Article

Infrastructure Project Financing Through Sukuk as an Alternative to Conventional Bond Financing

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Abstract: The infrastructure development is one of the vital elements in achieving the goals of the country development. When infrastructure and other public facilities are available, basic human needs can be met accurately. Financing infrastructure has been the main concern of many countries and there is a very little foreign direct investment in developing nations for many reasons. These nations apply for loans from international institutions which are expensive with many attached conditions. Similarly, evidence have shown from Gulf Cooperation Council (GCC) and Malaysia that the adoption of sukuk is an assured way toward infrastructural development of a country. For this reason, many authors perceived sukuk as alternative to conventional bond for infrastructure projects and other essential needs for countries to develop. Therefore, this study is motivated by the infrastructural development which has taken place in those countries that have been practising/using sukuk as tool for infrastructure development. This innovation will increase a lot of strategic advantage and economic development of countries by utilizing sukuk as an alternative source of funding. Using sukuk as infrastructural development's tool will also assist countries that find it difficult to fulfil the requirement for the conventional bond.

Keywords: Sukuk; Ijarah; Infrastructure; Development

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Public Interest Statement

The *sukuk* issuance would help the public to keep resources inside the economy of the country, rather than being used to repay external borrowing and being without *riba* or interest the profit could be inserted once again into the economy. This innovation will increase a lot of strategic advantage and economic development of countries by utilizing *sukuk* as an alternative source of funding. Using *sukuk* as infrastructural development's tool will also assist countries that find it difficult to fulfil the requirement for the conventional bond.

1. Introduction

The infrastructure development is one of the vital elements in achieving the goals of the country development. When infrastructure and other public facilities are available, basic human needs can be met accurately. Financing infrastructure has been the main concern of many countries and there is a very little foreign direct investment in developing nations for many reasons. The fundamental reason is that these countries lack physical, technological infrastructure, telecom and quality of human resources (HR) is also lower in these nations. In order to develop educational institution and infrastructure, huge sums are required which many nations may not fit into their budget. These nations apply for loans from international institutions which are expensive with many attached conditions. In this paper, we attempt to provide an alternative to these foreign loans. This option is not new to numerous countries. The alternative for this international loan is *Sukuk* (Malikov, 2017).

Sukuk (plural Sakk) in Arabic means a certificate or *Shariah* security. *Sukuk* is one of the means utilized for raising funds. It is a key vehicle for resource mobilization in the private sector and public sector (Mohd, Hafizi & Shahida, 2010). According to the Accounting and Auditing Organisation for Islamic Financial Institutions (AAOIFI) cited by Shaikh and Saeed (2010), defines *sukuk* as "*certificates of equal value representing undivided shares in ownership of tangible assets, usufruct and services or (in the ownership of) the assets of particular projects or special investment activity*". *Sukuk* is a certificate of investment, including ownership in underlying asset that claims in the pool of asset. Nevertheless, in addition to the income, there must be an element of ownership in *sukuk* asset. It is not comparable to conventional bond in which the guarantor is obliged to pay a fixed return amount of interest to the bondholder as they agreed in the contract. However, in the case of *Sukuk*, the return on the principal invested relies upon the income generated by the asset as well as from the proceeds of the realization of the assets (Jobst, Kunzel, Mills & Sy, 2008; Majid & Rais, 2003). Philosophically, *sukuk* is a certificate of equal value representing undivided pro-rate ownership of tangible assets, services or usufruct. Although *sukuk* in principle is a nonrecourse asset-backed tool which the originator typically undertakes to repurchase the underlying assets at either referenced or fixed price. This renders *sukuk* asset based and gives certificate holders exposure to the credit risk of the originator (Zin *et. al*, 2011).

The origins of Sukuk can be traced to the early Islamic period (AD 700-1300). In the current time, there was no movement of *Sukuk* until 1990, when the first *sukuk* issued in Malaysia Ringgit by an international company. After eleven years another first sovereign sukuk was issued by the Bahrain Monetary Agency (now the Central Bank of Bahrain) in the line of the Ijarah structure, and an international *sukuk* issuance was made in US dollars by a Malaysian company. The Malaysia government made another international issuance in 2002, which is the first *sukuk* rated by international credit rating agencies. Numerous other sovereign issuances took place after, including those by Qatar, Pakistan, and the Emirate of Dubai, which set the phase for unparalleled *sukuk* development. In the GCC nations, for example, *sukuk* issuances relatively multiplied between 2005 and 2007, increasing from USD 25.5 billion to USD 48.2 billion (Latham & Watkins, 2015).

There are various types of *Sukuk* available, but in this paper, the focus is on Sovereign Ijarah Sukuk. The objective of the paper is to highlight the possibility of Sukuk for infrastructure development as an alternative for the conventional bond.

The remaining part of this paper is structured as follows: section two explains the literature review about *Sukuk* for infrastructure development and the importance of *Sukuk* as an alternative for the bond. Section three discusses the methodology of the study. Section four explains the finding from the literature and the conclusion.

2. Literature Review

This section will discuss about sukuk as an alternative for infrastructure development. An Islamic financial institution relies on the operation and objective of Islamic law (Shariah), in light of a verse from the *Al-Quran*, Allah says, "Allah has permitted just genuine trade and prohibited interest" (Ahangar, Padder & Ganie, 2013). Two major principles of Islamic financial system deserve merit attention. First, it depends on the theory of profit and loss sharing (PLS) between the borrower and the lender. In PLS, profit and loss are shared according to the return generated from the business or project. This is different from the conventional model in which fixed returns known as *Riba* is determined before the transaction. Secondly, it lays considerable emphasis on making an investment on a welfare basis, as against those that negatively affect society. Operations of the Islamic financial system is based on the prohibition of *riba*, *gharar* and avoidance of speculation, uncertainty and injustice (*Zulm*). It also discourages transactions in haram goods and services (Sadikot, 2012).

However, Sukuk is indicted as Islamic bonds that include an ownership right of a given class of asset where borrower offers it to a lender as an evidence of ownership. Comprehensively, Sukuk contract might be characterized as a debt funding arrangement agreed the sukuk holder and counter party such as, services, governments to involve economic activities of production or firms (Haque, Chowdhury, Buriev, Bacha and Masih, 2018). Ahmad, Zaheer, Masood and Usman (2014), mention that Sovereign *Sukuk* has played a significant role in the development of many nations. Developing and developed countries can benefit a vast extent by sovereign *Sukuk Ijarah* structure. The governments can satisfy their financial deficiencies by issuing sovereign *Sukuk*. Where the large sum of money is required for building various projects such as dams, road, hospital, house, schools, air terminals then issuing sovereign *Sukuks* is the best accessible choice in the medium as well as in the long term.

As cited by Standard and Poor's, around US$77.1 billion of *sukuk* were issued by sovereign entities, government-related elements (GREs) and corporation in 2016, amounting to more than double the US$33.6 billion brought up in 2006. As lower oil costs keep on reducing the ability of banks to fund the billions of dollars of investment and state budgets in the GCC continue to operate at a deficit the *sukuk* market is probably going to be a key source of financing for some corporations for the following few of years (Latham & Watkins, 2015).

As described by Standard $ Poor the size of infrastructure *sukuk* issuances in Malaysia was $29.8 billion from 2006 to 2012. The funds were invested in enhancing many huge scale projects, including Kuala Lumpur International Airport (KLIA), Maju Expressway, Southern Link, and the Senai Dersu Expressway (Ibrahim Mardam-Bey 2013). All their development infrastructure projects were supported by the National Economic Transformation Program that is planned to transform Malaysia into a high-income country by 2020 (Money, 2014). Sovereign *Sukuk* issuances for infrastructure ventures increased progressively throughout 2012 and 2013 since it's have become important key drivers of economic development in the kingdom (Saudi Gazette 2013).

It is necessary to build up a well-functioning infrastructure for the fast and sustainable development of the economy. Sufficient and well-organized infrastructure is critical because of its effect on economic performance and their development, which thus relates to the welfare of the general society. Investment and improvement in infrastructure sector bear an immediate association with the GDP development of the country; one per cent of the stock of infrastructure is related to one of a per cent or increment in GDP (Srinivasu & Rao, 2013).

According to Hamza (2006), sovereign *sukuk* are issued by countries such as Malaysia, Bahrain, Qatar, Pakistan, Sudan, Iran and Turkey. *Sukuk* has become very prominent as a method of financing infrastructure, debt repayment and credit growth through the banking segment. *Sukuk* today is widely applied to finance community expenditure programs, to develop infrastructure such as motorway, airport, medical, and substantial tourist development.

As indicated by Kammer et al., (2015) *Sukuk* is viewed to be suitable for infrastructure financing in view of their risk sharing property. This could equally help to fill financing gaps. According to Said and Grassa, (2013) *sukuk* has been the mechanism that has given sovereign government partnership within access to the liquidity pool according to Shariah. *Sukuk* are deliberately imperative for the Islamic financial industry, as well as a significant source for infrastructure development project financing (Hussain, Shahmoradi & Turk, 2016).

Diaw, Bacha and Lahsasna (2014), *sukuk* has various advantages with deference to supporting government expenditure on infrastructure developments. For example, they are relied upon to enhance the solidity of the business sectors and institution of financial since they depend on tangible assets. This is strengthening the association between the real sector and the monetary division of the economy. Besides, typical infrastructure projects require long-term financing techniques. Basically, *sukuk* holders prefer to have a stable and predictable cash flow a period of a long time. As quoted by the statistics reported by the Organization for Economic Co-operation and Development, investment in many infrastructure projects, including transport, electricity, power, roads, water and telecommunication will require $71 trillion Dollars by 2030 over the globe. In the meantime, the International Finance Corporation estimates that $21 trillion of those investments would be required by developing markets. *Sukuk* have been perceived as a suitable financing technique for infrastructure project development in developing countries. It merits saying that Islamic finance depends on two major concepts: socioeconomic and risk sharing. Viewed from this point of view, *sukuk* issuances in infrastructure developments require sharing of risk on the side and an involvement in the social and monetary growth of developing nations on the other (Azlin 2013).

Chermia and Jerbi, (2015), sites that the Islamic finance industry has perceived vital development, especially in the area of *Sukuk*. *Sukuk* indicate as one of the greatest successful products in Islamic finance. They have gained the attention of many investors and become progressively popular in different markets around the world. They have grown prominence as financial instruments serving both government financing through the issuance of sovereign *sukuk* and private segment through corporate *sukuk*. The authors explain why *sukuk* become an attractive alternative instrument of financing and investment for Tunisia. *Sukuk* are standout amongst the best successful instruments in Islamic finance industry and it is also one of the quickest developing sectors in the universal financial market (Mohd Zin, 2011).

The flexibility of *Sukuk* permits to adapt it for the various nature and benefit. It is can be utilized for the development of ports, stations, highways, airports and so many projects for the development of the country. The global increasing interests in spiritual and beauty of Islam and its spread to Western nations have helped to develop an interest in Shariah compliance products (Chermia & Jerbi, 2015).

Enthusiasm for the *Sukuk* market has surged as alternative finance for a sovereign, national and multinational organizations. It has also grown in advanced, developing and emerging economies; with the objective to finance investment in a wide range of financial activities and project development (Kammer. *et al*, 2015).

According to Malikov (2017) concluded in his paper sovereign *sukuk* issuances have a positive effect on the economic development of Saudi Arabia and as there were significant contrasts in the economy, state financial and social prosperity indicators of the two nations after and before the issuances.

Sukuk as an alternative to conventional bond. The major contrast between conventional bond and *Sukuk* is that the conventional bond does not back from an underlying asset, but *Sukuk* is backed by a tangible asset (Srinivasu & Rao, 2013).

Through this idea, *sukuk* appreciate the advantage of being backed by assets, thereby the investor or *Sukuk* holder have a level of protection which may not occur from conventional debt securities. Besides, dissimilar to conventional debt securities that mirror loan or debt on which interest is paid, *sukuk* can be organized based on new innovative applications of Islamic concepts and principles. Nonetheless, *sukuk* share a few similarities with traditional debt securities and similarly organized in based on assets that generated income. The generated income from these underlying assets pays to *sukuk* holder as a profit (Zin, et al., 2011).

According to Balibek (2017), the conventional bond can be simply created, supported by the full confidence and credit of the guarantor, sukuk depends on the transfer ownership or utilization benefits on an underlying asset, and its structure should follow objective of (*Sharia*) Islamic law.

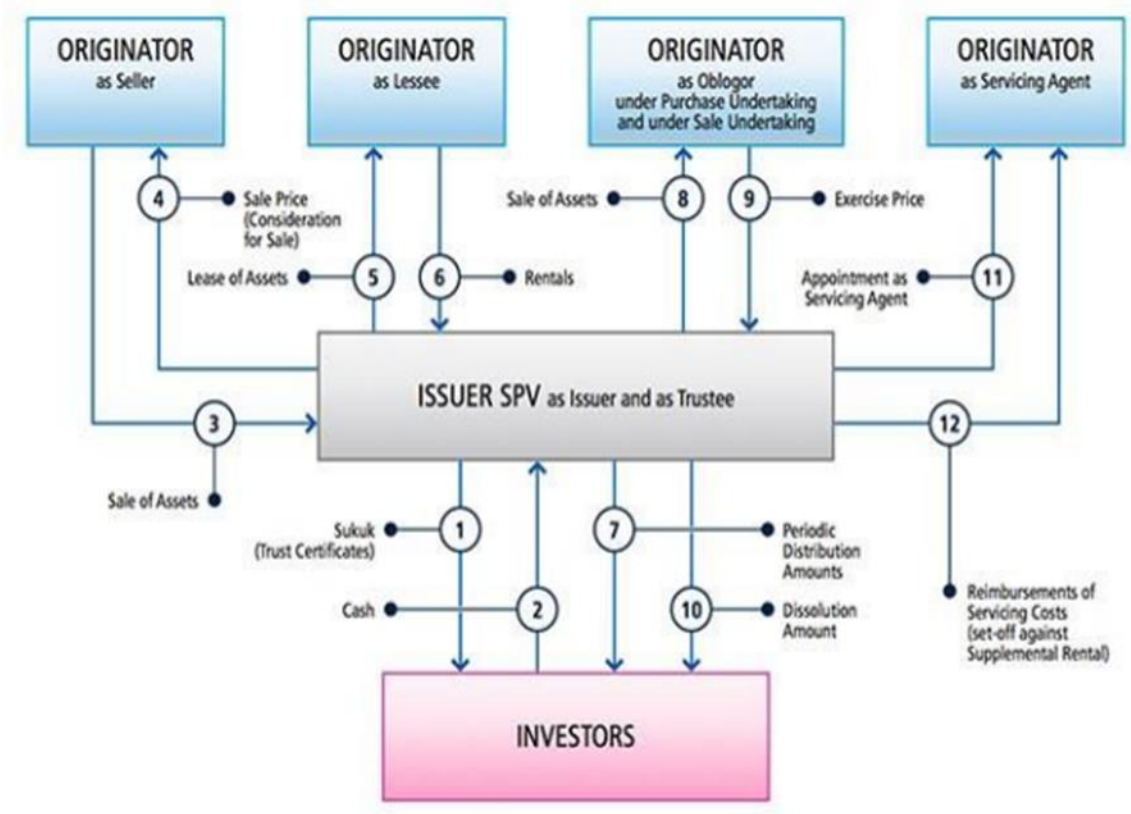
Sukuk holder guarantee that the investment will be utilized for infrastructure development and returns are permissible with the objective of Islamic transaction, the investment would not be occupied towards any un-legitimate activities, there would not be any fraud from the fund managers and asset development would be done by safe hands stopping any kind of manipulation or misbehaviours. In the recent decade, market participants and *Shariah* scholars have worked to develop a *Shariah*-compliant product which gives a lot of advantages of conventional financial products while at the same time staying faithful to religious principle. The universal Islamic finance market is evaluated to be worth a huge number of US Dollars and most financial institutions around the globe are associated with Islamic financing somehow, with many, particularly engaged in the arrangement, the management or trading *Sukuk* (Latham & Watkins, 2015).

The greatest characteristic of the *Sukuk* issuance is the larger macroeconomic position of the nation. In any case, given the achievement of past *Sukuks* issues by Malaysia, Pakistan, and GCC nations, it is probable that it would be a great point to consider. And if this big amounted *Sukuk* are issued, it would be an incredible achievement if the fund is managed and utilized effectively and efficiently. Bureaucratic and corruption must not hamper this gigantic investment (House, 2014 and COMCEC, 2018).

3. Methodology

This paper is based on literature review. The information has been accumulating from different articles, reports and difference sources available on *sukuk*. The focus of this study is on sovereign *sukuk* Ijarah for growing countries through raise fund for infrastructure projects to attract foreign direct investment.

Figure 1. Model of Sovereign Sukuk Ijarah



Source: Suwadi 2016

The paper concentrates on *Sukuk Ijarah*, it is one of the most significant *sukuk* in the market. *Sukuk Ijarah* relates to the securities in which jointly the proprietor, gangs some piece of the underlying resources that the benefits would have been consigned to the obligor or the *sukuk* holders at the time stated *Ijarah* agreement. *Sukuk Ijarah* has the privilege of making incomes of the basic resources are transferred from the obligor to *sukuk* holders in replace of the lease payment. The *Ijarah* contract would declare and the lease payment could be paid both toward the start of the month or the end of the month or quarterly, or yearly payment until the point of the dates. This sort of *sukuk* represent a joint of ownership and is tradable at secondary markets with a value which is predetermined by the market. For the first time, many nations issue these types of *sukuk*. Right now, the universal trend shows that investors prefer Ijarah *sukuk* because of their more stable returns (Nazar, 2015).

According to Hussin, Muhammad & Awang, (2012). *sukuk Ijarah* is very well known in many nations issued *sukuk*, especially in the volume of issuances and is considered by a few researchers at the old *sukuk* structure contrasted with other *sukuk* structures issued. Why *Sukuk Ijarah* is well known? It is basically because of its ease, generally accepted and simply to understand by traditional innovators and the international rating agencies. *Sukuk Ijarah* requires the delivery of proprietorship or benefits or usufruct of tangible resources, for instance, land, building, real estate, aircraft or ship from an originator to a special purpose vehicle (SPV), which that issue *sukuk* certificate to investors representing undivided of ownership of underlying resources. The fundamental asset, then rented back to the originator through the SPV for identifying conditions, which is equivalent to the condition stated on the certificates. Besides that, the rent in *Sukuk Ijarah* must comply with these coming *Shariah* requirements of the lease application. (1) The lesson needs to have legitimate ownership of the underlying resource, services or usufruct before entering into lease agreement; (2) The profit derived from *sukuk Ijarah* structure must be legitimate under Islamic law; (3) The property leased out should be exit at the time of lease and must not lease it another person; (4) The amount of payment must be specified by the period of the agreement beforehand; (5) The lessee needs to use the rented fundamental resource merely to design in the rent agreement; (6) The lessor needs to take care and promise that during the leasing time, delegate this obligation to a trustee during the leased period and (7) The liabilities coming up from the ownership of the underlying resources for example any harm or loss, are bore on by the lessor (Karim, 2007; Suwadi, 2016).

According to Naifar and Mseddi (2013) the most structure *sukuk* is *Ijarah sukuk* because of its flexibility, simplicity and tradability. The lease basis *Sukuk Ijarah* permits Governments to easily securitize their resource to get financing for different purposes as infrastructure improvement as well as financing budget deficits. As cited by Zin et al., (2011), *Sukuk Ijarah*: it is divided into the lease agreement, purchase agreement, undertaking purchase and servicing agreement. It depends on letting property rights to some other according to the agreed price. *Sukuk Ijarah* is issued on lease and sale backed agreement of land or real estate and have been a well-known structure for sovereign issuers specifically. The *sukuk* holder applies the *Sukuks* proceeds to buy land from the originator and after that lease it back to the originator. The originator embraces to repurchase the land or assets at the maturity time or upon early settlement of the first price. The *sukuk* holder or owner of the asset required by Islamic law to undertake the maintenance of the property but will often appoint the originator to carry activities on his/ her behalf (Radzi, 2011).

4. The Concept of *Sukuk Ijarah* Structure

Every *sukuk* issued must be back with the underlying asset. It is must avoid any speculation and interest. *Sukuk* process issuance can be typed into these methods which include originator/ obligor, SPV and *sukuk* holder. *Sukuk* issuance with SPV involvement in six general steps.

1. SPV as guarantor on behalf of obligor/originator issues sukuk to the sukuk holders.
2. The sukuk holder subscribes or purchase for sukuk and give payment to the SPV.
3. Obligor/originator comes into a deal and buyback plan with SPV (as a trustee), to which constitutes that obligor/originator agrees to sell and SPV agrees to buy underlying asset from the obligor.
4. SPV gives the proceeds got from sukuk holders to originator.
5. SPV at that point rents the underlying asset back to the originator by consent of the rent arrangement.
6. Lessee (originator) pays rental instalments at the periodic time as determined in the rental agreement.
7. SPV as issuer pays each periodic rental to sukuk holders.
8. In the case of insolvency/default or at maturity date (under the repurchase undertaking agreement), and originator will repurchase the underlying resource from SPV.
9. Originator gives the proceeds as a result of repurchase undertaking of the underlying asset for SPV.
10. SPV gives the payment to sukuk holders.

5. Brief Difference between Sukuk and Conventional Bond

Hassan and Mahlknecht, (2011), Safari, Ariff and Mohamad, (2014), they contrast and compare between conventional bond and *sukuk* based on their definitions, the structures and main characteristic, the intention of issuance, the underlying asset prerequisite, risk exposures and the ratings. Firstly, relationship between the consumer and the issuer of bond is very difference from the relationship between the purchaser of *sukuk* and the issuer of *sukuk*. In the issue of bond, the bond issuer is a loan recipient while the consumer is acting as a loaner. For this situation, the loan as interest fixed and therefore being as a riba (Al-Deehani, Karim & Murinde, 1999). The purchaser has purchasing the asset of *sukuk* which have value instead of participating in a certain loan contract. Secondly, difference between *sukuk* and bond is that the asset contains in *sukuk* certificates abide by Islamic law while the bonds certificates might be supported by assets that are not allows with *Shariah*, which might be packaged together with another type of assets without the customer's knowledge (Ramasamy, Munisamy & Helmi, 2011; Safari & Ariff, 2014). The buyer of *sukuk* is guaranteed that the estimation of the certificate relates to assets that are in the public good and not associated to the activities or items that are allow in Islam. Thirdly, underlying contract for *sukuk* issuance is an allowable contract such as, rent property or any other *sukuk* that are categories defined by AAOFI (2003). In conventional bond, the essential relationship is a give a loan of money which indicates a contract whose subject is purely making money on money, which is means as a *riba*. Fourthly, in contrast to the bond, there is no ensure return and principle in *sukuk*. Fifthly, *sukuk* price is market value and rely upon depreciation or appreciation of the market estimation of the underlying asset while bond depend on the creditworthiness of the issuer and do not depend directly on the particular assets. Sixthly, the sale of bond is the sale of debt while sale of *sukuk* represent share of asset. Lastly, at least 51 percent of *sukuk* contract must be tangible asset to be backed but there is no that condition for bond (Abdullah & Terebessy, 2014).

6. Conclusions

There has been growing recognition that Islamic finance offers a diversity of financing structures that are a feasible alternative to conventional finance. The *sukuk* has been especially instrumental in raising money and investment activities. Likewise, it suits well to fill the long-term infrastructure financing gap and supporting sustainable infrastructure development. Seeing that infrastructure investment is the key importance for the countries to obtain economic development sustainable, Islamic financing, for example, *sukuk* has possibility element to provide an alternative financing for infrastructure development solution. The contribution of the *sukuk* to the development of infrastructure is supported by various catalysts. *Sukuk* has potentially wider market section compared to the bond products. Particularly, at the same time, various countries need to develop infrastructure to make life easy for their citizens while this infrastructure development needs a lot of money. In that case, development in infrastructure through *sukuk* issue can be an alternative for all these and it can attract local and foreign investors. It is given a part in the long-term fund mobilization, *sukuk* is the most appropriate instrument for infrastructure financing as its underlying asset is the project itself. Infrastructure development plays an important role in sustaining and promoting rapid economic development. In order for this part to be realized, the capability of *sukuk* will be important to work as a bridge between funding needs and infrastructure projects.

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