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Trends and Implications of Islamic Project Finance: A Study on the GCC Region

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1. The Growth of the Islamic Finance Industry[1]

The Islamic finance industry, which is based on Sharia, the religious law of Islam, has been growing at a relatively fast pace despite the 2008 global financial crisis. Islamic finance assets across the world have risen from USD 639 billion in 2007 to USD 1,357 billion in 2011, displaying an annual average growth rate of 20.7 percent. Financial institutions in accordance with Sharia law stood at 362 in 2007, globally, but the figure jumped to 469 in 2011, and the number of conventional banks also running Islamic windows increased from 163 to 206 during the same period.[2] However, assets held by Islamic banks are minimal compared to those held by commercial banks, so it is hard to say the Islamic finance industry is in a mutually competitive relationship with the conventional finance industry.

GCC nations and Malaysia are mainly responsible for the growth of the Islamic finance industry, but Islamic finance is also expanding in non-Islamic nations in Europe and Asia.

[1] This is modified from a policy report “The Structure and Risk Factors of Islamic Project Finance” written by the authors in 2012 .

[2] The Banker (2009, 2011), *Top 500 Islamic Finance Institutions*, London, UK.

While there are deviations by nation, an average of about 22 to 25 percent of financial assets in GCC countries are Islamic, while in the case of Malaysia, the figure stands at 20 percent.[3] Of non-Islamic countries, the UK is working to become a global Islamic finance hub centered on London, and in Asia, Singapore is doing likewise by fostering the Islamic finance sector. Non-Islamic countries are now developing new Islamic financial products that are acceptable by Sharia law, and there are analyses that financial markets targeting Muslims have the potential to expand in China, India and Russia. The causes behind such growth could be pointed out as the sustenance of high oil prices since the early 2000s, the rapid increase rate of the Muslim population, and policy support from Islamic nations.

As the Islamic finance industry continues to grow, project finance in the Middle Eastern construction market is witnessing a growing inflow of financial procurement through Islamic finance. With European banks suffering from insufficient financing capacities due to the 2008 financial crisis and the European fiscal crisis, the necessity for Islamic financial procurement has increased. Local demand for financing Islamic capital has also grown as project companies seek to raise their chances of winning project contracts, and also to minimize country risk in project finance.

In order to expand the number of construction projects in the Middle East and reinforce financing capacity to this end, Korea should focus more attention on the Islamic finance industry and Islamic project finance. Since the failure of the Korean government's efforts to introduce Islamic finance in the late 2000s, there has been a pressing need to develop ways through which Korean companies operating in the Middle East can utilize Islamic finance. Efforts are being made to strengthen financial cooperation between Korea and the Middle Eastern countries, as seen in the IR sessions held in Dubai by the Korea-Middle East Financial Cooperation Team, joined by the Financial Supervisory Service, in January 2013. This paper takes a look at trends in Islamic project finance, mainly in the GCC region, and seeks policy implications for Korea.

2. Definition of Islamic Project Finance and its Key Financial Schemes

Islamic project finance is basically the same as the project finance we know in that it is a financial technique that involves the financing of the entire or partial capital needed to fund a large-scale construction project. However, Islamic project finance requires that the purpose of the project involved and the financial schemes used are in accordance with Sharia. For instance, investment purposes must not be related to gambling or the sales of pork or liquor, all of which are forbidden by Sharia law. Also, financial schemes cannot involve interest-based lending, and cannot include unclear terms of contract. Islamic financial institutions therefore have to design their financial structure so that profit is generated from commissions and rental fees through actual trading, without collecting interest. As long as these few Sharia principles are adhered to, all financial transactions in the conventional sense are possible.

Aside from the inherent risk factors of project finance, Islamic project finance also entails additional risk factors that arise from the combination of Islamic and conventional financial methods. Although Islamic project

[3] Paul-Henri Pruvost (2012), "Do Islamic Banks in the GCC still hold a vantage point over their Asian counterparts," The Globalisation of Islamic Finance: Connecting the GCC with Asia and Beyond, Standard & Poor's. (September 25th)

finance can provide all the capital a project needs through Islamic financial tools, in general large-scale projects tend to procure only part of the necessary funds from Islamic finance. As already mentioned, however, Islamic project finance must be in accordance with Sharia law, and since there are no standard criteria for avoiding restrictions of the law, the decision is up to the interpretation of scholars on the Sharia committee, which means it takes a considerable time before the procedure can be officially accepted. As a rule, in project finance all interested parties must be allocated profit and risk according to participation shares under equal conditions, but as contracting terms differ between Islamic and conventional financial methods, the complexity of the financial structure inevitably leads to a delay in negotiation procedures. Also, there is no mutually acknowledged resolution method, legal system or regulatory governance that can be applied in disputes between Islamic and conventional banks.

Financial schemes mostly used in Islamic project finance include *Istisna, Ijara, Murabaha, Musharakah* and *Wakala*. *Istisna* is normally involved in financing for the construction stage, whereas *Murabaha, Musharakhah* and *Ijara* are used in the construction or operation stages. With *Istisna*, an Islamic financial institution provides financing for an underlying asset which is a product or building that does not yet exist but will be completed in the future. This contract is utilized mostly in a project's construction stage. The Islamic financial institution provides funds to the manufacturer in exchange for ownership of the underlying asset, and when manufacturing is complete, the financial institution resells the asset to the manufacturer, adding a sales commission to the manufacturing cost.

Ijara is most similar to the concept of a lease in conventional finance, and is actively used in the operation stages of Islamic project finance. Through *Ijara* contracts, Islamic financial institutions lend property or equipment in their own possession to consumers, and profit from the rental fees. The contracts generally involve *Ijara-wa-Iqtina*, which means rent with an acquisition or rent to own when the contract is up.

Murabaha is a process in which an Islamic financial institution, in the construction or operation stages, purchases the necessary materials instead of the project company, and resells them to the company with an additional margin. The project company can choose to pay in installments. Risk levels are low since *Murabaha* contracts involve transactions based on tangible assets, and they thus tend to be used in short-term transactions.

Musharakah is in the form of a joint venture, where the Islamic financial institution is given ownership of the project company's tangible assets, and in turn provides financing. In this case, the project company must pay the financial institution a share of its profits according to a predetermined profit-sharing ratio. Since Islamic financial institutions lack the necessary project operation expertise, the project company stands in as a *musharik* and assumes business management responsibilities.

Wakala involves cases in which an Islamic financial institution is in charge of managing and overseeing a project's construction and operation as the funder, but lacking the relevant expertise, delegates those responsibilities to a *wakil* with sufficient experience and knowledge. The *wakil* receives commission for standing in for the financial institution and deals with the supervision of the project contract and related procedures, as well as the transfer of facilities that have completed construction.

The financial schemes described above can be used independently, but in many cases are mixed in a combination of *Istisna* and *Ijara* or *Wakala* and *Ijara*. Since *Istisna* is generally reserved for the construction stage, and cannot generate sufficient profit in the operation stage, the *Ijara* contract is applied to transfer ownership of the completed facility to the financial institution so as to receive operating funds. Meanwhile, the *Ijara* entails maintenance obligations on the facilities that the financial institution has received ownership of, but since financial institutions tend to lack the expertise or manpower to do the job, a w*akil* usually steps in at this point.

3. Developments of Islamic Project Finance by Country

The Middle Eastern project finance market, centered on the GCC region, seems to be shrinking dramatically since the 2008 global financial crisis. Around the early 2000s, orders for infrastructure construction projects skyrocketed on the back of high oil prices, but since the late 2000s, the global financial crisis, European fiscal crisis and political and economic instabilities following the Arab Spring have caused the project finance market to contract sharply. Due to the Eurozone fiscal crisis, the market participation of European banks like the Royal Bank of Scotland and BNP Paribas, which led project financing in the Middle East, is dropping. It is also highly probable that the regulatory system of the Basel Ⅲ will weaken the profit base from project finance participation, and will also make it hard to effectively manage conventional syndicate models centered on major banks.[4]

[4] Tae-Joon Park (2012), "Recession in the Global Project Finance Market", *Capital Market Weekly*, 2012-18, Korea Capital Market Institute

The supply scale from Islamic project finance also rose rapidly until the mid-2000s, but plummeted soon after the project finance market contracted in the aftermath of the global financial crisis. In GCC nations, USD 63,685 million was procured for 116 projects from 2001 until the end of 2012 with Islamic project finance. Despite the downward trends, Saudi Arabia and Qatar showed signs of recovery, each listing USD 795 million and USD 500 million in 2011. In 2012, Saudi Arabia and the UAE each recorded financing scales of USD 1 billion and USD 644 million, a 23.5 percent increase from the year before.

In terms of financial schemes, mixed ones such as Istisna-Ijara and Wakala-Ijara were used the most at 53.8 percent in Islamic project finance from 2001 to 2012, followed by *Istisna* and *Ijara*. As for sectors of financing, real-estate development accounted for 63.4 percent of total Islamic project finance in the same period. This is because Islamic assets accumulated on the back of high oil prices in the 2000s were invested in urban development or real-estate development for tourism or business as a means to escape the oil-dependent economic structure. There was also a lot of investment made in the industrial diversification, such as the petrochemical industry, which utilizes oil and gas resources, accounting for 13.0 percent of Islamic project finance. Along with the growth of the Islamic finance industry, demand for social infrastructure in the GCC region is also steadily increasing, and this is expected to contribute to the rise in procurement volumes from Islamic project finance. GCC countries like Saudi Arabia, the UAE and Qatar are continuing to initiate projects on development of the petrochemical industry, power and water production facilities, and urban infrastructure by hosting mega events, contributing to the expansion of the project finance market. As already mentioned, while conventional European banks are struggling to find the capacity for large-scale financing, GCC countries are actively fostering the Islamic finance industry, opening up many more possibilities for the utilization of Islamic project finance.

The UAE is the most avid user of Islamic project finance, having procured USD 35,347 million for 48 projects from 2002 to 2012 through Islamic financial schemes. The business area of highest concentration was real-estate development, in contrast to Islamic project finance in Saudi Arabia, which was focused on the petrochemical industry. This can be attributed to the high number of large-scale construction projects for mega shopping malls and skyscrapers centered in Abu Dhabi and Dubai.

Saudi Arabia comes in second after the UAE in terms of utilizing Islamic project finance, and projects are generally related to industrial diversification, for instance the petrochemical and information and communications industries. From 2004 to 2012, USD 14.8 billion was funded through Islamic project finance for 31 projects. Saudi Arabia has been the most quick to recover from the 2008 global financial crisis on the back of high oil prices.

With the aim of becoming the financial hub of the Middle East, especially in Islamic finance, Bahrain has been hosting international Islamic financial institutions as well as seeking ways to develop and utilize diverse Islamic financial schemes. Like the UAE, Bahrain's utilization of Islamic project finance has been focused mostly in real-estate projects like urban development. A total of 18 projects from 2003 to 2012 used Islamic project finance, and 12 of these involved real-estate projects. Bahrain hit its record high in terms of Islamic project finance performance in 2008, and then the market suffered a recession due to the aftermath of the global financial crisis and the Shia anti-government protests inspired by the Arab Spring. The country's fiscal balance continues to worsen, while political instabilities still remain, clouding prospects for a recovery in the project finance market any time soon.

Qatar, the host of international events like the 2022 World Cup tournament, is boosting demand for social infrastructure and accommodation facilities. The Islamic finance sector is also being fostered on the government level, making it safe to assume that the Islamic project finance market will grow. In Qatar, USD 4,313.3 million was procured for 13 projects through Islamic project finance. In terms of capital funded, power production and freshwater facilities topped the list, while in terms of project number the highest concentration was in real-estate development. The Qatari government prohibits the joint operation of conventional and Islamic finance, and by doing so, encourages the establishment of Islamic banks that only deal with Islamic finance.

In the case of Kuwait, Islamic project finance is not yet enjoying high levels of utilization, with a total of five projects having procured USD 746.8 million through Islamic project finance for the past ten years. Although Kuwait was the first Middle Eastern country to use Islamic project finance~~,~~ for the Equate petrochemical project promoting economic reconstruction after the Gulf War in the mid 1990s, there has not been much activity in the Islamic project finance market since then compared to GCC neighbors. Kuwait is continuing to suffer political instabilities, as seen in the frequent cabinet replacements since 2006, as well as conflict with parliament, and the forecast for the country's Islamic project finance market remains unclear.

In Oman, there have been no cases of Islamic project financing ever since the Sohar Aluminum Refinery project first received Islamic project financing amounting to USD 260 million in 2005. This is because the Central Bank of Oman prohibited Islamic banks from conducting business independently. However, since May 2011, the Central Bank of Oman allowed financial institutions to provide Islamic financial services in order to restrain outflows of investment funds, and this is shedding a positive light on the expansion of Islamic finance in the country. Thanks to oil and gas exports, Oman's fiscal surplus has recently been expanding, encouraging the construction of social infrastructure and oil or gas-related plants.

4. Policy Implications

It is necessary to increase research on Islamic finance in order to promote the globalization of the domestic finance industry and to reinforce financing capabilities of Korean companies operating in the Middle East. Islamic finance is no longer a religious financial method reserved for Islam nations, but is developing even in non-Islamic developed countries like the US, UK and France. Thus, the Korean finance industry should be institutionally prepared to deal with Islamic financial products. Since large-scale financing capabilities are vital for the success of mega projects like power production or oil and gas plants, the government should devise policy measures that can actively utilize Islamic capital and Islamic financial schemes.

The government should start with the establishment of an Islamic finance research center that not only studies Islamic financial schemes and cases, but also conducts comprehensive studies on topics related to Islamic finance, such as laws, institutions and Sharia compliance principles. Since Korea is not yet equipped with the institutional infrastructure for adopting Islamic financial schemes, and lacks systematic understanding of Islamic finance, it will be necessary to conduct studies integrating Sharia, Islamic culture, and the politics and economies of Middle Eastern countries. In addition, the center should conduct research on the use of Islamic finance in non-Islamic developed countries like the UK, France and the US, and on trends of easing Islamic finance-related regulations in Australia, Turkey and Japan, all of which are eager to introduce sukuk.

As for measures to support Korean companies, a system should be established to provide systematic support for companies that encounter difficulties when using Islamic finance due to lack of experience, knowledge or professional manpower. There should be a knowledge network that can provide various information regarding market trends in Islamic finance, facts on key Islamic financial institutions, and the latest case studies. Companies should also be provided with professional manpower such as Sharia experts or international finance attorneys in the negotiation or contract-signing stages. It is necessary to cultivate professionals in diverse areas, such as Islamic finance, Sharia and international finance law. KIEP