BANK LONG-TERM FUNDING: DEVELOPING NON-TRADITIONAL ALTERNATIVES

INFRASTRUCTURE FINANCE: THE UNLEASED POTENTIAL OF ISLAMIC FINANCE
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Consider some issues relating to developing non-traditional structures for, and sources of, Shari‘ah-compliant infrastructure financing.
Shari‘ah-compliant tools.

Fundamental transactional considerations.

Appendix A: Capital Stack for Infrastructure Projects

Appendix B: Inducing Banks to Participate

Appendix C: Quadratic Partnership Structure
INTRODUCTORY NOTE

• Implementing Shari‘ah-compliant contractual arrangements for infrastructure finance is relatively simple.

• We have the contractual tools:
  • Istisna‘a
  • Musharaka
  • Mudaraba
  • Ijara
  • Murabaha
  • Others

• Other speakers will provide more specifics on these tools.
INTRODUCTORY NOTE

• More difficult, determining:

• **why** and **how** the transactions are done (COORF):
  • **who controls what** (two major segments)
    • **ownership** arrangements
    • **operational** arrangements
  • **risk** allocations
  • **finance** arrangements

• **Then develop the structure**: capital, organizational, contractual

• in light of existing realities that affect both Islamic and interest-based infrastructure financing.

• This is the focus today.
BANKS AND INFRASTRUCTURE PROJECTS

LIMITATIONS AND INDUCEMENTS
LIMITATIONS ON BANK FINANCING

• Large, expensive, capital-intensive projects.

• **Need syndicates and consortia**; individual banks cannot and should not finance these projects.

• Financing cannot be undertaken by only Islamic banks.
  • Transaction size is too large.
  • Risk concentration would be too great (consider the position of bank regulators).

• **Need both Islamic and interest-based banks.**

• **Influences the transactional structures**, and should be welcomed but adds complexity.
PROJECT SIZE AND TENORS

• **Tenor** of financing influenced by:
  • Project **size**.
  • Project **economics**.

• Project cash flows:
  • insufficient to repay the financing in the short term or the medium term.

• **Need long-term** repayment schedules.
PROJECT SIZE AND TENORS

• Many banks are reluctant to finance for the long term.

• **Likelihood of long-term bank financing increased** where:
  • the debt is **liquid**.
  • there are **other objectives** (China): political, growth, fiscal, etc.
  • the **industry** is **desirable** (e.g., oil and gas).
  • developed, stable, predictable **legal regime**.

• **Islamic finance industry** should **focus on these** types of factors in their various jurisdictions.
PROJECT FINANCE FUNDING SOURCES

Source: Infrastructure Journal – Global Project Finance Infrastructure Review Full Year 2013
INDUCING BANK PARTICIPATION

• Can induce banks to participate.
  • **Equity enhancements**: means more financing alternatives.
    • More and stronger equity.
  • **Financing enhancements**.
    • More liquid finance.
    • Stronger, more predictable legal regimes.
  • **Different combinations of equity and financing**.
    • Evidencing different risk allocations among public and private.
• See Appendix B to these slides.
COST REDUCTIONS FROM LEGAL ELEMENTS

• Demonstrable evidence that legal elements and reforms reduce financing costs and encourage broader participation in financings.

• Special purpose vehicles (SPVs) are one such factor.
  • They reduce bankruptcy/insolvency and other credit risks.
  • Ease of formation is a critical factor.

• Bankruptcy/insolvency reform is another factor.

• Contractual enforcement is another obvious factor.

• There are many others.
INFRASTRUCTURE PROJECTS

SOME BACKGROUND
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.
INFRASTRUCTURE FINANCE: WHO AND HOW

• **Who owns and who operates?** These two questions must be separately analyzed.
  
  • Government.
  
  • Public sector - private sector combinations.
  
  • Private sector.

• **How is infrastructure financed?**
  
  • Sometimes depends upon the “who” answers.
  
  • Government.
  
  • Private corporate.
  
  • Mixed: public-private partnerships (PPP).
  
  • Project finance: a structural methodology.
INFRASTRUCTURE FINANCE: RISK COMBINATIONS

• Usually, and appropriately, a combination of

• Project finance techniques.

• Different combinations of risks and different transaction participants determined by risk determinations relating to:
  • Ownership
  • Operations.
  • Regulation.
  • Outsourcing.
PROJECT
FINANCE

CRITICAL DYNAMIC ELEMENTS
WHAT IS PROJECT FINANCE?

• Project finance is **financing** of an economic unit

• in which the **lenders/financiers** look to:
  • operational cash flows, and
  • cash flows and project assets – collateral.

• **Isolate** risks and then **reallocate** risks:
  • greater efficiency and certainty.
WHAT IS PROJECT FINANCE?

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

• Must structure remedies that allow collateral realization.
PROJECT FINANCE CHARACTERISTICS

- Lending to a **special purpose vehicle** (SPV project company) that owns/holds the project assets
  - Lower bankruptcy and creditor risk.

- No or **limited recourse** to shareholders of the project company.
  - Careful credit analysis of the project stand alone.

- **Off-balance-sheet** to the grantor: lower direct credit risk.

- **Shifts** some project **risks to the lenders**, who get a higher margin than normal corporate loans.

- Often **high leverage** and **syndicated debt**.
WHY HIGH LEVERAGE AND SYNDICATION?

• Expropriation (direct and creeping) and renegotiation risks for infrastructure assets are high: governments and concentrated buyers/suppliers.

• Investors cannot mitigate these risks effectively.

• Leverage and syndication enhance ex post negotiating positions of project company.

• Pre-commits cash flows.

• Enhances monitoring.

• Syndication increases reputational risk of government.

• High debt shields wealth from concentrated buyers and suppliers.
PUBLIC-PRIVATE PARTNERSHIPS
SHARED RISK AND RESPONSIBILITY
WHAT IS A PUBLIC-PRIVATE PARTNERSHIP?

• Many (and diverse) definitions and conceptions.

• Generally:
  
  • collaboration between (a) the public sector and (b) for-profit or non-profit organizations in the private sector,
  
  • different motivations: to provide enhanced services to the public, to accelerate economic growth, or to supplement revenues of government (note the different motivations; there are others – political, fiscal, etc.),
  
  • with some risk sharing as between the public sector and the private sector.
CAUTION REGARDING GOVERNMENT MOTIVATIONS

• Government motivations often:
  • political considerations
  • fiscal rule constraints
  • accounting considerations
  • other non-economic considerations

• Introduces significant costs and inefficiencies.
MOTIVES AND INVOLVEMENTS

• Motivation, relative involvement, balance among each (separately analyzed):
  • Operational elements: design, construction, operation, management, maintenance and the like.
  • Ownership
  • Financial elements: finance for design, engineering, construction and operation.
  • Regulation motives: manager benefit is private information; government control and 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.
RISK EXPOSURE AND ANALYSIS

• **Public** risks: often (usually?) **implicit** and **not isolated**, exposed and analyzed.
  
  • Effects on taxpayers, different taxpayer groups, future financial requirements, etc.

• **Private** entity risks are largely **exposed and analyzed**.
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)
    • Build, operate, transfer (BOT)
    • Build, own, operate (BOO)
    • Build, lease, transfer (BLT)
    • Build, transfer, operate (BTO)
    • Design, build, operate, maintain (DBOM)
• These are all quite different in terms of risk allocations.
• These all use Shari‘ah-compliant contracts.
Private Sector Risk

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

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

Generalized progression: each structure can vary significantly depending upon structure and negotiated terms.
INCOMPLETE CONTACTS

• Do the contracts address all risks?
  • Usually not, which makes private finance inefficient with varying and excessive costs.

• Private sector involvement:
  • more contractual complexity
  • higher transaction costs (at least initially)
  • more accurate risk exposure and allocation
  • blends operational and financial risks, with pricing difficulties.
INCOMPLETE CONTRACTS

• **Renegotiations** of contracts are commonplace in PPPs.
  • Governments rebid *ex post facto*.
  • Unanticipated circumstances lead to renegotiation.

• **Political risks** are omni-present (expropriation: direct and creeping).

• These two risks are priced into the private participation, resulting in cost increases.
CONCLUSION

OPPORTUNITIES EXIST
CONCLUSION

• Pressing need for infrastructure financing in OIC jurisdictions.
• Need new structures.
• Need new combinations of existing elements.
• Need both Islamic and interest-based banks and financing institutions.
• Need understanding of
  • Why the transaction is being considered.
  • How risks are allocated (transparently).
  • What Shari‘ah contracts are responsive.
• PPP structures are dominant, and Shari‘ah-compliant contracts and structures suit these arrangements well.
THANK YOU
CAPITAL STACK FOR INFRASTRUCTURE PROJECTS
WHAT COMBINATION OF EQUITY-DEBT?
THE CAPITAL STACK

• Two general categories of funds for financing: Equity and Debt

• Both have ranked subdivisions or components.

• **Equity**, includes:
  • Subordinated debt
  • Preferred equity
  • Common equity
  • Invisible equity (next slide)

• **Debt**, includes:
  • Senior debt
  • Subordinated debt
  • Mezzanine debt
IN ANY FINANCING, THERE IS ALWAYS EQUITY

• **Public finance (including public debt):** equity is provided by taxpayers or customers (if charges are made for goods and services).

• **Government guarantees:** equity is provided by (some or all) taxpayers or through increased usage charges.

• **Mutual arrangements and not-for-profits:** equity is in the form of reserves, retained earnings or some similar buffers (there is no ‘equity capital’ entry on the balance sheet).

• Taxpayers, customers, users, mutual entities and not-for-profits are often (usually) not afforded equity rates of return.
THE TRADE-OFF

- The over-all cost of financing is constant, whatever the mix of debt and equity and whatever the mix of public and private finance.
  - Debt finance is less expensive than equity finance due to the senior claim of debt on cash flows and assets.
  - Lower debt, means less risk and lower cost of funds.
  - But that also means more and riskier equity at a higher cost of funds.
- The foregoing assumes away the complexities of:
  - Taxes.
  - Transaction costs
  - Principal agent and other asymmetric information costs.
  - Incomplete contract costs and complexities.
Inducing banks to participate
INDUCING BANKS: ADDITIONAL EQUITY

• Equity:
  • Combinations: Government and private equity: PPPs (more later).
  • Private equity funds.
  • Targeted taxation arrangements.
  • User contributions, including through tolls, tariffs, fees, etc.
  • Numerous Shari‘ah-compliant contracts work well in this category.
    • Musharaka.
    • Quadratic partnerships (more later).
    • Mudaraba.
    • Ijara (various lease-leaseback, sale-leaseback, etc)
INDUCING BANKS: ADDITIONAL FINANCE

• Debt:
  • Combinations of Government and private equity: PPPs (more later).
  • Multi-laterals.
  • Insurance.
  • Government bond funding.
  • Government guarantees of debt, usage, off-take, etc.
  • Tax subsidies.
  • Capital market issuances for some portion of total debt.
    • Banks may purchase sukuk because of slightly increased liquidity (combine initiatives with sukuk markets).
INDUCING BANKS: ADDITIONAL FINANCE

• Debt (continued):

• Numerous Shari‘ah-compliant contracts work well here.
  • Sukuk.
  • Istisna‘a and istisna‘a - ijara.
  • Murabaha.
  • Diminishing musharaka.
  • Guarantees.
QUADRATIC PARTNERSHIPS

CLASSICAL PRINCIPLES
CONTEMPORARY TRENDS

APPENDIX C
QUADRATIC PARTNERSHIPS

• A Shari‘ah-compliant structure that we have used for outpatient medical facilities, hospitals and real estate projects.

• Considerable potential for infrastructure financing.
PARTNERSHIP AGREEMENTS GENERALLY

- Management
- Responsibilities
- Distribution
- Tax
QUADRATIC PARTNERSHIP

- Categories of provisions:
  - Management provisions
  - Responsibility allocation provisions
  - Profit and loss distribution provisions
  - Tax matters provisions

- Conception:
  - convert these four sets of provisions
  - into four separate Shari‘ah-compliant agreements
  - in a manner that preserves (if desired) the partnership characterization for tax and secular law purposes.

- First step: disaggregate four sets of provisions into four components.
QUADRATIC PARTNERSHIP

• Second step: create four Shari‘ah-compliant agreements.
QUADRATIC PARTNERSHIP

Management

'istisna’a

Sale

Tax

Management

Istisna’a

Sale

Tax
QUADRATIC PARTNERSHIP: EXPERIENCE

• Transactional experience:
  • Relatively straight-forward process.
  • Can be done with fidelity to economic, financial and risk allocation parameters.
• Adaptable under differing tax, regulatory and secular law regimes in numerous jurisdictions.
• Adaptable where either a secular partnership is desired or it is not desired.
QUADRATIC PARTNERSHIP: EXAMPLES

• Where existing structure cannot be modified to accommodate subsequent Shari‘ah-compliant investment.

• Where legal requirements mandate a specific type of structure that is not compatible with Shari‘ah structures (e.g., due to tax-exempt financing).

• Where Shari‘ah-compliant investors desire no visibility in the transaction.

• U.S. health care facility financings are an example.
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