



CONTRIBUTION OF ISLAMIC FINANCE TO THE 2030 AGENDA FOR SUSTAINABLE DEVELOPMENT

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1. Executive Summary

In line with the theme of High Level Political Forum (HLPF) 2018, “Transformation towards sustainable and resilient societies”, this paper studies the role of Islamic finance in promoting the sustainable development goals (SDGs) by increasing investments in sustainable infrastructure. Most infrastructure projects are large and involve many stakeholders. The investment arrangements entail complex legal documentations and intricate financial planning. Infrastructure investments also usually require long-term commitments which makes them less liquid. The legal contracts have to ensure proper allocation of risks and returns to create the right incentives for attracting capital.

McKinsey (2016) estimates investments of US\$93 trillion would be needed in sustainable infrastructure projects during 2015-2030 to achieve the SDGs, with the bulk going to the energy sector (US\$ 40 trillion or 43%), followed by transport (US\$27 trillion or 29%), water and waste (US\$ 19 trillion or 20.4%) and telecommunications (US\$ 7 trillion or 7.5%). The funding gap for the period is estimated to be between US\$ 39 trillion (under an aggressive investment growth scenario) to US\$ 51 trillion (under conservative investment growth assumptions).

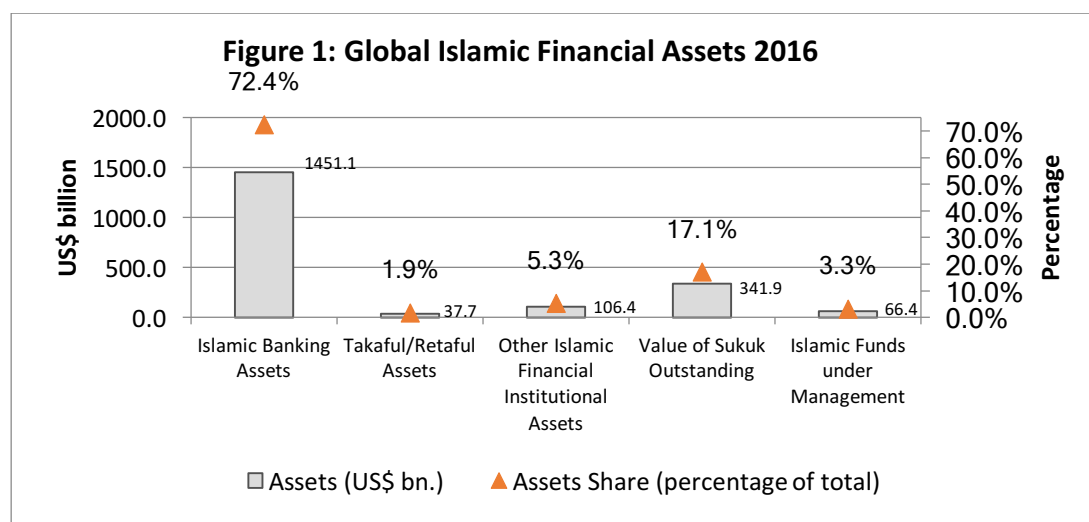
While infrastructure investments have traditionally been considered a public-sector responsibility, its role in filling the gaps is becoming more and more limited due to the large sums needed on the one hand and budget constraints and deficits that governments face on the other hand. The huge demand for investments in infrastructure thus necessitates seeking funding from multiple sources. In general, the sources for infrastructure financing can be divided into four broad categories: public-domestic, public-international, private-domestic and private-international. Given the large investments needed for infrastructure projects, investments also take the form of private-public partnerships (PPP) and blended finance.

Many countries with sizable Muslim populations have high levels of poverty and score low on the SDG Index (SDGI) – a composite index developed jointly by the Bertelsmann Stiftung and the Sustainable Development Solutions Network (SDSN) to provide a quick assessment of how countries are performing relative to their peers. To improve their situation, these countries will require huge amounts of investments in the sustainable infrastructure sector. In this context, whereas the financial sector can play a vital role in the promotion of the SDGs, Muslim-majority countries can face some limitations in mobilizing resources due to cultural and religious reasons. Since interest-bearing transactions are prohibited under Islamic teachings, many Muslims do not engage with the conventional financial sector due to religious convictions. Providing Islamic financial services in Muslim-majority countries, thus, becomes an issue of financial inclusion at the micro level and economic development at the macro level.

Guided by the values and principles of *Shariah*, Islamic finance provides an alternative source of resources that are compatible with Islamic law and ethics. The overall goals of *Shariah* entail realizing the human wellbeing by enhancing welfare or benefit (*maslahah*) on the one hand and preventing harm (*mafsadah*) on the other hand. Other than avoiding exploitative practices and prohibited activities such as alcohol, pork

products, gambling, etc., the key features of the Islamic financial system include risk-sharing and materiality in terms of links with the real economy. At the operational level, Islamic finance uses contracts that are devoid of *riba* (which includes interest in loan transactions) and *gharar* (legal ambiguity or excessive risk). Instead, the industry uses contracts that can be broadly classified as sale (*murabahah*, *salam*, and *istisna*), leasing (*ijarah*), partnership (*mudarabah* and *musharakah*) and agency (*wakala*).

Since its inception in the 1970s, the Islamic financial sector has grown rapidly to become systematically significant in many jurisdictions. With an estimated value of US\$ 2 trillion in 2016, the banking sector dominates the Islamic finance industry accounting for 72.4% of the total assets, followed by *sukuk* (or Islamic bonds) with 17.1%. The nonbank financial institutions and *takaful* (Islamic insurance) sectors are relatively small (see Figure 1). In addition to this asymmetrical performance across sectors, the development of Islamic finance has been highly uneven in different countries. While in some countries the industry has become a significant part of the financial sector, in many other countries it is still nascent or emerging.



Source: ICD & TR (2016)

Given its social and ethical principles and emphasis on risk-sharing and asset-backed financing, Islamic finance has a natural role to play in contributing to the achievement of the SDGs. However, since infrastructure investments require large amounts and Islamic banks are relatively small, Islamic contributions to infrastructure finance have in the past mostly taken the form of participation in smaller tranches of conventional financing structures. More recently, with the growth of the sector, some infrastructure projects have been financed wholly through Islamic syndications. Examples in which Islamic banks have financed projects include the Doraleh Container Terminal in Djibouti and the Madinah International Airport in Saudi Arabia.

Sukuk can also be used to mobilize funds from capital markets to finance infrastructure. Several projects have been financed wholly or partially by raising funds using various *sukuk* structures. Some examples include the Neelum Jhelum *Sukuk* that raised PKR100 billion to finance a hydroelectric dam in Pakistan and the East Klang Valley Expressway *sukuk* that mobilized RM1 billion to fund the construction of a toll road in Malaysia. The DanaInfra Retail *sukuk* in Malaysia raised funds to finance Kuala Lumpur's Mass Rapid Transit project by issuing a series of retail *sukuk*.

There have been some recent developments in promoting sustainable infrastructure by the Islamic financial sector. While Masterwind Energy raised financing of \$100 from an Islamic banking syndication to finance wind turbines that would generate 50 MW of electricity in Pakistan, the Khazanah SRI *sukuk* issued two series of impact bonds to enhance education standards in Malaysia.

Evidence shows that Islamic finance is used for infrastructure projects in countries where the industry is more developed. Other than implementing policies to provide an enabling environment in which Islamic finance can grow, increasing further infrastructure investments by the Islamic financial sector would require

a sound macroeconomic and legal/regulatory framework at the national level and good governance and risk management at the organizational levels. The study provides the following recommendations to enhance the role and contribution of the Islamic financial industry in promoting sustainable infrastructure development.

- **National SDG Strategies and Infrastructure Related Policies:** To ensure achievement of the Agenda 2030 there is a need for transparent national level SDG strategies that include infrastructure plans as well as accompanying financial strategies. The infrastructure plans should list pipelines of projects that need to be developed in different sectors such as energy, transport, water and communications. After assessing the sustainability features of these projects, the financial strategies would outline how these could be financed from different international-domestic and public-private sources. Financial policy should also lay out a framework for aligning environment, social and governance (ESG) and sustainability issues with financial sector practices. Within the private sources, the role and participation of Islamic finance in infrastructure development can be identified.
- **Legal and Regulatory Framework:** A stable and predictable legal and regulatory regime that covers the different aspects of infrastructure investment contracting and their enforcement is necessary to create the right incentives and instil confidence among investors to invest in long-term projects. Since most countries where Islamic finance operates have either common law or civil law regimes, there is a need to provide a supporting legal and regulatory framework that can cater to the needs of Islamic infrastructure financing. Specifically, there is a need to introduce enabling Islamic financial laws that would address the issues that arise in Islamic financial contracts and reduce legal uncertainty in disputes. Legal framework for capital markets should accommodate issuance of different types of *sukuk*. Other than ensuring transparency and disclosure, the laws should recognise the rights of *sukuk* holders that include reorganization and liquidation rights.

The tax regime should recognize the tax implications arising in different Islamic financial contracts and change relevant tax laws to level the playing field of Islamic and conventional finance. Tax laws should also address the favourable treatment of debt based financing over equity to bring balance to debt and equity modes of financing, given the preference of Islamic finance for asset-based and equity financing. In addition, a concession law that is flexible enough to deal with the specific requirements of Shariah compliant financing is also needed. Finally, there is a need to introduce enabling laws and regulations that encourage green and social investments in the infrastructure sector. For example, the introduction of the Sustainable Responsible Investment (SRI) *Sukuk* framework in Malaysia in 2014 facilitated the issuance of green *sukuk* and impact *sukuk* in the country.

- **Public-Private Partnership (PPP):** Given the need for large-scale investments in infrastructure in order to achieve the SDGs, one option of financing infrastructure projects would be to use PPP frameworks whereby the private sector develops and operates a project for a limited time under a concession agreement. Certain *Shariah* issues such as rights and obligations of the parties and ownership of assets have to be resolved to enhance the involvement of Islamic finance in PPP projects. This can be done by raising awareness of these issues and instituting a supportive legal and regulatory framework for PPPs. Since infrastructure projects are complex and Islamic finance is relatively new, standardizing documentations and developing Shariah compliant products that address issues such as the transfer of ownership and the responsibilities of different parties would help facilitate the involvement of the Islamic financial sector in new projects.
- **Capital Markets:** Capital markets play an important role in mobilizing funds from both institutional and retail investors. While *sukuk* has been used to raise funds for some projects, the share of the overall Islamic capital market is still small and the sector is underdeveloped in many countries. Developing Islamic capital markets in general and the *sukuk* sector in particular would require strengthening the Islamic capital market infrastructure, including through an appropriate legal and regulatory framework and supporting institutions such as liquidity providers, brokers and dealers who facilitate transactions in secondary markets.

Developing the sukuk market to raise funds for infrastructure projects will also help support the growth of a liquid secondary market that would increase asset choices for institutional investors. Governments can promote Islamic capital markets by not only providing the necessary legal and regulatory frameworks as well as market infrastructure, but also by taking the initial lead to issue sovereign *sukuk* for different infrastructure projects. In addition, a sound national level Shariah governance regime that reduces the diversity of *fatwas* (Shariah rulings) can reduce the legal risks and build confidence among stakeholders. In this regard, standardized sukuk structures that are well understood by different stakeholders, including the investors, are needed for an efficient sukuk market.

- **Financial Institutions:** Islamic banks dominate the Islamic financial industry and the nonbank financial institutions sector is very small compared to their conventional counterparts. Since the bulk of the funds for infrastructure finance at the global level come from nonbank financial institutions such as insurance companies and pension funds, it is to be expected that the scale of Islamic infrastructure financing can be increased if the industry becomes more diverse. Although the share of Islamic nonbank financial institutions is likely to grow with the expansion of the Islamic financial industry as a whole, this can be facilitated by instituting a supportive legal and regulatory environment. Promoting the institution of *waqf* (charitable trust/endowment) also has the potential to contribute to the development of social infrastructure in many countries.

The growth of Islamic nonbank financial institutions is also contingent on a robust Islamic capital market that creates Shariah compliant investment opportunities for them. In this regard, sustainable infrastructure projects not only provide new investment opportunities, but also create synergies for Islamic nonbank financial institutions and capital markets to grow together.

- **Products:** Infrastructure can be considered as a separate product class that has the potential to conform to the values and principles of Islamic finance. However, to enable stakeholders to invest in this asset class it is necessary to further develop Shariah compliant products and instruments for both retail and institutional investors. This in turn would require increasing the number of professionals who have the knowledge and skills of both Islamic law and complex infrastructure products.

Islamic banks can increase their share of financing infrastructure projects by transforming investment accounts that reflect risk-sharing features. For example, the Islamic Financial Services Act 2013 of Malaysia separates the investment accounts from deposits and investors take on risks. Since banks are not burdened with additional capital charges, they will be more inclined to invest in infrastructure projects. Introducing some features in *sukuk* that can increase their liquidity and tradability could also increase their use for funding infrastructure projects. Since debt based products cannot be traded, there is a need to increase the share of *sukuk* that are asset and equity based to enhance liquidity. Whereas there have been some developments in ESG related investments in Islamic finance, there is a need to come up with new innovative products that can finance sustainable infrastructure projects. Recent examples from Pakistan and Malaysia show that a supporting legal and regulatory framework can help enhance the development and use of such products.

- **Multilateral Institutions (MLIs):** There are different ways in which multilateral institutions (MLIs) can help promote sustainable investment for achieving the SDGs. Along with being key sources of investments for sustainable infrastructure development, multilateral development banks (MDBs) can further contribute to the sector by setting up dedicated infrastructure funds. Other than directly funding infrastructure projects, multilateral development banks (MDBs) along with MLIs can also play a key role in building capacity, sharing experiences and providing operational models of project financing. To overcome the constraint of a lack of professionals with knowledge and skills to implement large infrastructure projects, MBDs such as the Islamic Development Bank (IsDB) and the World Bank can provide technical assistance to train and build human capital in Islamic infrastructure financing.

An important aspect of increasing investments in sustainable infrastructure projects is to come up with a standardized definition and approaches to sustainability and to dealing with ESG related issues. Also, there are certain specific issues that arise in Islamic syndications and PPP structures. IsDB and other organizations such as the Islamic Financial Services Board (IFSB) and the International Islamic Financial Markets (IIFM) can enhance the contribution of the Islamic financial industry to infrastructure investments by providing standardized templates of Shariah compliant structures for sustainable project financing that can be used in different countries.

- **Conceptual Outlook and Mind-set:** There are three areas in which a change is needed in stakeholders' mind-sets, to increase the participation of the financial sector in sustainable infrastructure development. First, sustainability considerations need to be integrated in decision making by moving from economic considerations only to include social and environmental dimensions in the due diligence of projects. Among others, MLLs could provide a framework that can be used at the operational level. Second, investment horizons need to be changed, away from the current preference for short-term financing to longer term investments. This would require a supportive legal and regulatory environment that mitigates the risks and creates the incentives for long-term investments. Finally, for Islamic finance there is a need to move away from a purely legalistic compliance with Shariah to fulfilling the broader social and ethical objectives and using more participatory forms of financing. Considering the overall goals of Shariah (*maqasid*) in Islamic finance operations will enhance its contribution to SDGs in general and sustainable and social infrastructure in particular.

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