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Sharia-compliant investments in infrastructure and development capital financing in DFID/CDC/PIDG geographies

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Question

What information is available about the types and amounts of investments in infrastructure and development capital financing being made in DFID / CDC / PIDG geographies by institutions operating on Islamic finance principles both within these markets and globally? What are the barriers to further investment in these geographies?

Contents

1. Overview

Investments in infrastructure and development capital financing being made in DFID / CDC / PIDG geographies by institutions operating on Islamic finance principles are still limited in scope. The Islamic Development Bank Group is the main donor and agent encouraging other institutions to get involved in the process, through various initiatives. The major undertakings initiated by the Islamic Development Bank include:

- Deep Dive Initiative (DDI), a strategic partnership framework with the World Bank (WB), aimed at scaling-up development assistance in common member countries;
- Arab Financing Facility for Infrastructure (AFFI), also with the World Bank (WB), designed to support development of high quality infrastructure in Arab countries in a bid to boost region's economic and social growth;
- Islamic Infrastructure Fund (IIF) established with the Asian Development Bank (ADB) in the form of sharia-compliant equity to contribute to "facilitation of mobilization of public and private sector equity funds and attracting foreign investment" in the twelve common member states.

Two main groups of obstacles to further investment in these geographies can be identified: i) those connected with the economic, legal, and political environment in the countries in question, and ii) those resulting from the nature of Islamic finance itself. The former include:

- Political and legal barriers, such as counterparty risk and uncertain political environment;
- Financial obstacles, such as foreign exchange risks and return rates;
- Limited capacity and lack of experience of governments;
- Contract and tender-level risks, related to lengthy and costly procurement processes and red-tape.

Specific to the nature of Islamic finance are:

- Lack of alignment between conventional legal frameworks and Islamic regulations;
- Legal/regulatory framework issues resulting from the asset-based nature of Islamic finance for taxation, ownership rights and bankruptcy laws;
- Standardisation problems;
- Lack of awareness and understanding of sharia-compliant finance.

Information on the types and amounts of investments in infrastructure and development capital financing being made in DFID / CDC / PIDG geographies by institutions operating on Islamic finance principle is scarce, with the richest source of practical information being the Islamic Development Bank. The majority of publications available are of theoretical nature, exploring the potential of Islamic finance in infrastructure and development capital financing rather than evaluating existing projects. This may be because this type of financing has only become operational – and consequently given attention – relatively recently. Consequently, no global, regional, or country-level exhaustive data are available.

2. Major initiatives

The main institution in the field of investment in infrastructure and development capital financing is the Islamic Development Bank (IsDB), whose current infrastructure portfolio consists of 203 projects with a value of USD 15.6 billion. Between 2010 and 2016, the bank allocated USD 31.1 billion to infrastructure development projects (Sonbal, 2017: 15). Apart from being the main source of funding, IsDB is also a major source of information on Islamic project finance and an initiator of cooperation initiatives in the field with other multilateral development institutions.

Deep Dive Initiative (DDI)

IsDB and World Bank (WB) signed in October 2015 a **Deep Dive Initiative** (DDI), a strategic partnership framework aimed at scaling-up development assistance in common member countries. In 2016, combined financing reached USD 2.4 billion (USD 910 million from IsDBG and USD 1.5 billion from WB) for eight projects in agriculture (Cameroon, Sahel), agriculture and infrastructure (Indonesia), energy (Palestine, Pakistan), and water (Kyrgyzstan and Mali). In 2017-2018, ten new projects are expected to be implemented under the planned USD 2 billion budget (Sonbal, 2017: 13-14).

Arab Financing Facility for Infrastructure (AFFI)

Another joint WB-IsDB initiative is the **Arab Financing Facility for Infrastructure (AFFI),** to which IsDB expects to provide up to USD 150 million (on top of a USD 1 million grant to AFFI's Technical Assistance Facility) (Sonbal, 2017: 16). AFFI was designed to support the development of high quality infrastructure in Arab countries (11 of which are within the DFID/CDC/PIDG sphere of interest) that would contribute to boosting the region's economic and social growth. Support is to be extended particularly to sustainable infrastructure projects developed under Public-Private Partnerships (PPPs) in energy (power plants, transmission lines and distribution services), transport (rail, road, airport and ports), water and waste (water supply, sanitation and solid waste), information and communication technologies (optical fiber, sea cable), and social infrastructure (hospitals, and schools).

Four components of the AFFI include the Arab Infrastructure Policy Forum (AIPF), providing a platform for dialogue on regional issues related to infrastructure; the Technical Advisory Facility (TAF) offering advisory services and grants to establish PPP projects; the Public Window, providing funding to governments for PPP and infrastructure project; and the Private Window – Arab Infrastructure Investment Vehicle (AIIV), a private equity fund offering predominantly mezzanine funds (both on sharia-compliant and conventional basis) to the private sector for infrastructure projects (IFC, 2011: 1-6).

Islamic Infrastructure Fund (IIF)

IsDB has also worked with the **Asian Development Bank (ADB)** to establish a sharia-compliant equity fund under the name of **Islamic Infrastructure Fund (IIF),** with the goal of "facilitation of mobilization of public and private sector equity funds and attracting foreign investment" in the twelve common member states (Afghanistan, Azerbaijan, Bangladesh, Indonesia, Kazakhstan, Kyrgyz Republic, Malaysia, Maldives, Pakistan, Tajikistan, Turkmenistan, and Uzbekistan). The fund is expected to total USD 500 million and invest ca. USD 6 billion in various infrastructure projects "though its multiplier effect" (Sonbal, 2017: 16, ADB).

Other

IsDB Group is also providing funding through its members: International Islamic Trade Finance Cooperation (ITFC), Islamic Solidarity Fund for Development, Islamic Cooperation for the Development of the Private Sector (ICD). Between October 2015 and December 2016[1] ICD delivered USD 824 million for private sector development, financing 38 projects in 23 countries (ICD, 2017: 7).

Aid for Trade Initiative for the Arab States (AfTIAS) is an initiative developed in 2013 by IsDB Group's ITFC on the request of the Arab Group to the World Trade Organization (WTO) and in cooperation with UN Agencies (ILO, ITC, UNCTAD, UNDP and UNIDO), League of Arab States (LAS), the Permanent Missions of Arab Countries in Geneva, the Arab Regional Organizations and other stakeholders (AfTIAS). The initiative targets 22 members of the LAS, 16 of which (all but GCC countries) are within DFID/CDC/PIDG geographic scope.

3. Selected examples

The section below presents a selection of infrastructure and development capital financing projects made using a variety of sharia-compliant mechanisms. While an effort was made to compile a representative sample, due to time and space constraints it needs to be bore in mind that the list is by no means exhaustive.

Sub-Saharan Africa

One of the biggest (over USD 600 million) IsDB investments in the region was launched in the early 1970s: the Trans-Saharan Road (TSR), a road network connecting Algiers with Lagos, Gabes (Tunisia), Bamako (Mali), and N'Djamena (Chad) built to boost economic integration between the Maghreb region and Sub-Saharan Africa. Apart from providing funds itself, the IsDB also "facilitated investment of Arab Funds" to help finance the project (Sonbal, 2017: 13).

In **Senegal**, Dakar Airport was constructed under a Public Private Partnership (PPP). Among institutions that provided senior loans to the project were IsDB and AfDB.

In **Burkina Faso**, 211 new rural water points were constructed (on the top of 81 old boreholes being repaired and 277 new water pumps being installed) thanks to, among others, USD 20 million indicative concessional loan granted by IsDB (of which USD 2.5 million was disbursed to Burkina Faso; other beneficiaries included Niger and Senegal). The project provided access to safe drinking water and contributed to female empowerment (since it is traditionally women and children who collect water), improving the lives of almost a hundred thousand people in Kenedougou Province (IsDB No. 23, 2015: 1-4).

In **Togo**, IsDB helped increase access to and quality of education by providing a loan of USD 7.5 million for a four-stage project. During the first three stages of the project, almost 1500 new classrooms were constructed (IsDB No. 16, 2014: 1-7).

[1] IsDB moved from the use of traditional lunar Hijri calendar for their financial year to solar Hijri year, which resulted in a transition reporting period of 15 months.

Mauritania: In 2015 IsDB contributed USD 760 million under a Public Private Partnership to a project increasing iron ore concentrate production by SNIM (an Iron Ore Mining Company), the second largest iron ore producer in Africa employing ca. 6,000 workers. IsDB owns 1.79% of SNIM's equity. As a result of the project, iron ore extraction in the company increased from 10.7 million tons in 2006 to 13 million tons in 2014, when SNIM accounted for 25% of the country's economy (Corr, 2015: 10; IsDB No. 24, 2015: 1-3).

In **Niger**, IsDB supported a project aimed at diversifying and increasing agricultural production and increasing the nutritional value of foods produced in the country. During the first phase of the project, implemented between 2001 and 2005, donors worked in 167 villages mostly on improving and installing irrigation structures, training farmers in their usage, and supporting farmers' organizations. Phase two, which commenced in 2010, additionally offers farmers access to microfinance. IsDB provided USD 2.5 million out of the project's total cost of USD 4 million. The project significantly contributed to improving food security in the country, as well as female empowerment (52% of beneficiaries were women) (IsDB, No. 17, 2014: 1-11).

In **Guinea**, IsDB participated in a project aiming to boost access to funding for micro and small entrepreneurs and support institutionalisation of local microfinance institutions (MFIs). The project was run by three such institutions: Crédit Rural de Guinée, Programme Intégré pour le Développement de l'Entreprise and l'Agence Autonome d'Assistance Intégrée aux Entreprises, to whom IsDB provided a line of financing and who used the funds to provide funding for local entrepreneurs though sharia-compliant instruments. Six hundred and fifty different activities were supported throughout the country, mostly benefitting female entrepreneurs (62% of the beneficiaries) and by extension their families (IsDB, No. 13, 2013: 1-3).

Mali benefitted from an IsDB loan granted for the construction of a bridge over the Niger River in Gao, providing the region a reliable connection to eastern Mali. The project, which cost USD 16.2 million, contributed towards boosting trade and agricultural production, facilitating access to health and other services, and generally improving the quality of life of local inhabitants (IsDB, No. 2, 2011: 1-3).

In **Djibouti**, Dubai Islamic Bank, Islamic Development Bank and others (African Development Bank, West LB, Proparco) contributed towards construction of the new Doraleh Container Terminal. The USD 396 million project (of which USD 133 million was in a form of equity), launched in 2006 and completed in 2009, was the first ever PPP financing in the country. The project contributed to the creation of 500 jobs for local workers and in 2013, 600 people (over 40 women) were employed at the port full-time and 200 part-time. Moreover, construction of the port supported Djibouti's imports and exports capacity (IsDB, No. 10, 2013: 1-3).

In **Sudan,** Islamic Development Bank, the Bank of Khartoum (Sudan), and the Central Bank of Sudan invested in the small rural community of Abu-Halima**,** sponsoring 125 agriculture college graduates to work with their families towards establishing a greenhouse financed through a profit-sharing contract of restricted *mudaraba*. The greenhouse is expected to produce ca. 1,400 tons of vegetables each year. USD 4 million is being contributed towards the project (IsDB & WB, 2016: 58).

Another project implemented by IsDB in the country alongside the Bank of Khartoum (BoK) was the IRADA microfinance program established in 2009. Under the project, SD 200 million were directed to Al-Aman Fund for Microfinance under a strategic partnership of 32 Sudanese banks, Diwan Zakat (the managing institution for the distribution of obligatory religious tax). Working in the commercial, agricultural, and vocational sectors, the fund "provides insurance to the program against genuine defaults by clients at the second level" (IsDB & WB, 2016: 159).

The country also benefitted from the renovation and modernization of Khartoum North Power Station supported by an investment from IsDB that took place between 1999 and 2011. In total, USD 30.8 million was provided by the bank towards the project, thanks to which power generation in Sudan increased by 529 MW between 2000 and 2004 (IsDB No. 5, 2012: 1-4).

In **Mozambique**, a project aiming at the electrification of a province of Cabo Delgado was implemented between 1999 and 2013. Among the investors engaged were IsDB, Arab Bank for Economic Development in Africa (BADEA), European Union, and Government of Mozambique. 32% of total funding was supplied by the IsDB (USD 9.5 million) and used to fund 248 km of sub transmission lines (IsDB & WB, 2016: 149).

IsDB assisted the Islamic University in **Uganda**, contributing USD 6.72 million towards building two large hostels for its growing body of students. The project, implemented between 2004 and 2011, helped raise the prestige of the university and improve comfort for its students, allowing the university to grow and thus increasing access to higher education. Benefits extended to the town in which the university camp is based (Mbale) and the country (IsDB No. 26, 2016: 1-6).

Central Asia

In **Tajikistan**, legislation introducing Islamic finance was adopted in 2014. Asian Development Bank (ADB) is currently providing technical assistance to the country through a programme called “Islamic Finance for Inclusive Growth” with the aim of improving the regulatory environment and consequently supporting development of Islamic finance (ADB).

In 2013, a first *ijara*[2] company, ASR Leasing, was established in Tajikistan by Ansar Leasing of Azerbaijan and two local partners. With paid-in capital of USD 4 million from shareholders such as IsDB Group, ASR Leasing offers deals to SMEs and corporations, leasing fixed assets worth up to USD 200 thousand per deal for up to four years (WB & IsDB, 2016:131).

The country also benefitted from IsDB’s help in boosting its hydropower potential and reducing energy shortages. The project, named Construction of Mini Hydropower Plants (MHPP) in Rural Areas of Tajikistan aimed to construct a total of 170 mini hydropower plants in rural areas providing power to social infrastructure buildings such as schools and hospitals and private households alike (IsDB, No. 9, 2013: 1-3).

South and Southeast Asia

One of the biggest projects in the region is the Turkmenistan-Afghanistan-Pakistan-India (TAPI) Gas Pipeline Project, established to help meet the growing energy demand in the abovementioned countries. IsDB is contributing USD 700 million towards the project’s estimated USD 10 billion cost.

In **Afghanistan**, in 2011 the “Technical Assistance: Rural Finance Expansion” project was delivered by ADB to help establish a regulatory framework for Islamic finance. Since 2016, ADB has been implementing in the country its “Islamic Finance for Inclusive Growth” capacity development technical assistance project (ADB).

In **Bangladesh**, ADB helps implement policy actions facilitating issuance of *sukuk* under its 2015 Third Capital Market Development Program. IsDB in turn, founded a *Fa’el Khair* Program, first

[2] Sharia-compliant leasing contract.

established to assist victims of the November 2015 Sidr cyclone. Under the project, several hundred schools (which can also serve as cyclone shelters) were created in the coastal belt of the country; the initial funding for this arm of the project was USD 110 million. Moreover, a microfinance program with an initial budget of USD 20 million was established as well in order to provide funding for livelihood and business restoration to small businesses, farmers and fishermen affected by the cyclone. Working with local NGOs, IsDB extended the second arm of the project, which as of January 2014 has disbursed USD 105 million to 192,821 beneficiaries. One third of the project funds were redirected to a *Fa'el Khair Waqf* (endowment), which funds are invested in sharia-compliant products; proceeds are used to cover administrative costs of the program (WB & IsDB, 2016:161).

Moreover, IsDB contributed to the upgrade of rural roads in the Sylhet District of the country. The Bank contributed USD 93.6 million to six consecutive projects in the province implemented between 1990 and 2019 (forecasted completion), contributing to construction of 1,800 km of new roads (or upgrade of the existing ones) and 4,341 km of new bridges, as well as establishment of 89 feeder growth centres and 35 rural markets. This improved quality of life for 10 million Sylhet inhabitants by improving farmers' access to markets, facilitating work commute, boosting small transport businesses, and making it easier for children to reach their schools (IsDB, No. 31, 2016:1-8).

Another, earlier IsDB-funded program in the country aimed at providing access to high-speed internet and mobile phones. IsDB contributed USD 60 million to the project (88% of the total cost), implemented between 2005 and 2008, covering the cost of 1,065 km of fibre-optic cable. Implementation of the project contributed to an increase in a number of internet and mobile users in Bangladesh from 23 thousand internet users and 3 million mobile users in 2004 to 54 million and 133 million respectively in December 2015.This significantly improved the quality of life of Bangladeshis, facilitating access to information and communication, as well as benefitting businesses (IsDB, No. 27, May 2016: 1-6).

In 2001, Asian Development Bank (ADB) approved USD 60 million partial credit guarantee under *ijara*-structure to **Pakistan** facilitating payments to IsDB by project companies. ADB is also implementing the technical assistance program "Islamic Finance for Inclusive Growth" in the country (ADB). In 2007, WB Group's International Finance Corporation – the first private equity fund in the country – approved investment of up to USD 20 million into Jahangir Siddiqui Private Equity Fund I. The investment is meant to help the fund reach a critical size needed to provide financing for private sector companies (WBG).

Another infrastructure-related project in the country was co-financed by IsDB and focused on reconstruction of Kashmir region, which was at the epicentre of a devastating 2005 earthquake. Working with Earthquake Reconstruction and Rehabilitation Authority (ERRA), an authority established by the Pakistani government, IsDB first provided USD 80 million in soft loans for the purpose of construction of 30,800 homes in various parts of the region. During the second phase of the project, which commenced in 2007, *istisna'a*[3] financing worth USD 127 million was provided for construction of further 57,500 homes. Under the third phase, USD 93 million was invested in constructing roads, bridges, and health facilities, and in electricity generation. New buildings were constructed in an earthquake-resistant way, at the same time providing more living space for the families than traditional houses (IsDB, No.20, 2014: 1-6).

[3] Manufacturing contract with deferred delivery (unlike in a similar *salam* contract, full advanced payment is not necessary, but possible).

In **Maldives**, ADB alongside IsDB implemented in 2012 an Inclusive Micro, Small, and Medium-Sized Enterprise Development Project aimed at establishing an Islamic finance framework for supporting SMEs (ADB).

Middle East and North Africa (MENA)

Queen Alia Airport in **Jordan** is one of the most often quoted examples of implementation of Public Private Partnership (PPP) for the purpose of infrastructure development. Awarded "the best airport of its size in the Middle East" title by the Airports Council International for three years in a row, it was renovated over 25 years. IsDB and IFC (along with other partners) co-financed the process between 2007 and 2016, contributing USD 100 million in a sharia-compliant schemes (*istinsa'a* and *ijara*) and USD 120 million in a loan respectively (IFC, 2017: 1-5).

International Islamic Trade Finance Corporation (ITFC), under its Aid for Trade Initiative for Arab States (AfTIAS) program provides capacity building for **Palestinian** SMEs, equipping them with physical quality infrastructure required for international quality certification (ITFC, 2017).

In **Morocco** IsDB contributed USD 150 million under a Public Private Partnership scheme to a project aiming at rehabilitation and expansion of the Jorf Lasfar port, used by the Moroccan OPC company, a world leader in the phosphate value chain (Carr, 2015: 11).

Another project in the country funded through Islamic finance focused on providing electricity to rural parts of Morocco. IsDB contributed ca. USD 150 million to five projects that in total connected 1.3 million people in over 4,000 villages across the country to electricity. Apart from significantly improving the quality of life of individuals, the project contributed to boosting the economy by virtue of establishing 4,900 electrical connections for agricultural purposes and more than 1,500 for small businesses (IsDB, No. 11, 2013; 1-4).

In **Tunisia**, IsDB contributed USD 120 million (of the project's total cost of USD 535 million) under a Public Private Partnership scheme towards the creation of a phosphoric acid plant. The project was completed in 2013, and by 2015 had contributed to the creation of 466 permanent jobs and the generation of high dollar value exports for the country (Carr, 2015: 12).

Another IsDB-sponsored project in the country, implemented between 2004 and 2010, aimed at providing high-quality health services through construction of new health facilities (2 new hospitals and 2 new reginal maternity centres), expansion of specialized medical services (benefitting 3.6 million people), and acquisition of supplies and medical equipment for regional hospitals (scanners, dialysis machines, cardiographs, operating tables, ambulances and others). The total cost of the project amounted to USD 77.29 million, of which over one third (37.4%) was provided by IsDB using instalment sale financing for the supply of medical equipment and vehicles. The remaining funds came from EIB and the Government of Tunisia. As a result of the project, Tunisians received greater access to health facilities, maternal and infant mortality rates fell, and general life expectancy increased (IsDB, No. 30, May 2016: 2).

In **Iraq,** WB Group's International Finance Corporation invested in 2015 USD 18 million in a form of sharia-compliant *ijara* structure into the purchase and installation of a yogurt production line by Al Safi Danone for Dairy Production and Distribution LLC (WBG).

4. Barriers to further investment

Barriers to further investment by institutions operating on Islamic finance principles in DFID / CDC / PIDG geographies can be classified in two groups: firstly, those stemming from general impediments to investment in these economies, and secondly, challenges arising from the nature of Islamic finance.

Barriers to private sector investment

In the MENA region, four major groups of barriers to implementation of infrastructure projects through PPP have been identified by the OECD: political and legal risks, financial risks, limited capacity of governments, and contract and tender-level risks (OECD, 2015: 42). While a number of country-specific issues exist in other regions, this general classification seems to be applicable to other countries of interest (e.g. IFC, 2011: 63) so the following section adopts the classification proposed by the OECD.

Political and legal barriers

Consultations conducted by OECD show that private sector investors in the MENA region are particularly uneasy about counterparty risk. Investors need to be certain that project agreements will be enforceable against counterparties, which in case of PPP projects are public authorities, ministries, or government agencies – in other words, the state. Even if this certainty is to an extent secured in the form of a sovereign guarantee (which governments are typically reluctant to provide), unstable political situations and serious fiscal challenges faced by states in the region may deter investors. Moreover, as the majority of governments in the MENA region have sub-investment-grade credit ratings, their obligations likewise are rated below investment grade, a major red light for many commercial financial institutions. Uncertain political environments and the lack of political and institutional continuity, transparency, clear legal and regulatory frameworks, and rule of law are harmful to projects' smooth and timely implementation even if they are approved (OECD, 2015: 42-43). Fears over lack of political commitment in the long term and regulatory instability – as well as lack of transparency – are similarly a major problem of investors in Asia (Inderst, 2016: 27). "Poorly applied regulations" were likewise identified as one of the major obstacles for investment in Sub-Saharan Africa (IFC, 2011: 63).

> "The violence in Tunisia and Cote d'Ivoire will send a lot of the new portfolio money straight back out of the region, even though the trouble is confined. Non-specialist money dislikes event risk and Africa offers that in abundance."
>
> (Keith Mullin, Reuters in: IFC, 2011: 54)

Investment culture appears to be another important issue. As noted by the OECD, "it has also been reported that some MENA governments and government officials are suspicious of the private sector and uneasy with private-sector participation in the provision of public services" (OECD, 2015: 43-44). Related to this are project location criteria applied by some governments – based on political rather than economic merits, they disqualify the projects in the eyes of investors.

Financial obstacles

PPP based infrastructure projects are by nature long-term, capital-intensive and perceived as risky both by foreign and domestic investors – with risk being especially problematic in countries where the political environment is unstable. As a consequence, commercial banks which traditionally finance PPPs, but are additionally constrained by post-financial-crisis prudential regulations, are less willing to provide capital for projects in countries where high risks associated with their implementation would require high capital reserves. Banks that are ready to do so tend to limit their involvement to the construction phase, resulting in a “need for refinancing or construction loan take-out [which] is currently a significant barrier to private sector investment in MENA region infrastructure” (OECD, 2015: 44-45).

Another problem for investors may be revenues generated in local currencies (due to public bodies’ preferences to pay their obligations in local money), which creates additional foreign exchange risks. From the government’s point of view, high return rates required by investors under risky environments (20%-25% compared to 11%-13% typically charged in OECD countries) are problematic (OECD, 2015: 45).

Domestic investors are in turn limited by a lack of sufficient financial capacity, local regulations, and exposure to sovereign debt (OECD, 2015: 45-46).

Limited capacity

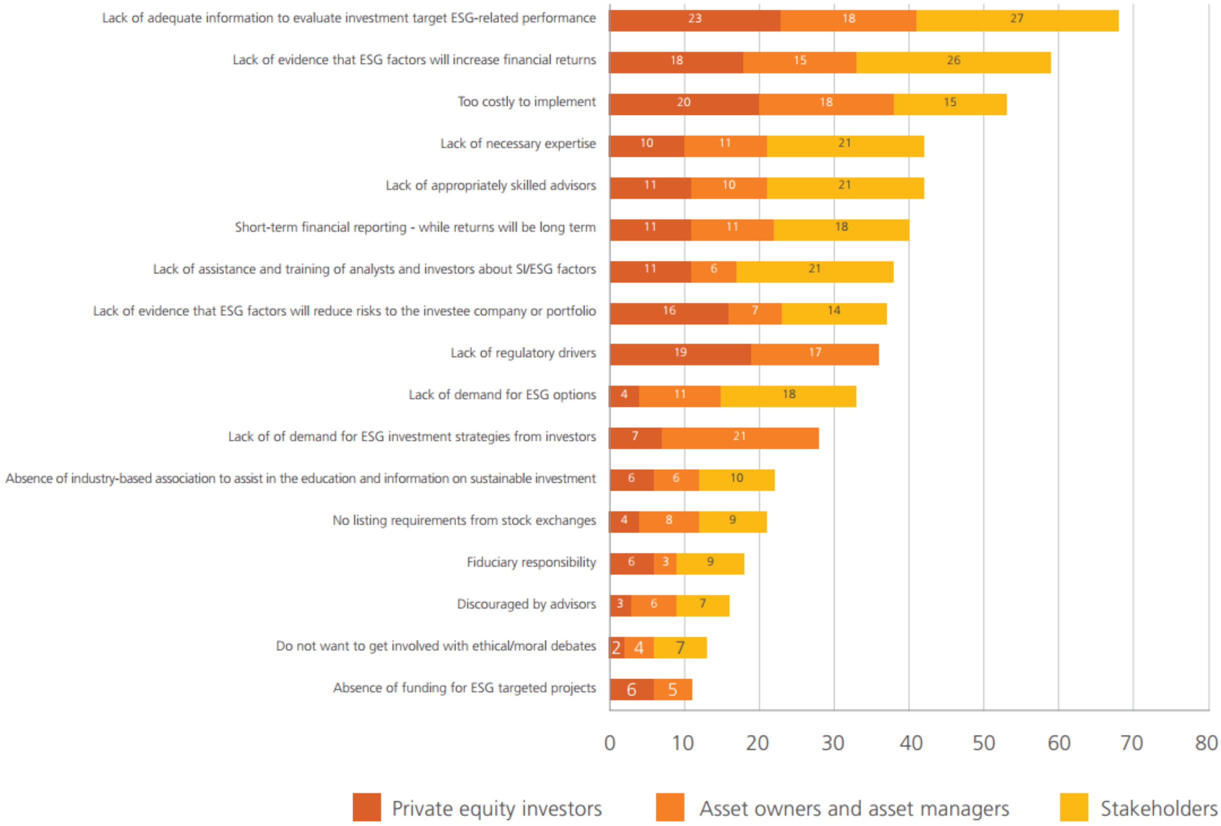
Governments usually lack “the experience and expertise” to effectively and efficiently engage in complex PPP transactions (OECD, 2015: 46). Limited capacity and lack of experience is likewise a problem on the investor side, especially for smaller, local institutions (Inderst, 2016: 27). Knowledge gaps were also identified as main barriers to sustainable development in Sub-Saharan Africa (IFC, 2011: 63).

Contract and tender-level risks

Weak procurement processes are generally acknowledged as a barrier to institutional investors’ involvement (Inderst, 2016: 26). Governments, due to the abovementioned limited capacity, tend to prepare tenders without due diligence; demand and feasibility studies are not conducted, important geographic, geological and other factors are not taken into consideration, and in general the responsibility to evaluate the workability of the proposed project is shed on the prospective contractors (OECD, 2015: 46-47). This is not only not economically viable but also harmful to the infrastructure development as a whole, as prospective bidders may withdraw from the process, reluctant to bear additional costs without the guarantee of winning the tender (OECD, 2015: 47; Inderst, 2016: 27).

Red tape and lengthy bureaucratic processes (e.g. for obtaining permits and approvals) are another obstacle, especially for foreign investors unfamiliar with local procedures.

Figure 1: The most important environmental, social, and corporate governance barriers to investment in Sub-Saharan Africa in the next 3-5 years



Source: IFC, 2011: 63.

* Ranking of 17 options, n=45 PE investors + 43 asset owners/managers + 49 stakeholders; January 2010 – May 2011.

Barriers to Islamic financing

Legal and regulatory alignment

A favourable political, economic, and regulatory environment is as crucial to the development of Islamic finance as any other industry. The regulatory environment is of special importance to successful development of Islamic finance for infrastructure development.

While existing laws covering issues such as licensing, minimum capital requirements, or disclosure requirements can generally be extended for Islamic financial institutions, dedicated regulations are typically needed to accommodate specific sharia-compliant instruments such as *mudaraba*[4] or *wakala*[5]. Moreover, a sound legal and regulatory framework is needed to guide the

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[4] *Mudaraba* – a profit and loss sharing contract whereby one side of the contract provides capital and the other, using their know-how and experience, acts as a manager.

functioning of Islamic pensions funds, mutual funds, and leasing companies. In case of the latter, clarification of effective ownership and repossession rights of the lessor, as well as responsibilities of the lessee in custody of the asset, are crucial. Notably, in some Islamic leasing contracts (*ijara*) these issues are solved differently than in conventional ones (IsDB & WB, 2016: 134).

Lack of alignment between Islamic rules and laws in jurisdictions that do not support them may create uncertainty about transactions and investments involving sharia-compliant instruments, as it is unclear which laws will be applied in case of conflicts or default, and under Islamic law securities like cash collateral and receivables may not be imposed. Similarly, interest and penalties cannot be charged in case of late payments.

> "Integrating Islamic financing with conventional financing in a single deal, raises further complications regarding inter-creditor arrangements. In case of default, Islamic investors who own specific assets in the project could claim those assets. Although this structurally puts an Islamic investor in a better position than a conventional lender, who is usually only a beneficiary of security but this would violate the *pari passu* treatment of most inter-creditor arrangements. *Pari Passu* treatment refers to the fact that all creditors holding the same securities should have equal claim on project assets. The standard solution, opted in most of the project finance deals, is for Islamic investors to forgo their rights in case of liquidation or default."
>
> (Khan, 2013: 91)

Issues related to the asset-based nature of Islamic finance

Under certain structures used in Islamic finance for project financing (such as the above-mentioned *ijara* or *istisna'a*), Islamic institutions are the legal owners of the project assets, which makes them exposed to third-party liabilities (including environmental risks). Furthermore, they are responsible for maintenance and operation of the assets, although increasingly these responsibilities are performed by the client under service agency agreements (State Bank of Pakistan, 2014: 6). Consequently, a risk mitigation framework needs to be ensured as sharia-compliant insurance (*takaful*) may not be available for large-scale projects (Khan, 2013: 90, 92).

Another issue is the inherent problem of their tradability and related problem of excessive liquidity that Islamic financial institutions face. This results from the fact that all sharia-compliant instruments and operations need to be asset-based (therefore there need to be assets in which to invest). An additional obstacle is the lack of secondary markets for the assets, and all transactions must be in accordance with other Islamic rules such as the prohibition against charging interest and investing in certain sectors deemed unethical, or risk-sharing requirements.

Regulations are necessary in the fiscal field, as certain Islamic structures (such as *murabaha*[6]) can potentially result in multiple tax duties being applied on the transfer of assets. Tax neutrality

[5] *Wakala* – an agency contract.

[6] *Murabaha* – a mark-up sale or cost-plus financing, one of the most popular sharia-compliant financial instruments on the market.

should therefore be secured by governments wishing to attract Islamic investors (Khan, 2013: 92).

All the above-mentioned issues create problems for conventional legal and sharia advisors in their efforts to structure contracts in line with both local regulatory framework(s) and Islamic law (which is not necessarily consistent in itself, see section below) (Biancone & Shakhatreh, 2015: 5).

Lack of standardisation

Internal to Islamic finance are standardisation problems, prevalent despite a number of initiatives undertaken by institutions working on the issue (IFSB, 2017: 33; Iqbal: 2016; Iqbal: 2017). Even within a single jurisdiction, Sharia scholars tend to have contrasting opinions – a problem resulting from the fact that a number of Islamic schools of law exist and no singular set of rules extending beyond the elementary laws exists. As a result, some instruments (e.g. *murabaha* based *sukuk*) are permitted in certain jurisdictions while in other they are forbidden (Khan, 2013: 90).

Another issue related to *sukuk*, one of the popular Islamic financial instruments used in infrastructure, is the burdensome nature of its issuance process, which despite attempts on part of the regulatory bodies remains complex, expensive, and time-consuming.

Lack of awareness

Feeding in to these problems is the generally low awareness of understanding of Islamic finance and its underlying regulations; in a survey conducted by Thomson Reuters among Islamic economy leaders, this ignorance was considered number one challenge for the industry development (Thomson Reuters, 2017: 22, 70). This is especially problematic as Islamic financial transactions tend to be more complex than conventional ones; without proper understanding of how sharia-compliant financial market works, law-makers and various authorities will be hard-pressed to create an Islamic-investment friendly environment (not to mention being willing to do so) (DIFC, 2009: 10).

Related to lack of awareness is a general distrust towards Islam and everything Islamic; as noted by Dubai Islamic Bank, “In wake of the heightened Islamophobia, Western banks and financial institutions continue to hesitate getting involved in IBF” (Dubai Islamic Bank, 2017: 39).

It has been therefore sometimes suggested that alternative ways of looking at and explaining Islamic finance – without using the word “Islam” or “sharia” – might improve awareness and uptake as well as “saleability” of Islamic financing mechanisms. For example, Z. Iqbal of the World Bank commented after a conference on Islamic finance in 2015 that “Some speakers suggested to rebrand Islamic finance as ‘asset-based’ or ‘participatory finance’ as a way to gain wider acceptance of this type of finance. This suggestion is gaining more momentum to reduce the sensitivity associated with the religiosity aspect and to encourage a view based on the merits of responsible and ethical finance” (Iqbal, 2015).

The idea in itself is not new; for instance, back in 2014 two large United Arab Emirates domiciled banks changed their names from Noor Islamic Bank and Abu Dhabi Islamic Bank to Noor Bank and Abu Dhabi International Bank respectively for international operations purposes (Vizcaino, 2014). Turkey treats Islamic financial institutions as participatory ones, “which has had a positive impact” (Iqbal, 2015). Islamic Development Bank representative acknowledged the problem as well, admitting that “Rebranding is an essential part of widening the appeal of the industry, whether we call it ethical, alternative or sustainable finance” (Vizcaino, 2014).

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