowding in Banks for infrastructure financing
  - Government bond guarantee is provided by Banks who charge a fee (insurance premium) to the concessionaire.

- **A Pilot Sector – Roads – selected to launch a series of Standardized Project Bonds**
- **WBG** will leverage private investors capital by providing credit lines to finance the two innovative channels (interest payments and guarantees).

### Pilot Projects and Potential

<table>
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<tr>
<th>5 roads – total investment US$ 3.7 billion 30% equity 45-60% BNDES loan 10-25% Bonds = US$ 0.37/0.94 billion Interest payment/year US$ 67/166 million</th>
<th>Total Concessions (PIL2*) - US$ 52 billion 30% equity 45-60% BNDES loan 10-25% Bonds = US$ 5.2/13.0 billion Interest payment/year US$ 920/2,303 million</th>
</tr>
</thead>
</table>

* Logistics Investment Program (includes highways, railways, ports and airports)