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Enhancing Cross Border Connectivity: Venturing into Islamic Finance as a New Source of Infrastructure Financing

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Abstract

Connectivity within Association of Southeast Asian nation (ASEAN) member countries becomes a central issue in view of the ASEAN Economic Community 2015. However, progress towards ASEAN connectivity especially for infrastructure developments has been limited. One of the problems is the resource mobilization for project financing. In recent years, rising demand for Islamic securities among global investors in jurisdictions where legal framework and financial infrastructure are well established has made sukuk a cost effective and preferred method of raising finance. It has also attracted liquidity to and has made Malaysia a leading global sukuk issuer and a leading Islamic financial hub. This paper is a case study on how Malaysia has used the Public-private partnership (PPP) for infrastructure development and how this has extended into Islamic financing and further examines how this model can be expanded into other ASEAN member countries in particular the Cambodia, Vietnam, Laos and Myanmar (CVLM) countries where issues of infrastructure financing is critical and need to be quickly resolved in view of an enhanced ASEAN connectivity and the future of an ASEAN community development.

1. Introduction

Islamic instruments specifically sukuk or Islamic bonds are increasingly gaining popularity as the preferred financing option in view of the apparent benefits that industry players and stake holders are beginning to appreciate. In recent years sukuk issuances have been used to raise finance for infrastructure developments in some countries like Malaysia. The process makes use of the public private partnership model (PPP) in order to speed up infrastructure projects as limited government funds often restraint or delay the implementation of such projects. Infrastructure projects are high risk projects with long gestation period and the huge cost coupled with large positive externality impact or third party spill-over effects often render such projects to be not commercially viable as business ventures. In the PPP model the government seeks to raise funds for infrastructure projects by allowing the private sector either through involvement of Government Linked Companies or GLCs or the set up of special purpose companies or SPVs to take part in the raising of funds and implementation of the project.

In Islamic Finance, taking or receiving interest (Riba) in loan transaction is prohibited. Risk in any transaction must be shared between at least two parties so that the provider of capital and the entrepreneur share the business risk in return for a share in profit. Besides riba other prohibitions include speculative behaviour and extreme uncertainty or risk (Gharar) and gambling (Maysir) and thus Islamic financing require contractual obligations and clear disclosure of information.

In recent years, rising demand for Islamic securities among global investors in jurisdictions where legal framework and financial infrastructure are well established has made sukuk a preferred and cheaper way of raising finance. It has also attracted liquidity to and has made Malaysia a leading global sukuk issuer and Islamic financial hub.

Connectivity within ASEAN member countries becomes a central issue in view of ASEAN Economic Community 2015. However, progress towards ASEAN connectivity especially for infrastructure developments has been limited. One of the problems is the resource mobilization for project financing.

To materialize connectivity the ASEAN community has to achieve targets in the three main pillars of connectivity ie Physical, Institutional and People to People connectivity. The connectivity is mainly directed through the Master Plan of ASEAN Connectivity (MPAC) document established in 2010 which listed several prioritized projects. The MPAC is a plan of action to be implemented starting from 2011 to 2015 and beyond in order to connect each ASEAN country members through the three main areas of focus. In 2011, ASEAN Connectivity Coordinating Committee (ACCC) has been established in order to ensure an effective implementation of the plan and to overcome any issues or impediments to the ASEAN Connectivity.

One of the colossal challenges in implementing MPAC, embarked in 2011 is financing the projects. In Project Information Sheet by ASEAN Secretariat (2012), most of the projects require funding assistance in order to complete the project. This includes the projects of the Construction of the ASEAN Highway Network (AHN) Missing Links and Upgrade of Transit Transport Routes in Lao PDR and Myanmar, the Completion of the Singapore Kunming Rail Link (SKRL) Missing Links, The Developing and

Operationalising MRAs for Prioritised and Selected Industries, and the Operationalisation of the National Single Windows (NSWs) by 2012 and the ASEAN Single Window (ASW) by 2015.

As governments face critical challenges in raising enough funds for infrastructure developments and as many governments now face budget deficits and in dire need for fiscal consolidation, public agencies mandated for infrastructure developments are often on the look out for new modes of financing which can reduce the public fiscal burden. One of the sources of financing that is often overlooked is through the capital market. With rising demand for Islamic securities among global investors in jurisdictions where legal framework and financial infrastructure are well established, sukuk or Islamic bond is becoming a preferred and cheaper way of raising finance including for infrastructure developments. In some markets and jurisdictions like Malaysia, the appeal for sukuk has also attracted liquidity to and has made Malaysia the leading global sukuk issuer and one of the leading Islamic financial hubs in the world.

This paper looks at a new mode of Islamic financing of using Sukuk or the Islamic bond as a new mode to raise funds from the capital market, leveraging on Malaysia as a platform to attract liquidity that float around the world in search of Shariah compliant investment instruments. This liquidity might come from Islamic investors from various parts of the world including the Gulf rich with petro dollar. This paper recommends the ACCC and other relevant agencies to look and explore into this new method of financing in its promotion for ASEAN connectivity.

This study focuses at Malaysia as a case study and through the examination of various government documents and publications illustrates how an established and comprehensive Islamic Finance market where regulatory legal framework and a deep enough capital market has allowed for the development of sukuk which are issued by the government or government guaranteed special purpose companies to provide for an alternative form of financing. These new modes of financing are often argued to have several benefits over the conventional methods of financing. This study reviews past research on ASEAN connectivity, examines budget allocations for infrastructure through various 5 years Malaysian Plans, Malaysian budget reports and Malaysian Economic Reports. Data is also collected through expert opinion interviews with government agencies and Islamic finance experts.

2.0. INFRASTRUCTURE DEVELOPMENT OF MALAYSIA

The West Malaysia is served by major highways which are of world class standards. A major highway running North-South the whole length of the Peninsular is the North-South Expressway is the longest expressway in Malaysia with the total length about 775km from Bukit Kayu Hitam located at North area of Malaysia to Johor Bharu located at south area of Malaysia. Its development has been impactful, contributing hugely to the development of major sectors of the economy such as manufacturing, transportation, domestic tourism and other services industry such as retailing, and banking and contributed to fast and efficient connectivity within Malaysia as well as with its ASEAN neighboring countries of Thailand and Singapore.

Another impactful project towards ASEAN connectivity is the Kuala Lumpur International Airport. The new national airport was moved from the old location in Subang to Sepang and the project commenced in 1998. The cost of the project was approximately RM 10billion (USD3.5billion) and successfully built via Public Private Partnership scheme. After the existence of KLIA as the international airport, a low cost carriage terminal by Air Asia was built in 2006. The successful operation of both KLIA and LCCT stimulated not only the Malaysian economy but the regional economy as well and has contributed towards ASEAN connectivity.

Infrastructure Development Plan falls under Government Transformation Plan (GTP) were executed in three phases. First, GTP 1.0 up to 2012, focused on basic infrastructure, such as road and clean water. Despite a budget cut of RM3 billion, the achievements of the GTP 1.0 are rather impressive. The percentage of Malaysians living within five kilometers of a paved, gravel road and laterite roads act as the indicator of benchmark test for this initiative. By the end of 2012, 3,147 kilometers of road was completed, and the percentages of Malaysians now being serviced by the paved road are 98.6% of Peninsular Malaysia's rural population, 87.0% of Sabah's rural population, and 86.0% of Sarawak's rural population. The key performance indicator (KPI) for 2011 was to complete the construction of 905km of road, which was surpassed as 1,013km of roads were completed.

In the effort of improving urban public transport, GTP 2.0 focuses on Kuala Lumpur and Klang Valley area. The initiatives involve the implementation of projects such as Inter Urban Transport Terminal (IUTT) located at the periphery of the Central Business District (CBD), and implementing the Bus Rapid Transit. Other initiatives are enhancing the rail system by conducting the rehabilitation programs, power upgrades of KTMB's networks as well as upgrading of the communication and electrification system, and Expanding the KL Monorail capacity. In addition to that, GTP 2.0 also aimed to transform the taxis services in Malaysia into high quality of services by implementing a centralized taxi service system. Other than that, a new taxi business model was introduced by providing repair and maintenance facilities in Kuala Lumpur/Klang Valley.

The final phase for transformation before 2020 and was to be launched in 2015 known as GTP 3.0. It will have feedback on the impediments brought about by the two previous phase to establish new innovative governance structures that are claimed to be people-centred. These structures will thus support other economic activities that will result in Malaysia achieving a developed nation status as planned by the government.

3.0 MALAYSIAN ROLE IN PROMOTING THE CONNECTIVITY INITIATIVE

MPAC has been developed and created in order to achieve overall ASEAN connectivity among ASEAN Member countries. The project will involve the participating countries in each project to play their role in ensuring the completion. The following is the list of projects directly coordinated and monitored by Malaysia:

Table 4: Malaysian role in MPAC project

Project	Malaysian Role	Current Status	Remarks
Singapore Kunming Rail Link (SKRL) Missing Links	Coordinating Country (Ministry of Transport Malaysia)	Seeking technical assistance and funding	Target Completion Date: December 2015
Melaka – Pekanbaru Power Interconnection Indonesia-Malaysia-Thailand Growth Triangle (IMT-GT)	Coordinating and Implementing Country (Tenaga Nasional Berhad)	Seeking financial resources for the whole project. Detailed Terms of Reference (TOR) prepared for the undersea submarine cable survey. Contract to be awarded soon and survey would be completed by the end of first quarter of 2012.	Target Completion Date: December 2015
West Kalimantan – Sarawak Power Interconnection BIMP – EAGA	Implementing Body (Sarawak Energy Berhad)	Term Sheet for a Power Exchange Agreement (PEA) between Sarawak Energy Berhad (SEB) and PT PLN Persero (PLN) for the export of bulk electricity from Sarawak to West Kalimantan was signed in Jakarta July 2011.	Budget Estimated Total Project Cost: US$ 161 million. Malaysia: US$ 41 million, Indonesia : US$ 120 million Funding Partner(s) Asian Development Bank (ADB).

Source: ASEAN (2012)

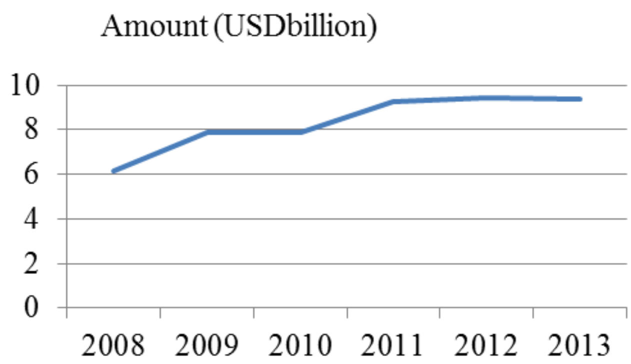
4.0 INFRASTRUCTURE FINANCING IN MALAYSIA

In Malaysia one of the sources of funds to finance the infrastructure project is derived from the national budget. Malaysian budget tabled annually covers all the aspects of the operating and development expenditure. Infrastructure development has always been made a focus by the Federal Government in its attempt to make Malaysia a developed nation by 2020. The trend of the budget allocated for the infrastructure development is illustrated in the table below:

Table 5: Budget allocation for infrastructure development

Year	Amount (USD billion)	% growth
2009	7.88	27.51
2010	7.89	0.13
2011	9.25	17.24
2012	9.44	2.05
2013	9.38	-0.63

Figure 1 : Budget allocation trend



Sources: Malaysia Economic Report (2011, 2012)

With reference to the above table and figure, the budget allocation from the federal government indicates an overall increasing trend, although there appears to be a slowing down of budget allocation in 2013. While federal government plays their prominent role in ensuring the development of the infrastructure, there has been attempts to reduce government burden by adopting other sources of financing for example using at the same time the PPP model which combines the resources of the government and the private sector thus contributing to the national saving.

Hence, besides the national provision in the National Budget, infrastructure projects are also funded by both public and private sectors. Privatization policy was launched in 1983, with the establishment of Special Task Force in the Economic Planning Unit (EPU) of the Prime Minister's Department to coordinate the implementation of the policy. In 1991, Privatization Master Plan was published and the special task force was renamed the Privatization Section of the EPU. In 2009, the Privatization Section was transferred into a new dedicated agency to plan and implement PPP known as the Public Private Partnership Unit or UKAS (Unit Kerjasama Awam Swasta, formerly known as 3PU).

The establishment of UKAS helps the government in evaluating PPP projects and proposing potential projects to the Cabinet for final decision and to act as secretariat to the government's projects that are to be implemented. UKAS is responsible to monitor the implementation of PPP projects, Facilitation Fund and corridors of development in Malaysia. Besides that, UKAS also supervise the Facilitation Fund which is allocated from the national budget in order to carry out projects.

5.0 SUKUK AND ITS ROLE IN PROJECT FINANCING

Islamic financial instruments, sukuk specifically, are increasingly gaining popularity as a preferred way of financing in view of benefits that industry players and stake holders are beginning to appreciate. Sukuk are Islamic securities, often referred to as Islamic bonds. In recent years, sukuk issuances have been used for several funding purposed. One of these funding purposes is to attract funding for infrastructure developments in countries like Malaysia. Public private partnerships (PPPs) are often used in order to speed up infrastructure projects as limited government funds often restraint or delay the implementation of such projects. Infrastructure projects are high risk projects with a long gestation period and the huge cost coupled with large positive externality impact and possible third party spillover effects often render such projects to be not commercially viable as business ventures. In a PPP model a government seeks to raise funds for infrastructure projects by allowing the private sector to participate either through Government Linked Companies (GLCs) or by incorporating special purpose vehicles (SPVs) that take part in the raising of funds and the implementation of the project.

Within Islamic finance, taking or receiving interest (Riba) in a loan transaction is prohibited. Profit should be made either through trade in tangible assets or according to a profit-and-loss-sharing model (PLS). According to PLS risk in any Islamic finance transaction must be shared between at least two parties, so that the provider of capital and the entrepreneur share the business risk in return for a share in profit. Besides Riba, other prohibitions within Islamic finance include uncertainty (Gharar) and speculation (Maysir). Hence, Islamic financing requires certainty on contractual obligations and clear disclosure of information.

Sukuk can be structured as fixed income securities. Sukuk are permissible within the provisions of Islamic law known as Shari'a because sukuk transactions are structured on the basis of underlying transactions that result in PLS or in trading in or construction of specific identifiable tangible assets. Thus, sukuk certificates are structured to generate returns that are paid through to the sukuk holders.

According to the Securities Commission of Malaysia (2009) and the International Shari'ah Research Academy for Islamic Finance (ISRA) (2011), sukuk can be structured on the basis of specific Islamic finance contracts that result in the trade of Shariah compliant assets.

Such Islamic finance contracts can be categorized into:

1) sale contracts (exchange/*muawadat* contracts): contracts that result in the sale and purchase of an asset such as *Murabahah* Sukuk, *Bay' bi Thaman Ajil* (BBA) Sukuk, *Salam* Sukuk and *Istisna'* Sukuk;

2) leasing contracts: contracts that result in the lease of specific assets such as *Ijarah* Sukuk, *Ijarah Muntahiyah bi Tamlik* Sukuk and *Ijarah Mawsufah fi Dhimmah* Sukuk;

3) PLS contracts (participation/*ishtirak* contracts): contracts that result in participation in joint-venture businesses such as *Musharakah* Sukuk and *Mudarabah* Sukuk; and

4) agency-based contracts: contracts that result in an agency arrangement such as *Wakalah bi Istismar* Sukuk or investment agency sukuk.

There are differences and similarities between sukuk and conventional bonds. A similarity is that both are tradable securities that provide their holders a return. Further, both conventional bonds and sukuk can easily be rated by rating agencies. However, a sukuk transaction does not solely result in the exchange of tradable paper in consideration for money with the imposition of interest. It rather leads to an exchange of Shariah-compliant assets for a financial consideration applying various Shariah contracts that allow the investors to earn profits with the underlying transactions. A conventional bond is a contractual debt obligation whereby the issuer is contractually obliged to pay the bond holders interest according to the terms and conditions of the bonds. This differs from sukuk because each sukuk holder holds a beneficial ownership interest in the underlying asset and is entitled to share the profits made with the sukuk asset.

Sukuk is fast becoming a Shariah-compliant alternative for conventional bonds and an attractive source of financing in many countries, especially in Malaysia and the Middle East. It is used for government development projects, e.g. Islamic Development Bank (IDB) has issued a 400Million Ringgit (US$120Million) sukuk in local currency in Malaysia during 2008 to finance toll road in Malaysia (IDB: 2008).

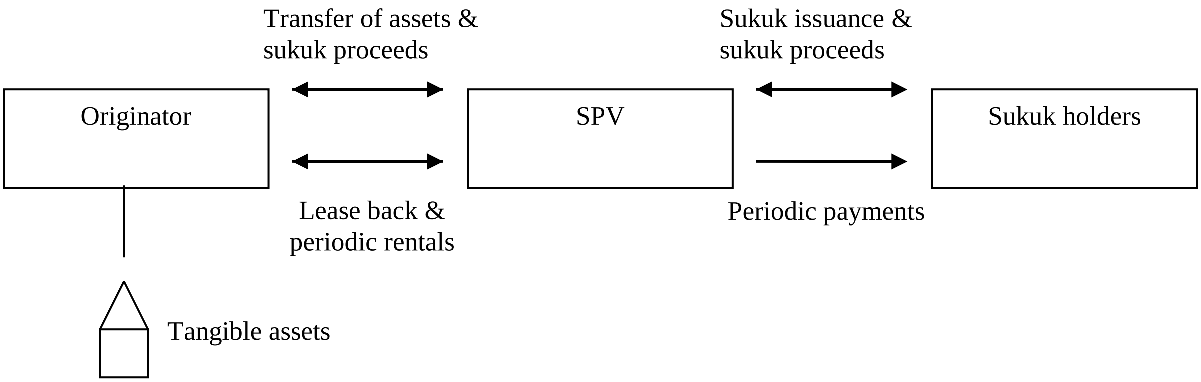
In Malaysia, the successful PPP model of project financing the infrastructure has been extended to adopt shariah compliant methods of raising funds. These include notable projects like the PLUS North – South Highway project involving RM 11 billion worth of government guaranteed (GG) sukuk issuances and RM 19.6 billion of AAA sukuk musharakah issuances and the Syarikat Prasarana Negara Berhad (PRASARANA), the Malaysian public infrastructure company which issued RM 2 billion government guaranteed sukuk al- Ijarah, under its RM 4 billion nominal value sukuk programme arranged in 2009. Another company, DanaInfra issued RM300 million retail sukuk in 2013 as part of its RM 1.5 billion sukuk programme intended to partially fund the Klang Valley's mass rapid transit (MRT). Its minimum required investment of RM1,000 made it possible for small investors to take part, making the sukuk the first Malaysia's retail sukuk (Mohamad 2014).

In the telecommunications industry, AXIATA Celcom Transmission (M) Sdn Bhd. issued RM5 billion nominal value Murabahah Sukuk in 2012 which was used for the refinancing of the issuer's existing debt, funding of capital expenditures and working capital, and other shariah compliant corporate funding.

6.0 SUKUK STRUCTURES FOR PROJECT FINANCING.

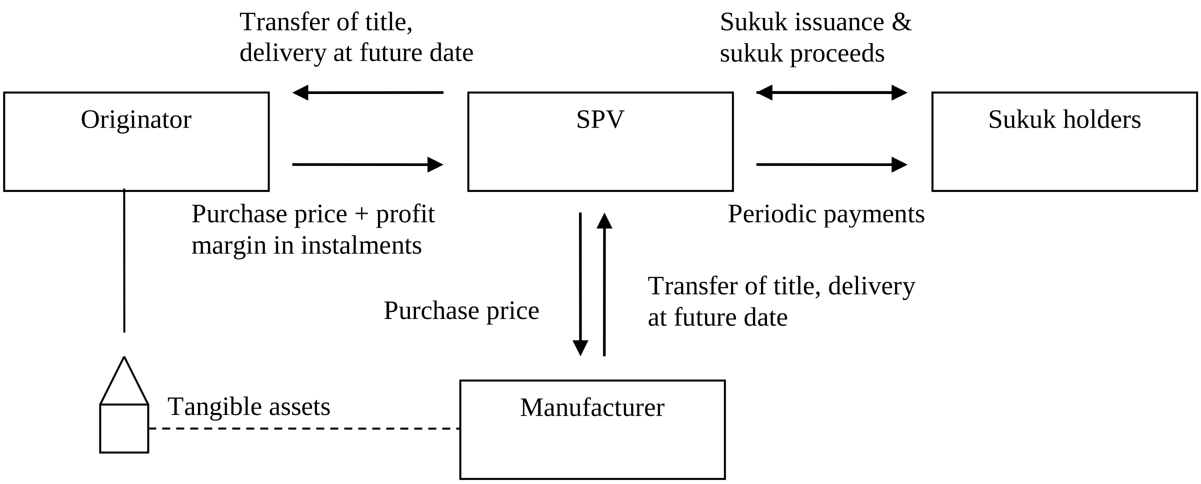
One of the most used sukuk structures is the *Ijarah* Sukuk (Salah 2014). The *Ijarah* Sukuk can also be used for project financing. Figure 2 depicts how the *Ijarah* Sukuk works. The *Ijarah* Sukuk is based on the Islamic contract of *Ijarah*. The transaction commences with the company that needs funding, referred to as the originator. The originator must select certain Shariah-compliant tangible assets which it will sell to an SPV. The SPV is incorporated by the originator itself, but it is a separate legal entity. In case of project financing for infrastructure development, the underlying assets can be real estate such as plots of land. The SPV will finance the purchase of the real estate by the issuance of sukuk. The sukuk must represent some degree of ownership and, consequently, the sukuk holders will gain the beneficial ownership of these underlying tangible assets, i.e. the real estate. The SPV, being the legal owner of the real estate, will use the sukuk proceeds to pay the originator the purchase price of the real estate. Next, the SPV will lease the real estate back to the originator. The original will make periodic rental payments to the SPV which the SPV, in turn, will pay through to the sukuk holders as the periodic payments over the sukuk, since the sukuk holders are entitled to that as the beneficial owners of the real estate. This will continue for the period for which the sukuk are issued. At maturity date, the SPV will sell the real estate back to the originator. The SPV will use the amount paid by the originator for the real estate to the sukuk holders after which the sukuk will be redeemed.

Figure 2: Basic transaction structure of *Ijarah* Sukuk



Another structure that can be used for project financing for infrastructure development is the *Istisna'* Sukuk. The *Istisna'* Sukuk concerns a structure whereby constructors, manufactures, and others wishing to construct, manufacture, and deliver specific assets at future date may raise funds for the costs of such future delivery assets through sukuk issuances. It is often used for financing large infrastructure projects. The transaction starts with an originator wishing to manufacture or construct something, but without the financial means to do so. The originator will incorporate an SPV that will issue sukuk. The sukuk proceeds will be used by the SPV to pay the manufacturer to manufacture certain assets. The right of ownership of these assets will be transferred to the SPV and the purchase price will be immediately paid to the manufacturer, while the assets will be delivered to the SPV at a specific future date. Then, the SPV will sell the title to these assets to the originator. Once again the title will be transferred immediately, but the assets will be delivered at a future date. Furthermore, the originator will pay a purchase price plus a profit margin, but payment will occur in instalments. These instalment payments will be paid through to the sukuk holders by the SPV as periodic distribution amounts on the sukuk and the purchase price itself is paid eventually as the principal amount of the sukuk. At maturity, the sukuk will be redeemed. Figure 3 illustrates this.

Figure 3: Basic transaction structure of *Istisna'* Sukuk



7.0 WHY ISLAMIC PROJECT FINANCING?

In recent years many sukuk have been issued, often through *Ijarah* Sukuk, to raise funds for infrastructure development. The PPP model is applied in these projects, whereby the government has allowed the private sector through either involvement of GLCs or the incorporation of SPVs in order to raise funds for infrastructure projects. In such cases a public interest is served since the development of infrastructure is in the interest of the public, but the way the fund is raised is very much through the involvement of the private sector.

In Malaysia, total sukuk issuances in 2014 have surpassed that of bonds, indicating that it is more attractive to raise funds through sukuk rather than through the issuance of conventional bonds. Sukuk is increasingly gaining popularity as the preferred way of funding in view of the benefits that are obtained from such sukuk financing. The following are some factors that explain the attractiveness of sukuk as a form of infrastructure project financing in Malaysia:

- ✓ lower cost of funds;
- ✓ tax Incentives (for both issuers and investors);
- ✓ flexibility;

- ✓ diverse investor base;
- ✓ greater transparency;
- ✓ enhanced security for investors; and
- ✓ supportive regulatory and legal framework.

How does ASEAN benefit from Malaysia being the world leader in Islamic finance? And how could some issues of ASEAN connectivity be resolved through Islamic financing? The Malaysian success stories in terms of project financing could be replicated elsewhere in other ASEAN member states or even anywhere for that matter. ASEAN countries could issue their own sovereign sukuk in order to raise funds for infrastructure financing. However, where markets are less familiar with Islamic finance and sukuk issuance, the challenges could be formidable.

The situation can be analyzed from the issuers and investors perspective. On the issuers perspective countries need to be ready in terms of the legal environment to issue sukuk. This also includes taxation laws. To be able to make Islamic financing attractive or at least not penalizing, countries need to have a tax neutral treatment of Islamic financial instrument with other conventional financial instruments. A few countries have already undergone tax reforms to allow for tax neutrality before issuing sukuk and be more involved in Islamic finance. Countries like Singapore, Thailand and Indonesia have made changes to provide for the infrastructure to support the Islamic finance industry and have either issued sukuk and other Islamic financial instruments or are well on the way to devising and reforming laws to make it possible to issue sukuk.

Would it be possible to raise sukuk in countries where the capital market development is still at infancy especially in the CVLM countries to benefit from the wave of Islamic finance the world is witnessing? The Asian region, Malaysia in particular, so far seems to be a far more attractive financial hub to invest through Islamic finance compared to some of the developed regions such as Europe, so in principle it is possible to issue sukuk in these CVLM countries. However, the credit rating of the CVLM countries could become an issue. Without a precedence in terms of bond or sukuk issuance the rating might not be attractive to investors. For that matter, in these markets where both credit rating and investor attraction could become issues, the issuance of bonds rather than sukuk would not make much difference. However, given the appetite from market players and a shortage of global supply of sukuk, sukuk issuance in the CVLM countries could attract Islamic investors across the globe who are always on the look out for new Shariah-compliant products. Based on the global scenario, and leveraging on the position of Malaysia being the leader in Islamic finance, it appears that it is worthwhile for other ASEAN countries to practically consider Islamic financing as a mode of infrastructure financing.

8.0 CONCLUSION

Malaysia could provide some lessons to ASEAN member countries as a country that has successfully used various modes of Islamic financing particularly in using sukuk as a tool of infrastructure project financing to contribute towards ASEAN connectivity. ASEAN financing agencies such as the Asian Development Bank could replicate the success of IDB in issuing sukuk for many of its infrastructure projects. ASEAN countries could leverage on the existing comprehensive and complete Islamic Finance market in Malaysia with its established legal and regulatory framework as well as the human capital and other infrastructure that has been developed over the last thirty years. Sovereign sukuk of neighbouring ASEAN countries can be issued using Malaysia as a platform and this could enhance ASEAN connectivity. Islamic financing instruments in particular sukuk, should not be treated as a financing tool only for Muslim countries or for the Muslims. Its use within ASEAN countries and for cross border infrastructure projects should be explored.

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