Financing National Infrastructure through Islamic Capital Markets – A Risk Sharing Proposal

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Why the Need

- Islamic finance assets are estimated to be $1.6 trillion, and is expected to grow at the rate of 15% over the next few years.

- Despite this impressive record, Islamic finance only accounts for 1% of the global financial system.

- A study revealed 19 from 39 Heavily Indebted Poor Countries (HIPC) are part of the OIC.
  - Heavily dependent on western financial intermediaries with high interest rates
  - Liability dollarization

- **Why do Governments Borrow?**
  - Infrastructural Development
  - Fiscal Space

Why the Need

- Government borrowing Source: International investors via bond or Sukuk issuances or through IMF, World Bank, Paris Club and/or other multilateral agencies.
- Leading to Liability Dollarization Crises.
- Economic recession are more likely to experience servicing difficulties. Country has three options:
  - Choose to default on their obligations, resulting in traumatic long term effect for the economy as a whole accompanied by higher cost of borrowings for future financing needs.
  - Renegotiate and seek restructuring, which in principle would have the same consequences as in the case of default
  - Undertake deep reaching austerity programs, and tightening Fiscal policies, all of which impose substantial economic and social cost.

- **Who Pays??? The Lowest strata of income and intergenerational debt is created**

What are we Proposing?

- An equity instrument whose payoff is tied to the growth of the economy.
- Our proposal - Structure a simple equity instrument based on the underlying contract of Musharakah.
  - GDP linked sovereign paper - Economy as an underlying business venture, and the GDP growth of the country as the indicator for the profit/loss of the venture.
- A form of partnership between the investor (international agency, or sovereign portfolio investors) and the government of the country.
- A concept of a lump sum provision of capital, at the beginning of the contract – And secondary market tradability for entry and exit of investors

How Will it Work?

- The Structure is based on Equity concept, akin to the Musharakah contract in Islamic Finance.
  - Why it is not termed a Sukuk like Diaw et. al (2011), is primarily due to the fact, that labelling an instrument Sukuk, brings it into quassi equity nature according to Islamic financial standards. And the instrument proposed in this study is a simple Musharakah partnership between the international aid agency/donor country and the government of the country, with the underlying business being the economy of the country.

- This study proposes and has factored in 5 different mechanism.

  Where r = Return in Year

  g_r = Growth of Real GDP in that year b_r = Base rate
- **Pricing Option A.** $r = Max\{\, g_r, 0)$
- **Pricing Option B** $r = Max\{\, (b_r + 0.5(g_r - b_r), 0)$

  Where $b_r = Average\ of\ last\ 5\ years\ of\ g_r\ before\ issuance\ of\ the\ instrument$
- **Pricing Option C**

  If $g_r > b_r$ $r = Max\{\, (b_r + 0.5(g_r - b_r), 0)$

  If $g_r < b_r$ $r = Max\{\, (b_r + 0.25(g_r - b_r), 0)$

  Where $b_r = Average\ of\ last\ 5\ years\ of\ g_r\ before\ issuance\ of\ the\ instrument$
- **Pricing Option D**

  $r = Max\{\, (b_r + 0.5(g_r - b_r), 0)$

  Where $b_r = Average\ of\ last\ 5\ years\ of\ g_r\ from\ the\ payment\ year$
- **Pricing Option E**

  If $g_r > b_r$ $r = Max\{\, (b_r + 0.5(g_r - b_r), 0)$

  If $g_r < b_r$ $r = Max\{\, (b_r + 0.25(g_r - b_r), 0)$

  Where $b_r = Average\ of\ last\ 5\ years\ of\ g_r\ from\ the\ payment\ year$

Investor Benefits

- Serious question – Would international investors be willing to directly expose their investments to volatility of GDP in Muslim and emerging countries?
  - International investors are already exposed to the economic growth of the country implicitly via the investments in the stock markets and the standard debt contracts.
  - GDP linked Sovereign Paper tend to provide a buffer against the possibility of default and its costs by providing the investors a steady return that is bound to pay a higher amount in the long term as economies pick up.

- Risk Exposure and Diversification
  - Developing and Islamic Economies all have different economic structure and different regions.
  - The economic cycles are not perfectly synchronized and have low or negative correlations.
  - A mass issuance of the GDP linked Sukuk is done by Muslim countries, from an investor perspective a well-diversified portfolio can be constructed to hedge against over exposure to a single business cycle.

Issuer Benefits

- Indexing sovereign debt payments to real economic variables as a mechanism to reduce financial distress.
  - Underlying principle is based on improving risk sharing among debtor countries and international creditors.

  - If the government debt is optimally indexed to real economic variables, it would allow the government portfolio of assets and liabilities to generate payoffs similar to country's economic health or real sector returns.

- How does it finance infrastructure?
  - Linked to specific infrastructure projects?
  - Limits ability of Government to excessive borrowing
  - Promotes local savings and investment culture.
  - Gives masses ownership of national infrastructure.

Conclusion

- This study has tried to address a gaping hole in the literature on Islamic finance, focusing on developing countries' financing needs.

- Smaller denomination in local currency would facilitate localization of financing.
- Involvement of general public in the infrastructure of the nation.
- Accountability of the representatives of the people.
- Decrease in reliance on international and foreign lenders, more autonomy in the system.