



FINANCING DEVELOPMENT THROUGH PARTNERSHIP

Alternative Resource Mobilization Options
for the Islamic Development Bank

1437H

Financial Product Development Center
SHAPE™ Financial Corporation

2015G

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King Fahd National Library Cataloging-in-Publication Data

Islamic Development Bank

Financial development through partnership./ Islamic
Development Bank – Jeddah, 2016

ISBN: 9960-32-322-6

1-Development	2-Partnership	3-Islamic finance	I-Title
332.042 dc	1437/7791		

L.D. no. 1437/7791

ISBN: 9960-32-322-6

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This Report was prepared by SHAPE Financial Corp., upon the request of the Financial Product Development Center. The views in this report do not necessarily reflect the views of the Islamic Development Bank Group.



Executive Summary

The Islamic Development Bank (“IDB”) has been financing development in its Member Countries (MC) mainly by relying on its balance sheet. Since 2002, IDB has been a leading issuer of *sukuk*. Yet, *sukuk* leverage the balance sheet, and IDB faces constraints from the continuous growth of its balance sheet, including challenges to maintain its “AAA” credit rating. Therefore, the goal of this study is to look at how IDB can leverage its knowledge of the needs of its member countries, in order to develop alternative financial methods to deliver rightly priced financial solutions. Taking the cue from the Member Country Partnership Strategy (MCPS), this study examines the role of partnership in serving IDB’s goals.

Because IDB is a development institution, the return on financing to MC is not in line with market expectations. The cost of financing is usually way below the risk of financed projects. To obtain external financing, IDB has usually relied on its balance sheet’s strength to reduce the risk to investors in its *sukuk*. Given the limits of this approach, IDB should find a mechanism to obtain off-balance sheet financing that strives for a low cost of funding to MCs, and seeks to compensate investors for the associated risks. This study seeks to address this challenge.

The study focuses on practical partnership solutions, notably fund structures. These do not stress IDB’s credit rating by adding more debt. The existing suite of funds and off-balance sheet vehicles at IDB helps to demonstrate that crafting a more expansive strategy can fulfill key objectives: meeting funding needs with situation specific financing; expanding funding without creating pressure on the balance sheet; reaching out to various classes of investors; and achieving properly priced financing.

In order to create a context for this study the first chapter discusses IDB’s partnership approach in the concept of IDB’s Vision 1440. The chapter examines the aspirations of multi-lateral development funds and asks whether or not a natural partnership exists in the capacity of IDB to serve specific high growth emerging markets and guide investment into weaker, but promising economies among the member states.

In the second chapter, the study evaluates *sukuk*. *Sukuk* are critical for the direct funding of IDB’s operations. IDB’s AAA-rated *sukuk* will also prove critical for Islamic banks to meet Basel III liquidity obligations. Yet, *sukuk* necessarily grow the balance sheet as most of IDB’s risk exposures cannot be securitized. As a result, *sukuk* have certain limits and therefore need to be complemented with off-balance sheet instruments. The chapter also includes a review of retail bond and *Sukuk* issuance trend in selected markets. Whereever relevant, the review also highlights the trend of infrastructure bonds and *Sukuk* issuances. This review is relevant for IDB to take an intermediate approach before pursuing a full equity infrastructure fund strategy.

The third chapter analyzes and compares various development funds. Multilateral development financial institutions (MDFI) like IDB are engaged in a dynamic transformation. Funds, direct investment, capacity building through funds and direct investment vehicles are allowing MDFIs to serve broader markets in more unique ways. The study evaluates MDFI and IDB experiences, and then looks at the strength of the Islamic funds market. A key reality is that for IDB to be successful in the delivery of development funds, IDB must reach out

beyond the Islamic market space and attract new investors to the member countries under IDB's mantle. Funds have significant capacity to meet IDB's goals in managing costs, relieving pressure on balance sheet, and reaching out to prospectively broader group of investors.

Funds, however, need the correct infrastructure. In the fourth chapter, the study delivers a SWOT analysis of 13 jurisdictions. The goal is to find out which domiciles are best suited to draw investors of different types, and to facilitate IDB's delivery of a master umbrella fund. IDB members like Bahrain and Malaysia perform well in the review. Some other global jurisdictions also show well. Therefore, IDB's opportunity lies in considering a blended approach to jurisdictions. Besides jurisdiction analysis, the chapter also reviews fund market development trend, and detailed discussion on target investors and their expectations.

The fifth chapter reveals a master-umbrella-feeder structure. The chapter takes into account how the master fund may benefit from a pooled investment in infrastructure projects, trade finance, and participation in IDB's existing portfolio. It also discusses how IDB may benefit from other member countries' experience with socially oriented funds.

IDB will not find a "one size fits all" solution to off-balance sheet financing. Although some tools for funding may facilitate low cost financing, funds will typically be more equity-oriented in their risk profiles. The proposed IDB master feeder fund structure is meant to give IDB a strategic and tactical flexibility in the delivery of funding to member countries. These could be specialized funds by type, business style, investment method, and even country or region. The proposed method is also meant to help with the construction of investment and investor capacity within member countries.

The master fund strategy achieves the following results:

- The strategy requires IDB seed money, without a major impact on the balance sheet;
- The strategy allows IDB to leverage its skills and relationships. This should be protective of IDB's AAA rating;
- The strategy allows sub funds to deliver targeted, right priced investment to member countries; and,
- The strategy also supports the development of domestic capital market capacity in member states.

We also conducted a simple market survey with selected industry players to gauge the market acceptance of IDB's funds strategy. A number of industry players still prefer that IDB pursue the Sukuk strategy, instead of a fund strategy. As such, the final chapter also summarizes how IDB may benefit from the retail Sukuk market experience to finance infrastructure.

Contents

Executive Summary	III
Chapter 1 - Resource Mobilization for Development through Partnerships	1
1.1 Introduction to IDB 1440H Vision	1
1.2 MDFIs Dynamic Role and Sources of Funds	3
1.3 Evaluation Criteria for Alternative Resource Mobilization Solutions	7
1.4 Conclusion	9
Chapter 2 - Evaluation of Sukuk as Resource Mobilization Tool	11
2.1 Introduction to Main Sukuk Types	11
2.2 IDB's Experience in the Sukuk market	15
2.3 Recent Innovation in Sukuk Structures	22
2.4 Common Operational Issues in the Sukuk Market	24
2.5 Retail Bond and Sukuk Market	25
2.6 Evaluation of Sukuk against the Research Objectives:	38
Chapter 3 - Development Funds as Source of Funding for MDFIs	41
3.1 Experience of other MDFIs in using development funds	41
3.2 The IDB Experience	50
3.3 Islamic Funds Market	55
3.4 Evaluation of Funds against Research Objectives	60
Chapter 4 - Structuring Considerations - Domicile	64
4.1 Market Development and Investors	64
4.2 Investors' expectations	78
4.3 Domicile Selection	92
4.4 SWOT Analysis of Individual Jurisdictions	97
4.5 Evaluation of Different Jurisdictions	110
Chapter 5 - Proposed Fund Concept	116
5.1 Proposed Structure	116
5.2 Murabaha Funds & Market Feedback	123
Chapter 6 - Conclusion	129

Appendix I: Top 10 investors in Unlisted Infrastructure Funds	139
Appendix II: Top 5 investors in Private Equity Funds	140
Appendix III: Indian Committee Report on Development Infrastructure Fund	144
Appendix IV: SEBI Regulation on Mutual (Infrastructure debt fund)	146
Appendix V: SEBI Regulation on Alternative Investment Funds (AIF)	148
Appendix VI: Dana Infra Retail Sukuk Distribution Channels	150

Chapter 1 - Resource Mobilization for Development through Partnerships

“The Mission of IDB is to promote comprehensive human development, with a focus on the priority areas of alleviating poverty, improving health, promoting education, improving governance and prospering the people.”

1.1 Introduction to IDB 1440H Vision

IDB has developed a clear vision for 1440H which is geared to achieving development through partnership. This is characterized as the Member Country Partnership Strategy (MCPS), developed in 1431H. The nature of partnership creates multiple avenues for investment in the emerging markets, which constitute IDB’s MCs. The MCPS is designed for the IDB Group to seek the optimal avenues for intervention in MC and to initiate suitable programs for economic development.¹ The “Vision 1440H: A vision for human dignity” is derived from an institutional desire for “introspection and reform”. The nature of partnership is to make all parties to a relationship equal in status, even if they are not equal in contributing factors like money or technology: therefore, it brings dignity to the seemingly weaker or less illustrious members of a partnership. A well thought out process of development should help in the process of “mainstreaming ... the integration of Member Countries’ economies into the global economy.”² The mainstreaming would also create the opportunity to showcase IDB’s values, improving lives with dignity.

The operating principles that flow from IDB’s mission include reaching out to governments, community needs, stakeholder feedback and collaboration, and participation. Among IDB’s strategic thrusts, the relevant elements for our purpose are the second: Alleviate poverty; the third: Promote health; the fifth: Prosper the people; and, the eighth in particular: Facilitate integration of IDB Member Country economies among themselves and with the world. In our approach to partnership, we will examine how poverty alleviation, health, and prosperity, socio-economic development³, have become investment targets to a growing universe of global investors. As IDB member states represent some of the states in the greatest need of assistance, IDB should become a partner of choice in leading efforts to channel commercial funds to MCs.

As a result, partnership tools are important means to meet IDB’s challenges, which include achieving “Strong and Sustainable Economic Growth” in the context of “Promoting Good Governance” whilst “Restoring the Image of the Muslim World”. These important challenges

¹ Islamic Development Bank Group in Brief, April 2012.

² Vision 1440H: A Vision for Human Dignity, Islamic Development Bank, Safar 1427 / March 2006; and, Report: IDB 1440H Vision Regional Workshop for ECO plus Albania (2 August 2005, Almaty, Kazakhstan) Prepared by Technical Experts Team “IDB 1440H Vision” Strategic Planning Office Islamic Development Bank; both accessed at www.isdb.org.

³ Vision 1440H: A Vision for Human Dignity, Islamic Development Bank, Safar 1427 / March 2006; and, Report: IDB 1440H Vision Regional Workshop for ECO plus Albania (2 August 2005, Almaty, Kazakhstan) Prepared by Technical Experts Team “IDB 1440H Vision” Strategic Planning Office Islamic Development Bank; both accessed at www.isdb.org.

are among those which may be pursued in a global fund partnership strategy. Leading this challenge, IDB follows the reminder of *Quranic* advice given by Tun Dr. Mahatir Mohamad who stated, “Muslims have to decide, and remember that Allah Subhaanahu wa Ta’ala will not change our destiny unless we put in the efforts to change it ourselves.”⁴

The role of IDB is to assist the evolution of markets. Part of this process may cause public goods to turn into business opportunities. The areas of investment include agriculture, infrastructure, water, energy, health, and transport. Some of these are traditionally under the purview of government. And, some are left to local authorities or subsistence farmers and small businesses to manage on their own. But, the dynamic goals of investors and the changing basis of business mean that improving the quality of life in poorer countries can be achieved by global economic integration. IDB may accomplish these outcomes by encouraging lateral investment and trade amongst emerging market nations; and engaging global investors to mobilize resources through investment partnerships.

The blend of private and public sector development with the objective of poverty reduction and eradication has proven as an attractive opportunity to global institutional investors. Yet, investing in such assets also involves new types of investment vehicles and risk (or pension funds, among other institutional investors) to manage. These include exposures to leverage, legal and ownership issues, environmental risks as well as regulatory and political challenges.⁵ Some of these issues are assuaged and overcome by the role of strategic partners like IDB and other MDFIs. The right partnership approach leads to the expansion and encouragement of foreign direct investment (“FDI”) in new ways.

Why are the emerging markets, which present both alternative investment characteristics and socially responsible opportunities, and their most basic investment needs, attractive to global institutional investors? First and foremost, many of these are believed to have low correlations to investments in the developed countries, especially listed equities and bonds. The lack of correlation is enhanced by the potential for exceptional, sustained and long-term growth in the emerging markets. The challenges for investors include a blend addressing social needs in emerging markets as well as finding the best investment vehicle: primary or secondary market tools; debt or equity; listed or private; or direct compared to indirect investment. Since data is often a major challenge, the role of MDFIs is fundamentally critical in helping institutional investors to overcome challenges in their risk analysis.⁶ An area which is less in the direct skill set of IDB, but within the purview of some MDFIs is the provision of political risk insurance.

IDB has long sponsored studies about the use of *musharakah*, *mudarabah* or *wakalah* (“MMW”) for the finance of development. But these approaches are typically limited to a focus on MMW in a way that does not integrate into the global capital markets, and fails to support the evolution of domestic capital markets. Some of these studies like Hennawi (1986) are very limited in their perspective and basic. Yet Hennawi’s type of study certainly

⁴ Ibid.

⁵ OECD paper on Pension Fund Investment in Infrastructure (Inderst, 2009)

⁶ Key thoughts derived from OECD paper on pension investing in infrastructure.

inspired the Unit Investment Fund (UIF) and the *mudarabah* deposits placed with IDB.⁷

This report aims to discuss resource mobilization for the development member countries (“MCs”) with funds sourced by the Islamic Development Bank (IDB) via capital market approaches. The next section will review the role of multilateral development finance institutions (“MDFI”). This will provide a clear context of MDFI operations, and how, over time, their role and focus has been shifting due to changes in the market. This shift has also affected how the MDFIs fund themselves.

1.2 Multilateral Development Finance Institution – Dynamic Role and Sources of Funds

The five main MDFIs are the World Bank, the Inter-American Development Bank (IADB), the African Development Bank (AfDB), the Asian Development Bank (ADB), and the European Bank for Reconstruction and Development (EBRD). These account 85% of MDFI lending. The World Bank accounts for 60% of the total MDFI lending.⁸

Over the past twenty-five years, MDFIs have made a significant shift in their operational profile, providing more market-oriented financing and investment. The main MDFIs were established as part of the reconstruction of war-torn Europe and Asia in the late 1940’s. The formal name of the World Bank is the International Bank for Reconstruction and Development. Only as its mandate expanded did the World Bank change its corporate identity. As Europe and Japan recovered, new MDFIs were created mostly by western powers to address the needs of emerging markets in the context of the Cold War. The focus was on using western aid to staunch the flow of communism.

The basic function of any MDFI was to transfer some of the surplus of developed countries to developing countries. The primary tool for an MDFI was to borrow in the form of bond issuances, and to lend to their relevant MCs. MDFIs were generally less active in the main emerging markets (in fact, commercial banks were often the lead lender until the Latin American loan crisis of the early 1980s). Three reasons framed the anemic MDFI lending to developing countries until the 1990s:

1. Crowding out by Europe and Japan: Until the mid-1970s, Europe and Japan were the main focus of the World Bank and Asian Development Bank;
2. Lending Conditions: Until the 1990s, most developing countries focused on import substitution strategies. Many MDFIs refused to lend until these strategies were ended or made less central to the policy of prospective borrowing nations; and,
3. Structural Balance of Payment Problems: Many developing countries could not qualify

⁷ El-hennawi, Mohamed, *Potential Islamic Certificates for Resource Mobilization*, presented in the seminar on *Developing a System of Islamic Financial Instruments* held in Kuala Lumpur, Malaysia, 1986, sponsored jointly by IRTI/IDB and Ministry of Finance, Government of Malaysia.

Hennawi also reports on the Jordanian Government *muqarada* Bonds Act in 1981 which financed a project to set up a commercial center by the Ministry of Awkaf. Unfortunately, the concept was not integrated into the local capital market.

⁸ Refer page 22 (Mistry, 1995)

for MDFI loans whilst they were under International Monetary Fund (“IMF”) structural adjustment programs. Since the 1990’s, very few countries have been under IMF’s structural programs, and their administration is much shorter.⁹

MDFIs have always focused on core infrastructure. The concept of infrastructure, over the years, has become a highly fluid and broad term. In the 1950s and 1960s, the term generally focused on power, transport and water. These three areas were frequently scalable as they could be integrated. Industrial development has also been an important area for MDFIs whether the object of MDFI loans, or indirectly with MDFI activities paving the way for DFI.

In the late 1960’s and 1970s, MDFIs were sponsors of the “green revolution”¹⁰ which notably boosted crop yields in Asia. Agriculture and social sectors including education, health, nutrition, population control became mandates, as the visionary mission of MDFI became poverty alleviation through the integrated planning of rural and urban development. When oil prices increased sharply in 1973 and again in 1979, MDFIs added the energy sector, including hydrocarbons and other energy resources, to their focus.

In the 1980s, the Latin American and African debt crisis shifted the focus of MDFI and donor nations from financing economic sectors to financing balance of payments. As a result of the crisis, commercial banks reduced their loan exposures to developing sovereigns which expanded the role for MDFI funding. Nonetheless, MDFI funding was typically contingent on compliance with an IMF mandated structural or sectorial adjustment program. The stated aim, often never achieved, was to improve economic management. Into the 1990’s, newer developmental priorities have become part of the development mandate. These include environmental protection, gender sensitivity, and good governance. Figure 1 summarizes the dynamic focus of MDFIs in the market.

⁹ One outcome of the 1997 Asian Financial Crisis was that Malaysia rejected IMF support and other Asian “beneficiaries” felt that the IMF-imposed conditions were harmful. As a result, many of the countries affected by the crisis have built-up both their own reserves and enhanced regional cooperation so as to insulate themselves from a future need to seek IMF assistance.

¹⁰ Improved seed and agricultural methods introduced widely in Asia to break the famine cycle.

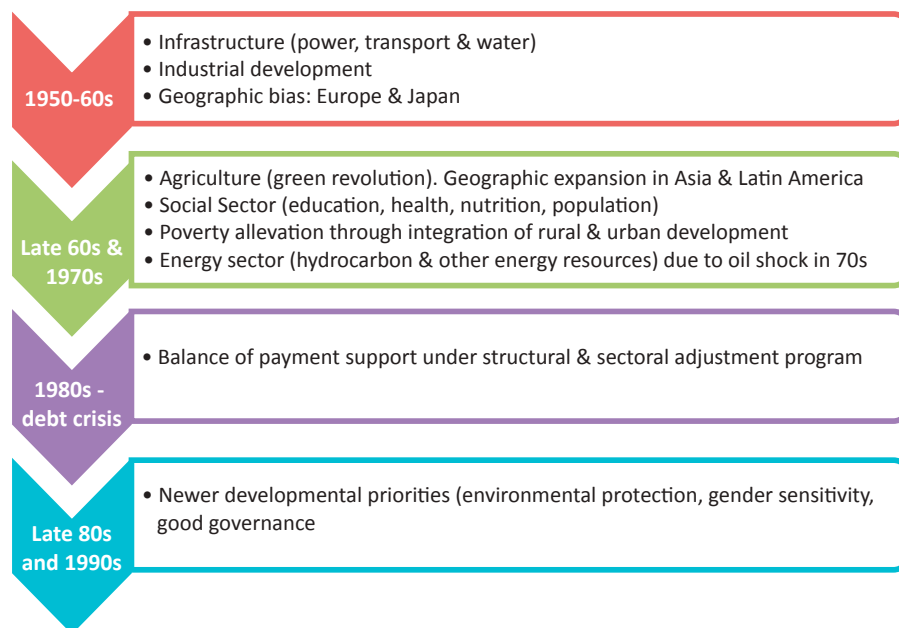


Figure 1: Summary of MDFI Dynamic Role in Development Funding

Interestingly, if one reads the mandates of many MDFIs and of various funds focusing on the emerging markets, they discuss “infrastructure” extensively. The term has been broadened to now include:

1. Power & Energy (including renewable and other forms);
2. Transport;
3. Water;
4. Agriculture;
5. Environmental;
6. Social Infrastructure including:
 - a. Education;
 - b. Health & nutrition; and,
 - c. Population control.

More recently, financial services, from micro-finance to conventional banking and capital markets have been added to the term “infrastructure”. In essence, “infrastructure” is the alternative term for “development private equity”, “development finance” or investment in “economic development”.

Since 1989, private capital has been more willing to invest in long term infrastructure projects, education and health (private university & hospital) due to liberalization of the economic and financial system¹¹ in many emerging markets. This has prospectively diminished the

¹¹ Especially abandoning of interest rate and exchange control.

roles of MDFIs and is driving MDFI to shift their focus to:

1. *Poorest developing countries* - Africa and South Asia, where the global capital market is not yet willing to invest;
2. *Human capital* – non-cash flow generating activities: Again, not interesting to private capital. These areas include public primary & secondary education, and rural health care; and,
3. *Institutional infrastructure* - proper functioning of market economies: These are often capacity-building activities involving the legal and judicial system, enforcement of property rights, developing transparent accounting systems, and improved public administration and political governance;

In the traditional focus areas for MDFIs, many are shifting from financing government and their agencies to financing investment undertaken by the private sector. MDFIs deliver finance to their constituents through various “hard” and “soft” windows.¹² The former are generally commercial forms of investment¹³ (i.e. funding according to market terms) whereas the latter are concessionary.¹⁴ The MDFIs “hard window” are funded using equity (paid in and callable capital¹⁵) and debt from the international capital market. MDFIs are very careful to maintain the highest possible credit rating to ensure they can raise debt funding from the market at a competitive rate.¹⁶ Unlike the hard window that is funded via the international capital market, the soft window is often funded by a multilateral ‘club’ of donors. The soft window is usually set up as a separate fund (commonly known as multilateral development fund) or as a separate association (for example, the International Development Association, IDA, is the soft window of the World Bank). As the soft window is funded via donation, the MDFI cannot lend out more than the funded amount. (Mistry, 1995)

The impact of the shift to private sector financing on the MDFIs is significant as they seek to supplement their equity capital, interbank, and bond resources. An important new resource has been the emergence of funds as a source of capital. This study will review both IDB’s experience and that of other MDFIs in the use of funds as a means to diversify their operation and activity. We have dedicated Chapter 3 to discuss these experiences.

¹² In this section, as the focus is on the main MDFIs, the report uses the terms loan, borrow etc. as this is not reflecting IDB funding mechanism.

¹³ Similar to a commercial bank, the funding is based on market rate. Normally the forex risk is transferred to the member country.

¹⁴ Beneficiaries are only charged a service fee to cover administrative cost.

¹⁵ Callable capital is not paid in by the member. It is basically a guarantee to pay if called by the MDFI. Thus the actual paid in capital of the MDFI is only a small portion of the MDFI sources of fund.

¹⁶ For many MDFIs, there is a gearing ratio (loan to capital) of 1:1. Although their constitution allows for MDFIs to borrow up to 100% of their subscribed (i.e. total capital), the market would consider this to be imprudent. Many MDFIs, in practice, limit their debt ratio so it does not reach the cap. In addition, different rating bodies have different interpretation of the notion of usable capital used in determining the debt ratio. The most common definition of usable capital refers to only callable capital from OECD countries or countries which enjoy the higher investment grade ratings on their own debt instruments in international capital markets; and countries with large trade surpluses and reserves.

1.3 Evaluation Criteria for Alternative Resource Mobilization Solutions

The study follows the IDB Group's Vision 1440H which includes partnership as a strategic tool. The three key elements of Resource Mobilization for Development through Partnerships, comprise of:¹⁷

1. MC Partnership Strategy ("MCPS") – Although many MDFIs pursue partnership strategies, IDB uses reverse linkage as a unique approach to implement this strategy where MCs help other MCs. For instance, IDB worked with Turkey to assist Syria and other countries in capacity building in Syria & other countries:¹⁸
2. Economic cooperation & regional integration –IDB's subsidiary the International Islamic Trade Finance Corporation ("ITFC") has played a crucial role in this form of MC-to-MC trade, as well as MC to the world and MC within their specific regions; and,
3. Co-financing: PPP funds with other MDFIs or other investors like the IDB-ADB Islamic Infrastructure Fund.

IDB seeks to create a robust and sustainable source of funding. The structure of the funding should embed a flexible design. Ideally, the solution should neither require pre-existing assets on IDB's balance sheet nor intend to deliver assets to IDB's balance sheet. The outcome of our analysis should be to preserve IDB's leadership role in leading partnerships for growth and development.

The importance of a well-defined portfolio of tactics is that it allows IDB to meet its objective of balancing investor expectations for high return and MC demands for cheap funding. The following criteria will be used as the benchmark in evaluating the proposed solution:

1. Off balance sheet – If IDB grows its balance sheet through more on-balance sheet, debt-like instruments, then IDB needs to continuously raise more capital in order to keep expanding its operations. Otherwise, if IDB is to maintain its AAA-rating, there will be constraints on the expansion of on-balance sheet operations.
2. Cost of funds – as MCs constantly look for efficient funding options, we will examine a solution that will reduce the burden on both IDB and its Member Countries;
3. Diversification of investors – An expanded fund strategy admits the possibility that IDB may include a wider range of investors, including new relationships into IDB's financing and investment operations.

¹⁷ See "Vision" on page 38 of the IDB 2010 Annual Report. Accessed at www.isdb.org.

¹⁸ For detail on the framework involving Turkey, see the IDB 2010 Annual Report, p. 39.

The two key capital market areas that the study will examine are Sukuk and funds, which are evaluated in **Chapter 2** and **Chapter 3** respectively. IDB has been an active issuer in the Sukuk market, while it has only sparingly used investment funds as an alternative funding strategy. Each of this study's chapters addresses a key issue in building IDB's fund strategy.

Chapter 2: The chapter will evaluate *sukuk* as a source of funding against the objectives of this study. In order to do this, the study engages in a SWOT analysis of the common *sukuk* types. The chapter also reviews the IDB experience with *sukuk*. IDB was a pioneer in the development of *sukuk* structures and the general architecture of the *sukuk* market. It has long term plans to access funds by issuing *sukuk*. These plans will be hemmed in by the size of IDB's balance sheet. The outcome of the evaluation of *sukuk* is that *sukuk* needs to be complemented by off-balance sheet instruments to meet the long-term goals of the IDB strategy. The chapter also includes a review of retail bond and Sukuk issuance trends in selected markets. How retail bond/sukuk strategies might facilitate IDB in taking an intermediate approach is analyzed in contrast to the pursuit of a full equity infrastructure fund strategy.

Chapter 3: The third chapter compares various development funds, which have been in the market since the early 1990s including IDB's experience in the funds market. After a short review of the Islamic funds market, the chapter will evaluate the funds market against the research objectives. The outcome of the evaluation is that funds have significant capacity to meet IDB's goals in managing costs, delivering off balance sheet finance, and a prospectively broader group of investors.

Chapter 4: This chapter addresses two main components; investors and fund domiciles. The investor segment reviews market developments, investor interests and expectations in different fund classes. The domicile section will focus on finding the jurisdictions that facilitate a broad fund strategy. After elaborating on the domicile selection and evaluation criteria, the chapter will perform a SWOT analysis on the individual domiciles and conclude the chapter with evaluation of the different jurisdiction.

Chapter 5: This chapter discusses the proposed structure applying the master-umbrella-feeder structure. It examines how the fund may benefit from a pooled investment in infrastructure projects, trade finance, and participation in IDB's existing portfolio. There will be a dedicated discussion on socially-oriented funds and how IDB may leverage on its reverse linkage policies in the MCPS to learn from the experience of other member countries that have successfully transformed socially-oriented projects into commercially managed projects. We also conducted a simple market survey with selected industry players to gauge the market acceptance of the IDB funds strategy. A number of industry players still prefer that IDB pursue the Sukuk strategy, instead of a fund strategy.

Chapter 6: In the final chapter we summarize the issues studied, recap the recommendations and also summarize how IDB may benefit from the retail Sukuk market experience to finance infrastructure.

1.4 Conclusion

The importance of funds in IDB's context is to find means to leverage IDB's wealth of knowledge instead of its balance sheet. As a result, partnership solutions to be investigated will not add to IDB's debt burden. The additional benefit is that the strategy will preserve IDB's AAA credit rating. The desired achievement will also balance properly between the delivery of a reasonable return to investors and competitive pricing to IDB's clients, the member countries (the "MCs").

The proper development of markets requires executing models which expand beyond institutional funding of investment projects. This means that the IDB partnership solution should ultimately allow middle and small investors in or from MCs to participate in financing development in their countries. Such an expansion of these concepts will support Islamic capital markets and Islamic financial institutions in MCs. As an intermediate solution, IDB may choose to develop the retail Sukuk market in different jurisdictions.

The execution of the partnership-funding strategy applying investment fund structures is meant to fit within the concept of the *maqasid* or objectives of the *Shariah*, as summarized by the scholar Al-Ghazali:

"The objective of the *Shariah* is the well being of the people, which lies in safeguarding their faith, their self, their intellect, their posterity and their wealth. Whatever ensures the safeguarding of these five principles serves the public interest and is desirable, and whatever hurts them is against the public interest and its removal is desirable."¹⁹

By promoting sound economic development and leveraging IDB's skills and knowledge alongwith external resources, IDB is able to safeguard these five principles, with a particular focus on wealth, its creation and preservation at the societal level. The proposed fund strategy will achieve this in the following ways:

1. Delivering an internationally accepted fund vehicle to key investor universes which support IDB Group's MC's needs;
2. Build a blended return that offers attractive financing and investing alternatives to MC states, entities, or projects;
3. Build a vehicle that leverages the IDB Group's knowledge more than its balance sheet and allows for enhanced value to all stakeholders, all partners in the process.

The concepts that are raised in this report are meant to address a conundrum raised in an Ernst & Young report:

"In the next 2-5 years, we do not foresee a dramatic change in the GCC market, unless the institutional sector, sovereign wealth funds, pension funds, *takaful* companies, etc. come into the Islamic funds market in a big way."²⁰

¹⁹ Al-Ghazali, 1937,VOL.1, P.139, cited by Dr. Umer Chapra in the appendix to *the Minutes of the Third IDB 1440H Vision Commission Meeting*, 22 March 2006/22 Safar 1427 accessed at www.isdb.org.

²⁰ Op. Cit. E&Y Funds Report 2011.

This is where the role of IDB comes, not so much to support the GCC funds market, but to draw qualified investors from those not currently active in the *Shariah* funds and development orbit, into it. Moreover, IDB's success in building the right fund structures means that instead of crowding the local financiers out of the development finance market, IDB will be able to strengthen local capital and financing markets into which IDB fund programs direct their efforts.

Chapter 2 - Evaluation of Sukuk as Resource Mobilization Tool

2.1 Introduction to Main Sukuk Types

The *sukuk* market has proven beneficial to IDB. Over the past nine years, IDB has come to the market 11 times²¹ and raised over four billion dollars in medium term funding. The purpose of this chapter is to evaluate *sukuk* as source of funding against the study's objectives. In order to do so, this chapter presents a SWOT analysis of the common *sukuk* types and reviews the IDB experience with *sukuk*. In addition, we will also analyze the development of retail bonds and Sukuk in different markets.

The *sukuk* market has applied a wide diversity of concepts. The market is constantly subject to experimentation. Often the market is faced with substantial obstacles in the absence of well developed capital markets infrastructure. The most popular forms of *sukuk* have been *ijarah*-linked (all markets) and *Murabaha*-linked (Southeast Asia) with fewer based on *Musharakah*, *Mudarabah*, *Wakalah*, hybrid, and *salam* deals. One of the reasons that the term *ijarah*-linked is used is that based on many local market laws, the ownership of the asset to be leased cannot be easily transferred to an SPV (Special Purpose Vehicle) or SPC (Special Purpose Company) or to foreign investors. This phenomenon has led to the use of the term "asset-based" for the majority of *sukuk* as opposed to asset-backed, which applies to securitizations. Even the capacity of non-banks to secure a charge or mortgage over an asset means that many investors have an investment that refers to an asset, but neither own it nor control it.

2.1.1 *Ijarah*:

Strengths	Weaknesses
<ol style="list-style-type: none">1. Non-controversial to all investors2. Asset-based, appear to be "secured"3. Income is contractual	<ol style="list-style-type: none">1. Require assets2. Assets require maintenance3. Residual risk
Opportunities	Threats
<ol style="list-style-type: none">1. Securitization of existing assets2. Development of assets3. Acquisition of assets	<ol style="list-style-type: none">1. Limited number of assets2. Not necessarily suited to general working capital3. Cross border enforcement4. Tax issues

Table 1: Sukuk Al Ijarah SWOT Analysis

²¹ As at January 2012.

The strength of *sukuk al ijarah* is that all scholars and markets are comfortable with the base concept. For investors, the asset is owned by them or their intermediate investment vehicle and this gives them “security”²². Moreover, the *sukuk al ijarah* investor enjoys the benefit of contractual *Shariah*-permitted fixed income.

However, not every business has current assets to allocate for this purpose, and many may not wish or need to acquire assets. If the client has or needs the assets to be leased, then the general *Shariah* rule is that the investor side has the primary obligation for maintenance, insurance and taxes. In many countries, rentals are taxed higher than interest. These factors may either diminish returns to investors or affect pricing to the client. Finally, at the termination of a lease, the asset has to be disposed of. If the obligor doesn’t take the asset, then the investor has residual risks, which may include whether or not the investor can recover capital upon disposal or must pay to dispose off the asset.

The opportunities for leasing include securitization of existing assets as well as the development or acquisition of new assets.

The threats include the fact that there are limited numbers of assets in any company. And the concept of leasing is not necessarily suited to general working capital finance as the Obligor needs to have a tangible asset to raise funding. Beyond these issues, there are sometimes cross-border enforcement issues arising from national regulations governing asset ownership. And until now, tax jurisdictions do not give rent the same benefit that they give to interest, which means that leasing can be more expensive than other forms of investment: and this cost is transmitted to the obligor or borne by the investor.

2.1.2 *Murabaha*:

Strengths	Weaknesses
<ol style="list-style-type: none"> 1. Ease of execution 2. Trade and cash concepts applicable 3. Comparable to traditional debt 	<ol style="list-style-type: none"> 1. Not tradable in AAOIFI jurisdictions due to restrictions on trading debts. 2. Some forms of Cash Murabaha are not permitted in certain markets or are restricted. <ol style="list-style-type: none"> a. <i>Bai al-Inah</i> b. <i>Tawarruq</i>
Opportunities	Threats
<ol style="list-style-type: none"> 1. Expedient entry into certain markets. 2. Ease of convincing conventional financiers to join a deal. 	<ol style="list-style-type: none"> 1. Easily abused 2. Easy to make procedural errors 3. Becomes tool of first choice

Table 2: Sukuk Al Murabaha SWOT Analysis

²² Unfortunately, many so called *sukuk al ijarah* do not actually have factual ownership or legal hypothecation. This is sometimes for technical reasons relating to the lack of development of the market or legal restrictions on foreign or SPV/SPC ownership of assets in certain countries.

Murabaha sukuk have several forms including true buying and selling of goods, and cash *Murabaha* (*bai al ainah*, and *tawarruq*). These are all fairly simple to execute. The end result is a straight-forward fixed-yield debt. As a result, *Murabaha*-based *sukuk* are easy to execute. This means that they may be applied expediently to facilitate entry into new markets, as was the case with *bai al ainah* in Thailand and *tawarruq* in many countries. The use of *Murabaha* for trade finance is almost universal. As a result, *sukuk* implementing true buying and selling have near universal applicability. And, this means that conventional financiers are able to join in deals.

The weakness of *Murabaha*-based structures is that they result in a debt. Apart from Malaysia and Thailand, the trading of debt is restricted. As a result, the development of an easily monetized, traded transaction is not widely accepted when using the *Murabaha* tools. Moreover, *bai al ainah* is not allowed under AAOIFI standards, and *tawarruq* faces strong resistance in many markets and among leading scholars.

One reason for the resistance to *Murabaha* structures, which is not unique to *Murabaha sukuk*, is that they have been easily abused in the past. The abuse is often in the form of a trade without a real object: buying and selling with paper “evidence”, but no goods backing the paper. Even when executed with the purpose of buying and selling, the actual rules of *Murabaha* require careful attention or else the sale may be invalidated resulting in rescission of the gains or donation of any profits to charity. More fundamentally, the problem in *murabaha* is that, whichever form is applied, its ease of use results in it becoming the business practice of choice, crowding out all other methods.

2.1.3 *Salam*:

Strengths	Weaknesses
<ol style="list-style-type: none"> 1. Delivers cash now 2. Simple procedures 	<ol style="list-style-type: none"> 1. Potential to be “<i>tawarruq</i>” 2. Requires commodities 3. Offtake required
Opportunities	Threats
<ol style="list-style-type: none"> 1. Strong product for commodity-based sectors 2. Good fixed income alternative 	<ol style="list-style-type: none"> 1. Ease of abuse 2. Procedural requirements

Table 3: Sukuk Al Salam SWOT Analysis

Until now, only a few governments, notably Bahrain, have issued *sukuk al salam*. In the basic process, the investors buy a commodity from the obligor: the investors pay the full price in advance, and the obligor will deliver the commodity at maturity.

At maturity, the obligor will receive the commodity, typically in the form of a warrant; then, the obligor will arrange to sell the commodity on a spot basis for the investors. The transaction generates upfront cash to the obligor, and should generate a profit to the investors by establishing a spread between the initial purchase price and the exit price.

Musharakah – Mudarabah – Wakalah (MMW)

Strengths	Weaknesses
<ol style="list-style-type: none"> 1. Allow participation in a business without selling shares or listing. 2. High degree of permissible negotiability in each MMW form. 	<ol style="list-style-type: none"> 1. Limited universe of investors willing to accept losses in “bond”-like instruments. 2. Conflicts with ministry of commerce rules. 3. Not directly defined by financial papers and bond rules.
Opportunities	Threats
<ol style="list-style-type: none"> 1. Managing the need for highly structured deals. 2. Build greater appreciation for risk sharing. 	<ol style="list-style-type: none"> 1. Ease of violating <i>Shariah</i> rules governing MMW. 2. Ease of mischaracterization via structuring.

Table 4: MMW Sukuk SWOT Analysis

2.1.4 Musharakah:

Since 2006, the market has seen many issuances of *Musharaka sukuk*. The errors or structuring approaches taken by many banks offering *Musharakah sukuk* resulted in AAOIFI issuing a strong clarification to encourage strict compliance with AAOIFI rules governing *Musharaka* (as well as *Mudarabah* and *Wakalah*). Sometimes characterized as *sukuk al istithmar*, *Musharakah sukuk* allow for a higher degree of flexibility in managing risk, profit sharing, and assets. Unlike *ijarah*, *Musharakah* allows for the participation in the overall operation of a business and does not require specific assets.

2.1.5 Mudarabah:

All of the factors affecting *Musharakah* apply to *Mudarabah*. But many scholars noted in the mid 2000s that the investment manager or *mudarib* was not submitting any business plan, or was presenting a perfunctory plan to investors. As a result, most scholars required a clear and detailed plan. This has dimmed the perspective of some issues for choosing the *Mudarabah* structure.

2.1.6 Wakalah:

These are also sometimes characterized as *sukuk al istithmar*. The *Wakalah* concept has greater flexibility than *Musharakah* and *Mudarabah* under *Shariah* rules. As a result, the market has become increasingly enthusiastic about the term “*Wakalah*”. But, is the concept applied properly?

The first problem for *Wakalah* is that the agreements are often structured to mean that the agent or *wakeel* offers a target yield that approximates the benchmark interest rate for the customer with all additional yield granted to the *wakeel* as an incentive for achieving the benchmark. Often structured so that there is no risk of loss, *sukuk al Wakalah* are often almost pure debt as opposed to risk sharing instruments.

The second issue for *sukuk al Wakalah* is that they are often structured to appear as risk sharing instruments. But the real business is to buy and sell commodity certificates in *tawarruq* operations, as we will see in the hybrid Sukuk structure.

2.2 IDB's Experience in the Sukuk market

Similar to other MDFIs, IDB uses both equity and debt funding to support its operations. IDB taps into the Sukuk market for long-term debt funding and leverages on the commodity *Murabaha* market to raise shorter term funding.

(Amount in million)					
Capital	Period	IDB (ID)*	ICD (S)	ICIEC (ID)	ITFC (S)
Authorized Capital	1432H	30,000	2,000	150	3,000
	At Inception	2,000	1,000	100	3,000
Subscribed Capital	1432H	17,782.6	806.64	149	750
	At Inception	750	400.03	68.8	500
Paid-In Capital	1432H	4,031.1	565.81	74.5	671.7
	At Inception	280	83	63.8	446.1
*ID = Islamic Dinar is equivalent to one unit of SDR (Special Drawing Rights of the International Monetary Fund)					

Table 5: IDB Group Equity Capital

Source: (Islamic Development Bank, 2012), p. vii

Table 5 shows the equity capital of different IDB Group entities.²³ As with other MDFIs, we can observe that the paid-in capital (i.e. cash capital) of IDB and its group are a fraction of the subscribed capital (i.e. callable capital), which is an even smaller fraction of its authorized capital. Since its establishment in 1975, IDB has increased its authorized capital from ID2 billion to ID 30 billion in 2011. Similarly, the subscribed capital increased from ID 750m to about ID18b, and the paid up capital has increased from ID 280m to ID 4 billion. Refer to the “at inception” row in **Table 5** for the amount of capital at the establishment of the different entities. With the exception of ITFC, other IDB entities also increased their authorized capital since their inception. All the IDB Group entities have increased their subscribed capital and paid-in capital since their inception.

Before 2003, IDB relied mainly on its equity capital and reserves to fund its operation. In 2003, IDB launched its first Sukuk (5-year fixed-rate transaction) to raise US\$400m. Then, in 2005, it set up a US\$1 billion MTN program (listed in LSE) to have a longer and larger Sukuk raising capacity. The MTN (Medium Term Note) size was updated to US\$1.5 billion in 2009,

²³ ICD = Islamic Corporation for the Development of the Private Sector, ICIEC = Islamic Corporation for the Insurance of Investment and Export Credit, ITFC = International Islamic Trade Finance Corporation

and further updated to US\$3.5 billion in 2010. Under the MTN program, IDB has issued multiple Sukuk, with a mix of fixed and floating rate, public and private placement.²⁴

- Series 1, US\$ 500 million issued in 2005 (matured in June 2010)
- Series 2, SGD 200 million private placement issued in 2009 (maturity in September 2012)
- Series 3, US\$ 850 million issued in 2009 (maturity in September 2014)
- Series 4 & 5, two tranches of SAR 1.875 billion private placement issued in 2010 (maturity in September 2020)
- Series 6, US\$ 500 million issued in 2010 (maturity in October 2015)
- Series 7, GBP 60 million private placement issued in 2011 (maturing in February 2016);
- Series 8, US\$ 750 million issued in May 2011 (maturing in May 2016); and
- Series 9, GBP 100 million private placement issued in January 2012 (maturing in January 2017)

Most of the Sukuk were issued in USD while some were in SDG and GBP. Besides the MTN program, IDB has also issued two MYR *Sukuk* (totaling MYR400m) under a MYR1 billion MTN program in Malaysia. Let us examine the two approaches that IDB has taken in structuring its *Sukuk*.

²⁴ Source: http://www.isdb.org/irj/portal/anonymous/idb_capital_en

2.2.1 IDB Sukuk Istithmar Structure

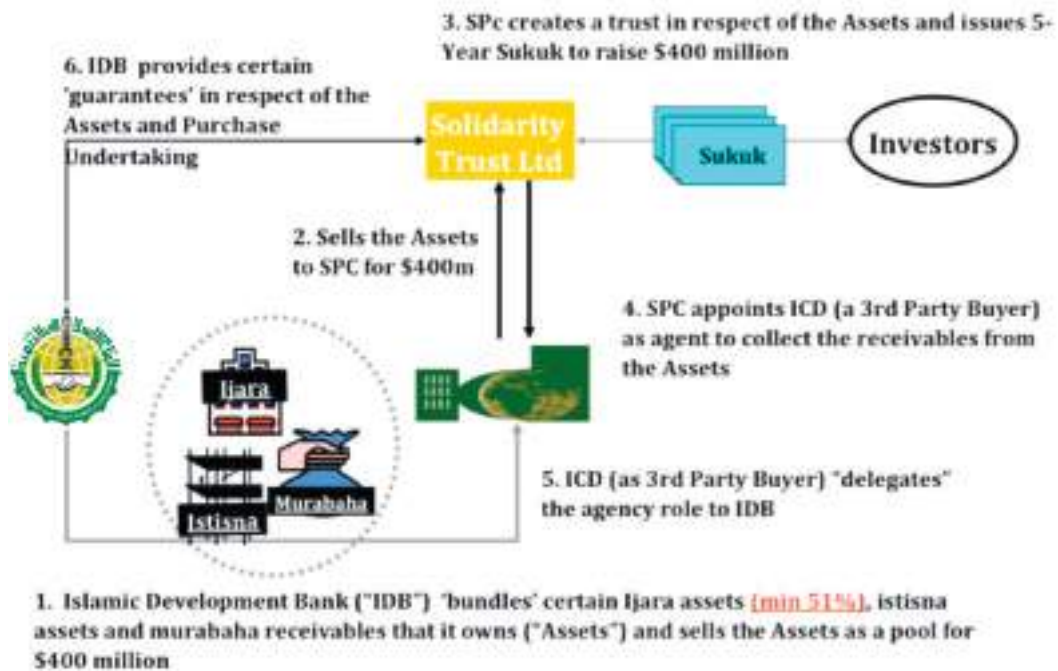


Figure 2: IDB 2003 Sukuk Al-Istithmar

Source: (Haneef, 2009)

Most of the IDB *sukuk* may be characterized as *sukuk al Istithmar*. In the first Sukuk deal, IDB wanted to emulate the income bond issued by the IFC in 1995. IFC had given loans to member countries, so they securitized their loan portfolio. These loans (73 in total) were well diversified; where no single loan represented more than 2.5% of the portfolio. It was also diversified by country, so no single country had more than 16% of the portfolio. IFC sold its loan portfolio in a proper securitization approach with rating. IDB wanted to take the same approach but they realized they didn't have the diversity and many of its member countries were not rated. So IDB didn't have the type of underlying asset that IFC had. Therefore, the securitization path was not viable and they chose the Sukuk Al-Istithmar route. The following were the transaction steps for the first Sukuk issuance of IDB:

1. IDB selects a pool of assets to serve as the reference pool of the *sukuk*. IDB is the originator and sells these assets to the Islamic Corporation for the Development of the Private Sector ("ICD");
2. An SPV was structured in a suitable tax haven: in this case Jersey, Channel Islands. The SPV acquires from ICD the rights to a bundled pool of assets of which 51% are *Ijarah* "hard" assets to assure tradability;
3. The SPV declares a trust over the assets;
4. The SPV appoints ICD to service the assets;
5. ICD delegates this role to IDB;
6. IDB provides a performance guarantee and purchase undertaking to the SPV; details are in Figure 3, and,
7. At maturity, the assets are sold back to IDB.

Liquidity Facility

- IDB undertakes to make an interest-free loan to the trustee to ensure timely payment of periodic distribution
- Maximum amount is the accrued but unpaid profit plus the admin expenses

Guarantee

- IDB guarantees to cover the shortfall in collection and prepayment
- Cover ICD's liability and the liability of trustee with regards to tax

Purchase Undertaking

- The Trustee has agreed unconditionally to sell to IDB on the Maturity Date or on the Dissolution Date the Sukuk Assets
- The purchase price equal to the aggregate Net Asset Value plus the amount of any accrued but unpaid profit

Figure 3: Credit enhancement in the IDB 2003 Sukuk Al-Istithmar

Source: IDB Sukuk documents; SHAPE™ Financial Corp

The second IDB deal used a similar structure, this time however, without ICD playing the intermediary role between IDB and the SPV. The *Shariah* Committee viewed the second IDB Sukuk as *Mudarabah*.²⁵

²⁵ From Page 8 of the Offering Circular; The Shariah Pronouncement Section: "The Trustee will invest the part representing the Principal – *Ijarah* and the Principal of the Instalments under *murabaha* and *istisna'a* contracts to purchase physical leased assets from IDB and in *murabaha* transactions to be entered into by IDB as *Wakeel*, and will not be used for any redemption of the Trust Certificates. **Accordingly, the Trust Certificates are investment certificates or *mudarabah* Sukuk** and not merely a sale of debts under *ijarah*, *murabaha* and *istisna'a* contracts. It is permissible, according to *Shariah*, **to conduct *mudarabah*** transactions involving physical assets after estimating their value, and in debts, after being commingled with physical assets in a separate and distinct portfolio. The return of the investment in purchasing leased assets and in *murabaha* transactions should be added to the Profit Account in favour of the Certificateholders and should be dealt with in the same manner as the Profit collected by IDB."

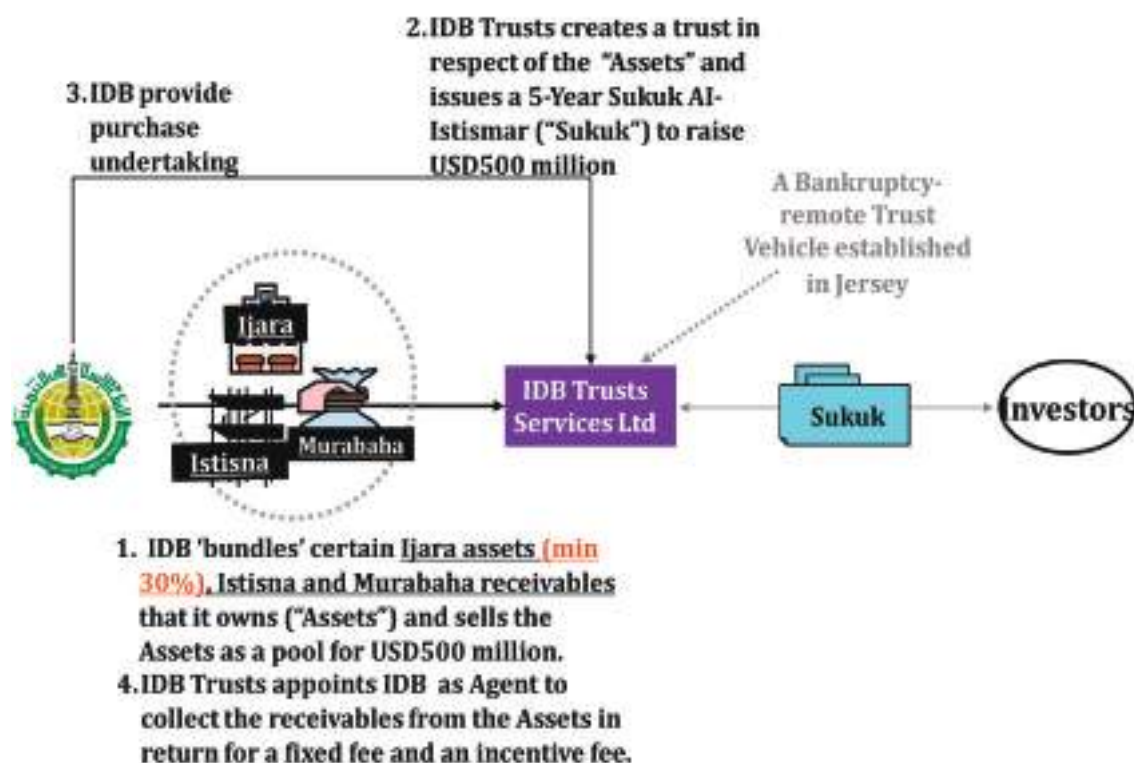


Figure 4: IDB 2005 Sukuk Al-Istithmar

Source: (Haneef, 2009)

1. IDB selects a pool of assets to serve as the reference pool of the *sukuk*.
2. An SPV was structured in Jersey with £2 capital. The SPV acquires the pool of assets from IDB of which at least 30%²⁶ are *Ijarah* assets;
3. The SPV declares a trust over the assets;
4. The SPV appoints IDB as the servicing agent.
5. IDB provides a purchase undertaking and a liquidity facility to the SPV;
6. At maturity, the assets are sold back to IDB.

There are a few differences between the first and second structure. In the first deal, Shariah scholars in the deal, particularly Sh. Taqi Usmani, were not comfortable with the idea that IDB would sell the asset and buy it back at maturity. Thus, he insisted that ICD comes in as the intermediary. This means that the investors bought the asset pool from ICD but sold it back to IDB, avoiding a direct *Bai al-Ainah* discomfort that Sh. Taqi had. A different group of scholars in the second deal did not have the same discomfort and allowed IDB to sell directly to the SPV, on the grounds that the SPV can be viewed as an independent party. All other IDB *Sukuk* followed the second approach.

²⁶ Note that the scholars in the second IDB Sukuk Al-Istithmar are different from the scholars in the first deal with the exception of Dr. Abdul Sattar Abu Ghuddah.

In addition, in the first deal, IDB provided a guarantee to cover any shortfall, in addition to the liquidity facility. Since ICD was the servicing agent, the guarantee also provided comfort to investors that IDB would back any non-performance by ICD. The second deal did not have any additional guarantee as the liquidity facility and purchase undertaking was sufficient to provide recourse to the investors. The purchase undertaking is an important legal mechanism to create recourse to IDB.

Table 6 summarizes the effect of the purchase undertaking in the first IDB *Sukuk* issuance. IDB basically promises to buy back the *Sukuk* asset from the SPV either at maturity or in the event of default at principal plus accrued but unpaid profit. The second deal had similar trigger events and pricing. Section 2.2.2 will discuss the role of the purchase undertaking in further detail.

Finally, the ratio of the minimum *Ijarah* assets in the pool differs in the first (51%) and second deal (30%). AAOIFI, in its *Shariah* Standard No. 12 (Financial Papers) allows trading of company shares that have at least 1/3rd tangible asset.²⁷

We can summarize that the ratio of minimum tangible assets to allow for the tradability of *Sukuk* may be different according to different *Shariah* boards – AAOIFI allows 1/3rd tangible asset. IDB's second *Sukuk* used slightly less than 1/3rd. Nonetheless, the commonly applied benchmark in the global market is 51% tangible assets.

Rafe Haneef, who had the opportunity to work on the first IDB deal, is of the view that the IDB 2003 *Sukuk Al-Istismar* set precedents in the *Sukuk* market.²⁸ The first three issuances were later taken and expanded upon vastly by other *Sukuk* market participants:

1. Co-mingling of asset (*khulta*) – there is no need to have 100% assets supporting the *Sukuk*, only 51% was sufficient. The second IDB deal brought this down to 30%.
2. IDB was the first deal to use the 'incentive fee' clause – if the return is more than certain benchmark, the *Sukuk*holders will waive the excess. Naturally, people will ask about the shortfall – so IDB provided coverage of the shortfall. This basically gave birth to the liquidity facility and incentive fee clause that is now widely practiced in the market.
3. No due diligence was conducted on the legal transferability of the assets and consequently IDB will indemnify the *Sukuk*holders if there is any legal problem subsequent to the issuance.²⁹

²⁷ Refer to pp. 380, 392-393 of AAOIFI *Shariah* Standards.

²⁸ Mokhtar, Shabnam, Interview with Rafe Haneef, at ISRA on 23rd October 2009

²⁹ The no due diligence clause commonly reads as follows: “**No investigation or enquiry has been made and no due diligence has been conducted in respect of the *Sukuk* Assets.** Only limited representations have been obtained from ICD and IDB in respect of the *Sukuk* Assets. **In particular, the precise terms of the *Sukuk* Assets or the nature of the assets leased or sold is not known (including whether there are any restrictions on transfer or any further obligations required to be performed by IDB to give effect to the transfer of the *Sukuk* Assets).** No steps will be taken to perfect any transfer of the *Sukuk* Assets or otherwise give notice of the transfer to any lessee or obligor in respect thereof. Obligors and lessees may have rights of set off or counterclaim against IDB in respect of such *Sukuk* Assets.”

4. ICD intervention – IDB cannot give a guarantee if it was the wakeel. With ICD coming in between, this was seen as a form of exit. This was not required any longer in the second and subsequent *Sukuk* issued by IDB.

2.2.2 Recourse to IDB

As highlighted briefly above, the purchase undertaking provided by IDB is an important legal instrument to create recourse to IDB instead of the investors taking the asset risks.

Table 6 shows the effect of the purchase undertaking in the first IDB deal. All other IDB deals had a similar undertaking. In the event of a default, the investors will sell back the asset pool to IDB and will claim the principal outstanding plus accrued but unpaid return. This takes away the asset risk from the investors and provides assurance on their capital amount.

When	Sell What	At What price
Maturity date	Underlying asset	Principal plus accrued but unpaid Periodic Distribution Amounts
Dissolution Date	Underlying asset	Principal plus accrued but unpaid Periodic Distribution Amounts

Table 6: Effect of Purchase Undertaking (PU) in IDB Sukuk 2003

Essentially, this form of *sukuk al-Istithmar* is a form of MMW, depending upon how IDB's role is characterized. The investors participate in the pool of assets, but do not own them in a manner that allows them to take control of the assets.³⁰ This has been the base form of almost all IDB *sukuk*. The method, however, does not remove the assets from IDB's balance sheet and the purchase undertaking creates an obligation on IDB (i.e. the *Sukuk* is treated as liability in the balance sheet, and the assets remain on IDB's book).

Although some documentation called this a form of securitization, IDB could not deconsolidate the assets. In the securitization market, the regulators and the rating bodies will look at it as if the asset-backed security (ABS) is credit linked to the originator. In other words, if the portfolio of assets sold is non-performing, does the SPV have recourse against the originator? If there is recourse against the originator, it usually does not fulfill the requirement of credit delinking and thus does not qualify as a securitization deal. The purchase undertaking plays this exact role – to create recourse to IDB in case of non-performance, thereby default. Therefore, the deal carries IDB rating instead of the rating of the asset pool.³¹

³⁰ From a *Shariah* perspective, the investors are the owners of the pool of asset. However from legal and accounting perspective, the investors may have different rights – closer to a creditor that funded IDB, rather than owner of the assets. This disconnect between *Shariah* rights and legal rights is a common challenge in many *Sukuk* deals.

³¹ There are misconceptions in the market that the rating bodies require the purchase undertaking. In reality, the *Sukuk* structures put in place the purchase undertaking because they want the rating bodies to rate the deal according to the credit of the purchase undertaking provider and not the asset pool in the deal.

Moreover, IDB makes no representations to the assets or their transferability: In a normal securitization, the buyer receives representations and warranties as to the underlying assets and the SPE (Special Purpose Entity) will take proper contractual ownership of the assets.

Another feature of IDB's initial issuance is the delivery of a liquidity facility which allows the investors to receive payments whether or not money has come upstream from the underliers. Normally, in a securitization, the investors must live with the cash flows, regular or irregular, as they come from the underliers.

2.3 Recent Innovation in Sukuk Structures

Strengths	Weaknesses
<ol style="list-style-type: none"> 1. Structured to capture characteristics of more than one business method or contract. 2. Allow asset light or new business strategies 	<ol style="list-style-type: none"> 1. Risk of error in the reconciliation of the methods – i.e. knowing which method has precedence in governing the obligor. 2. Limits on tangible assets. 3. Complexity; inefficiency 4. <i>Shariah</i> reputational risk
Opportunities	Threats
<ol style="list-style-type: none"> 1. Seemingly endless set of combinations 2. Capacity to address working capital and asset oriented business strategies 	<ol style="list-style-type: none"> 1. Errors in execution. 2. Drive out core methods

Table 7: Hybrid Sukuk SWOT Analysis

2.3.1 Mudarabah/Tawarruq Hybrid

Although the types of hybrids used in the *sukuk* markets vary, the blending of *sukuk al ijarah* and *Wakalah* to engage in reverse-*tawarruq* began as a trend in 2011. In this latest style, the quantum of *ijarah* assets is required to be big enough to allow tradable *sukuk*, but requires that the issuer actually have the assets. Often, the obligor acts as a *mudarib* or *wakeel* to manage the underlying assets: hence the *ijarah* leg is not always called *ijarah*, but *Mudarabah* or *Wakalah*. **Figure 5** illustrates this hybrid structure. If the Obligor is an Islamic Bank, the *Mudarabah* portion is where the investors are participating in the Islamic bank's *Ijarah* portfolio via a *Mudarabah* placement.³² This is normally for 51% of the Sukuk amount. The pool remains on the Obligor's balance sheet and the Obligor as *Mudarib* has obligations to source, manage and replace the assets in the *Mudarabah* pool.

Simultaneously, the *Wakalah* leg (49%), is meant to raise funds for the obligor to engage in new business. The reason it is called a *Wakalah* is that the obligor will undertake to act as

³² If the Obligor is not an Islamic bank, the participation into the *Ijarah* portfolio will be replaced via a sale and leaseback transaction, where the Obligor will sell an asset on a spot payment basis to the SPV and lease it back for the term of the Sukuk. This was done in the ALim Sukuk arranged by Al-Rajhi Malaysia for Cagamas issuance in 2010 for example.

an agent for the investors to use their funds to buy commodity on a spot basis and then buy these commodities from the investors on a deferred basis. As the owner of the commodities, the obligor will then sell commodities on a spot basis to a broker to generate fresh cash for the its business operations. This is the structure of reverse-*tawarruq* (*R-tawarruq* for short).

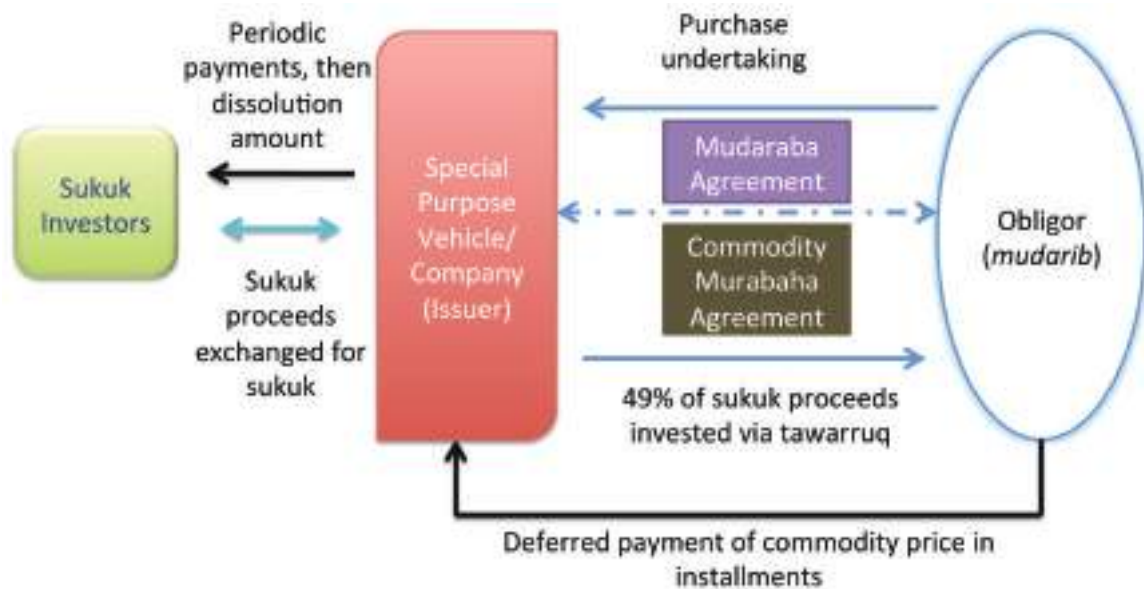


Figure 5: Mudarabah-Wakalah Hybrid Sukuk Structure

Source: SHAPE™ Financial Corp.

The *Wakalah/R-tawarruq* arm is effectively like a zero-coupon instrument, compensating for the possible risk under the *Mudarabah* element. In the *Wakalah/R-Tawarruq* arm, the investors use, for example, US\$200m capital to buy the commodities and sell it at US\$220m to be paid in, say, 3 years. The higher sales receivable effectively allows the investors to recover their capital in the *Mudarabah* to the extent of the Murabaha profit amount. If the *Mudarabah* is successful, the gross return will far exceed the benchmark or the expected return, and the *wakeel* will be rewarded with the excess yield as a performance fee.

Traditional fixed income investors prefer the *Wakalah* leg because their exposure is not to the new business initiated by the obligor, but to the *tawarruq* debt of the obligor to pay them a fixed profit and an assured payment of the capital.

It should be noted that when the markup of the commodity murabaha (*R-tawarruq*) is included, total debt of the underlying assets will exceed 49%, and might exceed 70% of total assets of the *sukuk*. Further, the stipulated combination of *Mudarabah* and *R-tawarruq* may be viewed as putting the *mudarib* in the position of guaranteeing the capital of the *Mudarabah*. This may be viewed as conflicting with AAOIFI's pronouncement on *Sukuk Musharakah, Mudarabah* and *Wakalah*.

2.4 Common Operational Issues in the *Sukuk* Market

2.4.1 *Benefits/Challenges of Special Purpose Entities - SPCs & SPVs:*

The role of a special purpose entity (“SPE”) is to isolate risks and liabilities. Investors may wish to own an asset, but direct ownership may generate upward liabilities from assets to the investors. Investors would also like to isolate the assets from the estate of the seller lest the seller should go bankrupt. Hence, SPEs are said to provide “bankruptcy remoteness”. If this can be achieved, then there should be accounting deconsolidation (i.e. off balance sheet treatment)³³ for the asset, and “securitization” will have taken place.

As we discussed in IDB’s *Sukuk al Istithmar*, there is no separation of the asset from the Bank’s balance sheet. So the investors must have another set of reasons for desiring to invest through an SPE. And, the issuer will also prefer to issue the securities via an SPE. The first is to agree on a common legal system and venue for orderly management of business when all is going well, and the management of disputes when there are defaults. In both cases, the issuer prefers the SPE as it will establish a single counterparty to deal with the issuer.

Investors will also select the jurisdiction of an SPE in order to manage their tax risks in the most efficient manner. The determination of what type of SPE or in which jurisdiction to locate an SPE is fundamentally the same for *sukuk* as it is for funds.

The two common forms of SPE are referred to as special purpose companies (“SPC”) or special purpose vehicles (“SPV”). The difference between an SPC and SPV is that the former is a company, and there is no trust declared over it. The latter may or may not be a company, but is a trust. Whereas a company has legal form, owners, and potential tax obligations, a trust is governed by an indenture which sets out rules for a trustee to follow governing an asset, a company, or a business. Modern trusts are generally creatures of English law, although a number of civil law jurisdictions like Bahrain and Thailand have introduced trust laws to facilitate capital market transactions. As a general rule, once a trust is declared over an asset, it is held in “trust” for a beneficiary, the “investors”.

During the financial crisis of 2008, SPCs and SPVs faced problems making claims in many IDB member countries. The problem was that offshore SPEs were typically not admitted to do business in the country where they thought that they had acquired an asset. As a result, the need to register an SPE in the country where the assets will be located is frequently considered, thereby increasing deal costs for investors.

2.4.2 *Jurisdictional Issues:*

Investors will often have strong preferences to select the jurisdiction for an SPE in order to secure the best protection of their rights during the life of a security. *Sukuk*-like funds may have multiple jurisdictions. There is the jurisdiction of the SPE, the domicile of the assets,

³³ “Accounting deconsolidation” means that an asset sale has met accounting tests for it to be removed from the seller’s balance sheet. This is either because there are no contingencies in the sale, or the legal title remained with the seller, but the risks and rewards or control of the asset have moved to the buyer.

and prospectively a completely different jurisdiction for the issuer or the obligor. This was certainly the case with the different IDB *sukuk al Istithmar* issuances. Sometimes, even the form of investment contract like an SPE will require recognition under local law. Multiple jurisdictions may make it difficult for investors to collect on defaulted payments or to seize an asset, whether it is from a securitization or is pledged as collateral.

2.4.3 *Benefits of Listing Sukuk:*

Most *sukuk* are not listed. Generally, investors have justified listing *sukuk*, like conventional bonds and equities for two reasons. Some issuers/obligors seek to raise their profile and listing places them in the public light and provides a form of marketing.

For other issuers/obligors, they have consulted with the investors who wish to have an easy means to exit their investment by selling on the market. Issuers/obligors often accept this approach as it does not affect the terms and conditions of their deal, and facilitates investor goals.

2.4.4 *Tax Issues:*

Most *sukuk* have been structured to appear similar to traditional bonds. This is so that the coupon payments will be treated as “portfolio interest” for international tax purposes. This is because international tax treaties give a lower tax rate to portfolio interest than dividends.

2.5 Retail Bond and Sukuk Market

We analyzed the trend of retail bond (and Sukuk) issuance in different markets, and further scrutinized the application of retail bond and Sukuk for infrastructure financing. From our review, we found that the experiences of India, UK and Malaysia provide most benefit to IDB as they took different approaches in developing the retail bond/Sukuk market for infrastructure finance.

In the USA, issuers may tap into retail investors if they have met the requirement under Section 33 of the SEC Act. So retail bonds are not a new phenomena in the US. In fact, retail investors hold about 50% of the muni-bonds in the USA, and they also hold about 15% of corporate bonds (Galagher, 2012). However, this is not a common trend in other countries. After the financial crises (both the Asian Financial Crisis, and the 2008 Global crisis), many countries are aiming to develop their retail bond markets.

Among the ASEAN countries, Indonesia was the first one to launch retail bond (2006). The purpose of these bonds was to fund the government budget. In 2008, Indonesia then launched the first retail Sukuk. The government issues these retail bonds and Sukuk periodically through domestic selling agents.³⁴ In 2011, the government started exploring the idea of using retail bond/Sukuk to finance infrastructure projects. At the date of this report, the government has not launch any specific infrastructure retail bonds or Sukuk (Standard Chartered, 2011).

³⁴ Refer to (Asian Development Bank, 2012) Indonesia Bond Market Guide

Thailand, Singapore and Malaysia launched their retail bonds in 2009, whereas Philippines only tapped into the market in 2012. In Singapore, the market started with the government bonds and retail investors participated via ATM to buy the bond. Since then the retail bond market has seen 11 corporate issuances including a Singapore Airlines issuance. Beginning July 2011, the government and corporate bonds were available for trading on Singapore Stock Exchange (SGX). Singapore is also aiming to become the hub for infrastructure bond to meet Asia's infrastructure need.

Besides the ASEAN market, New Zealand and Australia are also in the midst of enabling retail bonds. The Auckland Council issued NZ\$175 million fixed rate secured retail bonds to finance the infrastructure need in October 2012. New Zealand has an active retail bond market as it does not rely too heavily on external funding. Australia, which has always relied on external funding, was more interested to develop the domestic bond market to avoid being squeezed during financial crisis. Now let us examine the experiences of the three different markets; India, Malaysia and UK.

2.5.1 India's experience with retail bond and infrastructure bond

The mutual fund industry in India dates back to 1963. Since then the government has been liberalizing the industry in stages. In 2007, a committee was established to analyze the possibility of establishing a dedicated development infrastructure fund. At the time of the report, the investors could invest in the infrastructure sector only through the following options:

1. Mutual Funds: invest in listed companies related to infrastructure sector. There were restrictions for these funds to invest in unlisted securities.
2. Private Equity (PE) - local and foreign high net worth investors investing in unlisted infrastructure companies. But this was not available to retail investors.

The committee recommended that launching dedicated mutual funds that are allowed to invest in unlisted debt and equity securities would be the most suitable avenue to tap into retail investors. Appendix 3 summarizes the recommendation of the committee with its rationale on the different operational aspects (structure, liquidity, tenor etc.) of such dedicated mutual funds.

In 2008, a joint venture between State Bank of India (SBI), Macquarie and IFC was established. Two unlisted private equity infrastructure funds were subsequently launched in 2010 (Macquarie SBI Infrastructure Fund-MSIF) and 2011 (SBI Macquarie Infrastructure Trust-SMIT). We will elaborate further on these funds in the next chapter.

Meanwhile, the mutual funds investing in listed infrastructure companies continued. Different mutual fund companies even launched offshore funds to tap into this sector. For example, in November 2009, Kotak Mahindra (out of UK) launched a UCIT III compliant infrastructure fund to retail European investors. The fund was based in Luxembourg, and invests in listed shares and equity-linked instruments of companies directly or indirectly linked to the Indian infrastructure and realty sectors. Minimum investment was US\$500 (£299).

Although the committee made recommendations about launching dedicated unlisted infrastructure-focused funds in 2007, no retail mutual fund was launched at the end of this

research period. However, both the banking regulator (RBI) and capital market regulator (SEBI) allowed the launch of the “Infrastructure Debt Fund (IDF)”, targeting institutional investors. There was also regulation allowing Non-Banking Financial Institutions (NBFCs) to issue retail infrastructure bonds.

In July 2010, the government announced tax-free status for NBFC infrastructure bonds. However, the guidelines and regulations for IDF only came in the third quarter of 2011. IDFs may be issued via the mutual fund (trust-based) route or NBFC route.

Figure 6 summarizes the differences between the two routes.

The mutual fund IDFs are at-risk investments targeted at local institutional³⁵ investors. These come under SEBI’s regulation. At least 90% of the fund must be invested in infrastructure debt. These are close-ended funds, or must have a lock-in period of 5 years.

The NBFC-IDFs are targeted towards more risk averse investors. NBFCs will issue bonds to both local and foreign investors and use the proceeds to provide debt in infrastructure projects. However, NBFCs are restricted in providing debt to brownfield PPP projects, which has a government buy-out of the concession.

	IDF-NBFC	IDF-MF
Regulated by	RBI	SEBI
Funding tool	Bond issuance, with min 5 years maturity: <ul style="list-style-type: none"> • Either Rupee or Dollar • No min. amount 	Mutual Fund unit issuance (close ended or 5 year lock in period) <ul style="list-style-type: none"> • Rupee only • Min fund amount INR250m • Min investment per investor INR 10m
Investors	Local or institutional offshore	Local - institutional investors only
Investment	Debt in PPP with at least one year operation & tripartite agreement	At least 90% debt instrument

Figure 6: The differences between two IDF routes in India

The first IDF-NBFC was launched in March 2012 by a consortium of financial institutions in India (CICI Group, Life Insurance Corporation, Citicorp Finance India and Bank of Baroda). At the same time, IDFC (Infrastructure Development Finance Company) also applied to SEBI for launching the first IDF-Mutual Fund.

³⁵ There must be strategic investors contributing (INR250m) and every other investor must invest at least (INR10m). Each units are issued at a face value of INR1m.

In May 2012, SEBI issued guidelines to allow the establishment of Alternative Investment Funds (AIF). There are three types of AIF:

- i. Category I (Specific incentive from Government) - may be involved in venture capital, social ventures, SMEs, infrastructure or other sectors preferred by the government.
- ii. Category II (other than Category I and III): private equity funds or debt funds for which there are no specific incentives.
- iii. Category III (no incentive & deal with derivatives): Hedge funds or funds which trade with a view to make short-term returns.

Figure 7 summarizes the difference between AIF (Category I-Infrastructure) and IDF-MF. Unlike IDF-NBFC, the IDF-MF did not allow foreign investor participation. AIF explicitly allows foreign investors, and non-resident Indians to participate in the fund. Both IDF-MF and AIF focus on institutional or high net worth individuals since the minimum investment per investor is INR10 million. Unlike the IDF-MF, which must invest most of the fund in debt instruments, AIF may invest in debt and equity securities, listed and unlisted.

	AIF - Category I (Infrastructure)	IDF-MF
Regulated by	SEBI	SEBI
Fund requirement	<ul style="list-style-type: none"> • Close ended • Min. fund amount - INR200m • Min investment per investor – INR 10m 	<ul style="list-style-type: none"> • Close ended • Min. fund amount INR250m • Min. investment per investor – INR 10m • Requires strategic investors
Investors	Indian, foreign or non-resident Indians (institutional)	Local - institutional investors only
Investment	<ul style="list-style-type: none"> • At least 75% in unlisted securities (debt & equity) • May also invest in listed debt securities 	At least 90% debt instruments

Figure 7: The differences between two IDF routes in India

If we summarize the Indian experience, the committee in 2007 recommended that the mutual funds route presents an opportunity to tap into retail investors for infrastructure projects. However, in reality, the mutual fund route (both IDF and AIF) did not tap into the retail market, and only focused on institutional investors and high net worth individuals. Other parts of the recommendations, including permitting funds to invest in unlisted debt and equity has been formalized in the AIF regulation. Instead, the IDF-NBFCs were issuing retail bonds. This may indicate that in certain markets, it may be better to tap into retail investors via the infrastructure bond route instead of the equity funds route. Also, according to (PWC,

2010), the majority investors (50%) in the Indian mutual funds industry³⁶ are corporations. They also observed that retail and High Net Worth Individuals (HNWI) investors exit the mutual fund investments within two years.

Now let's briefly examine the experience of NBFCs issuing retail infrastructure bonds. Each retail bond was sold at INR1,000 (US\$18) and the minimum investment is INR5,000 (US\$91). Since the IDF-MF regulations were only issued in the third quarter of 2011, the NBFCs actively came to market only in 2012. The government also sanctioned 10 approved infrastructure financiers to issue these tax-free infrastructure bonds to mobilize the market. These institutions were required to raise INR300b in 2012 and were expected to raise INR250b in 2013. There are two main issues that IDB should take note from the NBFCs experience in the retail infrastructure bond market.

First, the inability of some NBFCs to deploy the funds raised. The National Highways Authority of India (NHAI) for example raised INR100b in 2012 but was only able to use 25% of the proceeds due to various delays³⁷ in the Indian infrastructure market. As such, they decided not to issue new bonds until after 2015. Figure 8 shows the amount that was sanctioned compared to the amount that was raised by the different institutions.



Figure 8: Actual funds raised by NBFC against their sanctioned amount

Source: (Dasgupta, 2013)

³⁶ This refers to the general mutual fund industry and not infrastructure funds

³⁷ Including the inability of line ministries to get clearance in place before awarding projects

One financial institution, the Indian Railways Finance Corporation (IRFC) had a different experience. As there were enough railway projects for it to invest in, IRFC successfully invested the funds it raised via the infrastructure bond. As such it was planning to continuously issue more infrastructure bonds.

The second challenge faced by the NBFCs was the price sensitivity (or unsophistication) for retail investors. With the success of raising US\$7b from retail investors in 2012, a number of NBFCs decided to tap into the market again in 2013. However, during this period, the government yield dropped, so the coupon rate offered in 2013 issuances was lower compared to the 2012 issuances. As such, the NBFCs did not get the expected take-up from the retail investors.

In summary, the Indian experience shows that it is possible to raise huge amount of funds from the retail market, but the price sensitivity of retail investors may impede fund-raising when rates fall. In addition, tax incentives and securities regulation to facilitate fund raising would not be successful without the smooth running of the infrastructure projects themselves. As (Kothari & Ladha, n.d.) mentioned: “Practitioners say that the way infrastructure operating companies are ailing under a pile of debt and stuck operations, what is needed is business, and not so much another line of funding.”

2.5.2 Malaysia’s experience with retail and infrastructure Sukuk

Although Malaysia is the third largest bond market in Asia (by GDP), the regulators and the Malaysian think tank felt that the investors were risk averse and only focused on high quality issuances (AA and AAA). This limited the number of companies that can tap into the capital market. In addition, the regulators also wanted to increase the secondary market trading of bonds and sukuk. As such, the action plan in Malaysia included the following (PEMANDU, n.d.):

1. Establishment of Dana Jamin. This is a financial guarantor established in May 2009 to facilitate the participations of companies with lower credit rating in the Malaysian capital market.
2. Active promotional effort from the regulators & investment banks to encourage foreign investors & issuers in the Malaysian market.
3. Strengthening of retail participation in the bonds & Sukuk market.

Prior to the retail participation framework, the minimum transaction size to participate in the bonds and Sukuk market was RM250,000. So retail investors usually participated in the fixed income market via fixed income funds in Malaysia. The Capital Market Master Plan 2, launched in April 2011, mooted the idea of retail participation in the bond and Sukuk market.

Since then, the Securities Commission (SC) of Malaysia, has put in place a framework to facilitate staged participation of retail investors in the fixed income market directly. The SC, however, wanted to introduce retail bonds/Sukuk to the public in stages. Therefore, in the first stage, only the government, or government guaranteed institutions were allowed to issue retail bonds or Sukuk.

In the second stage, public listed companies, banks & financial institutions (including Cagamas) or an unlisted company with guarantee from Dana Jamin or Credit Guarantee would tap into the retail investors. The final guideline for the issuers was released on 28th Dec 2012.

The “Eligible Sukuk” section in the guideline summarizes the characteristics of the retail Sukuk allowed in Malaysia. Refer to [Figure 9](#) for details. SC allows the issuance, fixed or floating rate Sukuk, with or without periodic distribution, and even convertible/exchangeable Sukuk. However, the retail Sukuk should not be subordinated, and should have recourse to the Obligor/originator. The retail Sukuk may be issued either over the counter (OTC) or on an exchange.

21.04 For an issue, offer or invitation to subscribe or purchase sukuk to retail investors, a sukuk must be denominated in Ringgit Malaysia with a tenure of more than one year and must have the following characteristics:

- (a) fixed term with principal and any profit payable at expiry;
- (b) fixed or variable profit rate;
- (c) except for sukuk without periodic distribution, profits are to be paid periodically on certain specified intervals from the issue date;
- (d) rank at least equally with amounts owing to unsecured and unsubordinated creditors; and
- (e) does not embed any swaps, options or other derivatives, except in the case of convertible or exchangeable sukuk where the option is to convert or exchange the sukuk into shares:
 - (vi) the option is at the discretion of the investor; and
 - (vii) the underlying shares are listed on Bursa Securities.

21.05 Notwithstanding paragraph 21.04, retail sukuk must not include:

- (a) ABS that fall within the definition of “asset-backed securities” under the Guidelines on the Offering of Asset-Backed Securities (ABS Guidelines); or
- (b) sukuk that is structured like ABS, where the sukuk is without recourse to an originator or obligor, or where the ability to meet obligations under the senior tranche is enhanced by less senior tranche(s), but does not fall under the purview of the ABS Guidelines.

Figure 9: Guideline on Retail Sukuk in Malaysia

Source: (Securities Commission Malaysia, 2012)

Now, let’s briefly examine the Malaysian experience with retail bonds/Sukuk.

	Merdeka Savings Bond	Retail Savings Sukuk	Sukuk 1 Malaysia	Dana Infra Sukuk
Date of Issuance	18 March 2009	14 May 2009	21 June 2010	8 Feb 2013
Tenor	3 years	3 years	3 years	10 years
Amount	RM 2b	RM 5b	RM 3b	RM300m
Return	5%	5%	5%	4%
Periodic Distribution	Monthly	Quarterly	Quarterly	Semi Annual
Transferable	No	No	Yes, but only to agent bank. Info on public website (Bond hub). 0.1% admin cost to agent bank	Yes - listed on Bursa Malaysia
Eligible investors	<ul style="list-style-type: none"> • 56 years and above; or • Retired on medical ground 	Malaysian 21 years and older	Malaysian 21 years and older	Malaysian 21 years and older
Minimum investment	<ul style="list-style-type: none"> • RM 1,000 	<ul style="list-style-type: none"> • RM 1,000 	<ul style="list-style-type: none"> • RM 1,000 	RM 1,000
Maximum investment	<ul style="list-style-type: none"> • RM 50,000 	<ul style="list-style-type: none"> • RM 50,000 	<ul style="list-style-type: none"> • RM 50,000 - not applicable to purchase of resale Sukuk 	<ul style="list-style-type: none"> • NA
Early Redemption	<ul style="list-style-type: none"> • After first profit payment • Minimum is RM100 	<ul style="list-style-type: none"> • After first profit payment • Minimum is RM100 	NA - because may resell to agent bank	NA - listed
Tax incentive	<ul style="list-style-type: none"> • Returns are tax exempted 	<ul style="list-style-type: none"> • Returns are tax exempted 	<ul style="list-style-type: none"> • Returns are tax exempted 	<ul style="list-style-type: none"> • Returns are tax exempted
Distribution channel	<ul style="list-style-type: none"> • Commercial banks including Islamic banks & savings institutions 	<ul style="list-style-type: none"> • Commercial banks including Islamic banks & savings institutions 	<ul style="list-style-type: none"> • Commercial banks including Islamic banks & savings institutions 	<ul style="list-style-type: none"> • Application form • Internet banking • ATM

Figure 10 summarizes this. As highlighted in the beginning of this section, Indonesia has tapped in retail bonds (2006) and the retail Sukuk market (2008) prior to many other ASEAN countries. Malaysia joined Thailand and Singapore in launching retail bond in 2009.³⁸ One month after the issuance of the Malaysian maiden retail bonds (targeted towards retirees), Malaysia launched its first government retail Sukuk open to all Malaysian aged 21 and above. With good demand, the government issued a RM5 billion Sukuk compared to the RM3billion retail bond.

³⁸ The government retail bond and Sukuk were issued via Bank Negara Malaysia

	Merdeka Savings Bond	Retail Savings Sukuk	Sukuk 1 Malaysia	Dana Infra Sukuk
Date of Issuance	18 March 2009	14 May 2009	21 June 2010	8 Feb 2013
Tenor	3 years	3 years	3 years	10 years
Amount	RM 2b	RM 5b	RM 3b	RM300m
Return	5%	5%	5%	4%
Periodic Distribution	Monthly	Quarterly	Quarterly	Semi Annual
Transferable	No	No	Yes, but only to agent bank. Info on public website (Bond hub). 0.1% admin cost to agent bank	Yes - listed on Bursa Malaysia
Eligible investors	<ul style="list-style-type: none"> 56 years and above; or Retired on medical ground 	Malaysian 21 years and older	Malaysian 21 years and older	Malaysian 21 years and older
Minimum investment	<ul style="list-style-type: none"> RM 1,000 	<ul style="list-style-type: none"> RM 1,000 	<ul style="list-style-type: none"> RM 1,000 	<ul style="list-style-type: none"> RM 1,000
Maximum investment	<ul style="list-style-type: none"> RM 50,000 	<ul style="list-style-type: none"> RM 50,000 	<ul style="list-style-type: none"> RM 50,000 - not applicable to purchase of resale Sukuk 	<ul style="list-style-type: none"> NA
Early Redemption	<ul style="list-style-type: none"> After first profit payment Minimum is RM100 	<ul style="list-style-type: none"> After first profit payment Minimum is RM100 	NA - because may resell to agent bank	NA - listed
Tax incentive	<ul style="list-style-type: none"> Returns are tax exempted 	<ul style="list-style-type: none"> Returns are tax exempted 	<ul style="list-style-type: none"> Returns are tax exempted 	<ul style="list-style-type: none"> Returns are tax exempted
Distribution channel	<ul style="list-style-type: none"> Commercial banks including Islamic banks & savings institutions 	<ul style="list-style-type: none"> Commercial banks including Islamic banks & savings institutions 	<ul style="list-style-type: none"> Commercial banks including Islamic banks & savings institutions 	<ul style="list-style-type: none"> Application form Internet banking ATM

Figure 10: Retail Bond & Sukuk in Malaysia

We can observe a few evolutions in the different retail Sukuk and bond offerings in Malaysia:

- The first two bonds/Sukuk were non-tradable, hence allowing for early redemption for the investors.
- The third issuance (in 2010) introduced the idea of trading to retail investors - thus it did not come with early redemption. In Sukuk 1Malaysia, the investors may sell the Sukuk to the agent bank, with 0.1% admin cost. However, the price will be at par.

- iii. The first three Sukuk/Bonds were not listed on the exchange, and the investors deal with the commercial banks to participate in the Sukuk.
- iv. Dana Infra Sukuk - represented two important evolutionary stages in the Malaysian retail Sukuk experience.
 - a. First, unlike the general obligation Sukuk issued by the government prior to this, Dana Infra is an infrastructure project Sukuk. The longer tenure (10 years) did not negatively affect the investor demand.
 - b. Second, the Sukuk was listed on the exchange. Unlike Sukuk 1Malaysia - which introduced tradability at par, the Dana infra Sukuk will be trading according to the market demand. In addition, the distribution channel was also expanded to include online banking and ATM, in addition to the formal application form.

Since Dana Infra set up a program issuance, they raised funding in smaller tranches compared to the Government. All the retail government bonds/Sukuk carried 5% return. Dana Infra originally contemplated a 3.7% return, but increased this to 4% in the final issuance. Some bankers highlighted that although issuing retail Sukuk expands the investor base, it comes at a higher cost. For example, some think that Dana Infra could have issued the Sukuk at 3% if it had tapped into the institutional investors. However, to entice retail investors, Dana Infra had to increase the profit payment.

Figure 11 shows Dana Infra's Sukuk price on Bursa Malaysia. It was issued at a premium and has been trading at premium during the first month. This reflects the good demand Dana Infra enjoyed.



Figure 11: Dana Infra Sukuk Price
Source: (Bursa Malaysia, 2013)

In conclusion, the retail bond and Sukuk offerings in Malaysia were driven by the long term planning from the regulators and the government. Although Malaysia was not the first to issue retail bonds/ Sukuk in the ASEAN market, it was the pioneer in raising the first infrastructure Sukuk. Indonesia has an infrastructure Sukuk in the works, but has not yet come to market. We anticipate that Malaysia may consider issuing inflation-linked Sukuk in the next phase of its evolution.

2.5.3 UK's experience with retail bond including issuance by a infrastructure company

The Italian MOT (Monte Titoli)³⁹ market is the biggest retail bond market in Europe, having raised €700b as at May 2012. In June 2009, Eni, an Italian energy group, enjoyed a book order of €6 billion when they tapped into the retail bond market to raise €1 billion. EDF, a French utility company also had a similar experience. Although issuing retail bonds requires onerous EU reporting requirements, a number of companies tap into the market as there is a strong demand from retail investors who are looking for alternative investments due to low interests in bank deposit. For example, **Figure 12**, shows the number of European corporate bond issues in €1,000 denomination. In the first half of 2009, the number of corporate bonds issued in this format exceeded the entire previous full year totals.

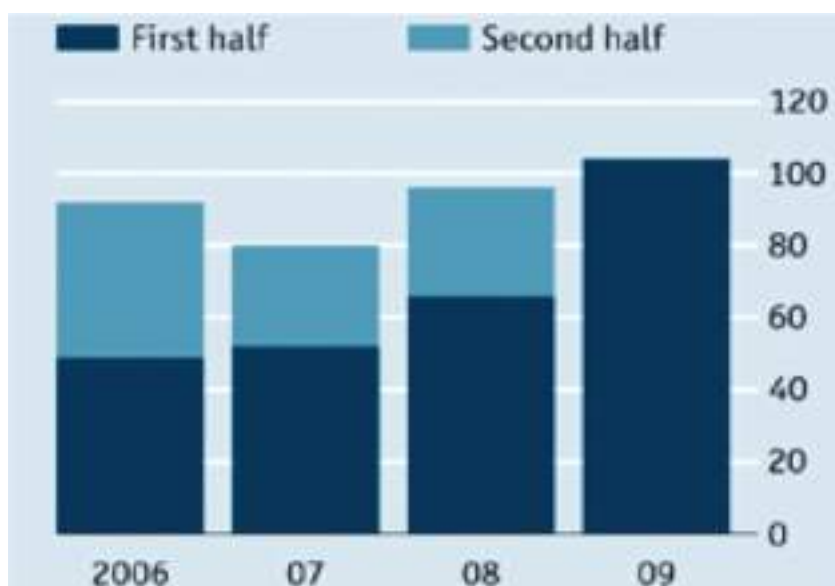


Figure 12: Number of Corporate bonds issued in €1,000 denomination

Source: (The Economist, 2009)

³⁹ Bursa Italiana has operated for more than 200 years (first established in 1808). The fixed income market on Bursa Italiana is known as MOT. It caters for regulated (domestic & euro bonds) and unregulated market. In 2007 there was a merger between Bursa Italiana & London Stock Exchange. <http://www.borsaitaliana.it/borsaitaliana/chisiamo/bicentenario/tapestoriche.en.htm>

Motivated from the MOT success, the London Stock Exchange (LSE) launched its retail bond platform (known as *Order Book for Retail Bond - ORB*) in Feb 2010. The portfolio grew from £100m in first 10 months to £1.2b by Nov 2012. Initially, small companies that did not have the size to tap into institutional investors utilized the market.⁴⁰ The recent trend shows that even larger companies that want to establish alternative funding options are tapping into the retail bond market. In addition, due to the low interest rate, many companies want to refinance their bank debt into a bond. The LSE's retail bond platform allows fixed rate, floating rate or inflation-linked bond issuances.

According to (KPMG, 2012), there are two principal routes for companies in UK to tap into the retail bond market:

1. The listed market i.e. using the LSE's ORB platform. Companies have issued both fixed-rate coupons and index-linked coupon bonds. Investors may trade these bonds on the LSE.
2. The unlisted mini-bond market. Companies like John Lewis, Mr & Mrs Smith and Ecotricity have tapped into this market, where they issue non-transferable bonds directly to the retail customers. This type of retail bond even uses exotic coupon arrangements such as store vouchers, products or customer discounts. (Bloomberg, 2012)

Figure 13 and Figure 14 show examples of bonds issued in both markets.

ISIN	Issuer Name	Date Listed	Maturity	Coupon Value	Coupon Type	Min Den	Issue Size
XSO880378728	EnQuest PLC	15/12/2013	9 year	5.5	Fixed	100	£150 million
XSO853368801	Alpha Plus Holdings plc	19/12/2012	7 year	5.75	Fixed	100	£48.5 million
XSO856594642	UNITE Group plc	12/12/2012	7 1/2 year	6.125	Fixed	100	£60 million
XSO869261620	Tullet Preben plc	11/12/2012	6 1/2 year	5.250	Fixed	100	£60 million
XSO841076455	St. Modwen Properties plc	07/11/2012	7 year	5.25	Fixed	100	£80 million
XSO845486040	London Stock Exchange Group plc	05/11/2012	9 year	4.75	Fixed	100	£300 million
XSO832324961	Workspace Group plc	10/10/2012	7 year	8	Fixed	100	£57.5 million
XSO827693653	Beebay plc	25/09/2012	7 year	5.375	Fixed	100	£75 million
XSO818634866	Intermediate Capital Group plc	20/09/2012	8 year	6.25	Fixed	100	£60 million
XSO820711215	CLS Holdings plc	12/09/2012	7 1/4 year	5.5	Fixed	100	£65 million
XSO805454872	iCAP plc	31/07/2012	6 year	5.5	Fixed	100	£125 million
XSO765445823	Primary Health Properties plc	24/07/2012	7 year	5.375	Fixed	100	£75 million
XSO766078193	Severn Trent plc	11/07/2012	10 year	1.3	Variable	100	£75 million
XSO76063235	Tesco Personal Finance plc	21/06/2012	8 1/2 year	5	Fixed	100	£200 million
XSO762418953	Provident Financial plc	04/04/2012	5 1/2 year	7	Fixed	100	£120 million
XSO731910765	Places For People Capital Markets	31/01/2012	10 year	1	Variable	100	£40 million
XSO716336325	Intermediate Capital Group plc	22/12/2011	7 year	7	Fixed	100	£35 million
XSO710391832	Tesco Personal Finance plc	16/12/2011	8 year	1	Variable	100	£60 million
GB0083YYW134	Royal Bank of Scotland	07/11/2011	7 year	2	Variable	1000	£20 million
XSO678522490 ⁴⁰	National Grid plc	30/09/2011	10 year	1.25	Variable	100	£282.5 million
XSO639914177	Places For People Capital Markets	27/06/2011	5 1/2 year	5	Fixed	100	£140 million
XSO605672558	Provident Financial plc	31/03/2011	5 1/2 year	7.5	Fixed	100	£50 million
XSO604804194	Lloyds TSB Bank plc	25/03/2011	5 1/2 year	5.5	Fixed	1000	£150 million
XSO602217159	European Investment Bank	11/03/2011	5 1/2 year	3.25	Fixed	100	£350 million
XSO591029406	Tesco Personal Finance plc	25/02/2011	7 1/2 year	5.2	Fixed	100	£125 million
GB00B42SH312	Royal Bank of Scotland	21/02/2011	6 year	2	Variable	100	£10 million
GB00B442C284	Royal Bank of Scotland	17/01/2011	7 year	3.3	Fixed	100	£15 million
GB00B4MTS317 ⁴⁰	Royal Bank of Scotland	06/12/2010	10 year	0	Variable	100	£35 million
GB00B4RHS3T66	Royal Bank of Scotland plc	01/11/2010	12 year	3.9	Variable	100	£20 million
GB00B4P5SL57 ⁴⁰	Royal Bank of Scotland plc	01/11/2010	12 year	3.9	Variable	100	£35 million
XSO517466198	Lloyds TSB Bank plc	21/06/2010	5 1/4 year	5.375	Fixed	100	£75 million
XSO496412064	Provident Financial plc	15/04/2010	10 year	7	Fixed	1	£25.2 million
GB00B3N3WC23	Royal Bank of Scotland	01/02/2010	10 year	5.1	Fixed	100	£60 million

Figure 13: Retail Bonds listed on LSE - ORB

(LSE, n.d.), p5

⁴⁰ These companies normally look for smaller issuance size - between £25 million and £250 million

UK unlisted – 'Mini bond'				
Issue date	Issuer	Amount	Maturity	Coupon
June 2012	Mr & Mrs Smith	N/D	4 year initial period	7.5% cash coupon or 8.5% in Mr & Mrs Smith 'loyalty money'
Dec 2011	Ecotricity	£10m	4 year initial period	8% plus 0.5% for Ecotricity customers
Nov 2011	Caxton FX	£3.9m	4 year initial period	7.25%
July 2011	Wind Prospects	£2.3m	4 year initial period	7.5% for subscriptions up to £10,000; 8% for subscriptions of £10,000 or more
Mar 2011	John Lewis	£57.5m	5 years	4.5% cash coupon plus 2% in store vouchers
Dec 2010	Ecotricity	£10m	4 year initial period	7% plus 0.5% for Ecotricity customers
July 2010	The Chocolate Tasting Club	£3.7m	3 year initial period	Bi-monthly deliveries of chocolates; equivalent to 6.72% for £2,000, 7.29% for £4,000

Figure 14: Unlisted Retail Bond in UK

Source: (KPMG, 2012), p3

National Grid's⁴¹ bond was the first inflation-linked bond to be traded on the LSE's ORB and was also the largest single amount raised through the retail bond market. They also increased the issuance size from £260 million to £282.5 million due to good demand. We can observe that (Retail Price Index) RPI-linked issuances have consistently enjoyed a longer tenure compared to the fixed rate issuances. In the third quarter of 2012, the LSE itself issued a £300m retail bond at 4.75% (tightest price so far), with a 9 year tenor (longest maturity on non-inflation linked).

Also notice that Provident Financial, Tesco Personal Finance and Places for People have completed repeat issues. (KPMG, 2012) shows that the ORB market has the potential to allow companies to set up program issuances.

After National Grid's pioneering role in issuing an inflation-linked bond, a number of companies have tapped into this bond issuance, including Tesco Personal Finance, Places for People and Severn Trent (water and wastewater services company). (KPMG, 2012) highlighted that an inflation-linked bond was preferred by Severn Trent because it offered a much more competitive rate compared to the fixed rate bond. Severn Trent also naturally earns inflation-linked revenue in its water business.

Besides the retail bond market development in Europe, there is also another interesting trend relating to bond funds in this market. Bond funds (that cater to HNWI and retail investors) were an uncharted territory to the European market (unlike Asian and American markets). In 2009, due to the financial crisis, the demand for bond funds increased from 3% to about 20%. Since this new investor group created further demand in the secondary market, the institutional investors were willing to take a tighter price and issue in smaller denomination (1,000 instead of 50,000). An example of fixed income/bond fund managers

⁴¹ This is an infrastructure company in UK

were M&G Investments and Invesco Perpetual that was managing £18bn AuM (Assets under Management).

However, in late 2012, a number of private bankers (on behalf of the HNWIs) were cutting down their investments in these funds as there were concerns regarding liquidity and the ballooning size of these funds (doubled since 2008). The private bankers were worried that the fixed income funds cannot meet the redemption requests. One has to keep in mind that retail bonds are separate from bond funds. In retail bonds the issuer is directly dealing with the retail investors instead of selling to the bond fund. As the bonds are listed, it provides an alternative exit mechanism and investors do not rely on the fund managers to redeem the bonds.

In summary, the development of the European and UK retail bond market spurred from the pull factor (i.e. demand) instead of the push factor (active government efforts to develop this market). Unlike Malaysia, which introduced a staged offering (government then corporate), the European & UK market ventured directly into the retail corporate bond market. In addition, if we refer to the pricing of the different retail bonds **Figure 13**, it shows that the investors are sophisticated enough to deal in different pricing mechanisms (fixed-rate vs. inflation-linked) and are able to understand factors that affect the coupon (timing, the interest rate environment, risk factors etc).⁴² This is quite natural as the investors in the European market have been exposed to capital market investments much longer than emerging markets, reflecting a higher degree of sophistication.

2.6 Evaluation of *Sukuk* against the Research Objectives:

Although this Chapter details many of the business problems with *sukuk*, it is not meant to attack the value of *sukuk* as an investment tool. Indeed, IDB's *sukuk* programs have provided the benefit of low cost financing to IDB and its MCs. IDB's issuances have been important as part of market development: helping to kickstart the market in 2003; introducing new markets; and experimenting with new forms.

2.6.1 Off Balance Sheet Funding

Since its initial benchmark *sukuk* in 2003, IDB has been a regular issuer. Most of IDB's *sukuk* are characterized as *sukuk al istithmar* or investment *sukuk*. These *sukuk* are structured to invest in a pool of assets that have already been generated by IDB. These *sukuk* are not pass-through securitizations in which an asset is sold by IDB to investors. Rather, investors have recourse or partial recourse to IDB. Because IDB did not securitize, the outcome is that the assets remain on IDB's balance sheet and the *sukuk* show on the balance sheet as well. Therefore, IDB has limited capacity to issue these types of *sukuk*.

The capacity of IDB to securitize is a reflection of the development of capital markets in IDB's member states. Securitization is a complex issue which requires a series of philosophical

⁴² Notice that different issuers have different coupons - either due to timing, maturity or just the credit factor. This is quite the contrary to the Indian experience in which the investors were price sensitive, without necessarily following the change in the interest rate environment.

decisions which have knocked on meaning for commercial law, national ownership laws, tax law, and securities laws. Only a few MCs have a modern coordinated securitization capacity based on either the Anglo-Saxon model (Malaysia) or the German model (Egypt). As the development of such laws takes many years in most countries, there is not going to be an increase in the market capacity for securities and securitization in the short term. The MCs may not be able to support IDB's *sukuk* programs in the generation of securitized assets. Many MCs have restrictions on foreign ownership and complex rules on the transfer of ownership of assets. And, more critically, the emerging market, and sometimes "less developed" status of many MCs, means that global institutional investors would be unwilling to invest in such securitized assets.

This leads to a limit in the market as to how many *sukuk* IDB may issue without showing high levels of indebtedness and jeopardizing IDB's coveted AAA rating. The evolution of emerging markets and their prospective openness to concepts like securitization is slow. Therefore, IDB needs to examine how to pursue alternative approaches to financing its development mandates. Although the on-balance sheet *sukuk* strategy has limitations, the anticipated funds could themselves become issuers of different types of *sukuk* in order to expand their funding mandates beyond the equity raised from certain classes of institutional investors.

2.6.2 *Cost of Funds*

IDB *Sukuk* have the benefit of delivering low cost of funds since they rely on IDB's credit rating. Thus they are an efficient tool to provide competitive funding to member countries, as long as IDB is able to maintain its AAA rating.

A strategy that aggressively issues *sukuk* or relies too much on IDB issuing more capital market obligations may result in one of three problems for IDB: the cost to IDB may rise; IDB may have to call more equity from its MCs; or IDB may face a negative credit watch followed by a possible downgrade. This will diminish its ability to deliver competitive funding in comparison to other MDFIs. This would have a negative impact on IDB's secondary mission to promote Islamic finance as well as its primary mission to finance development.

One could begin with a premise that expects a cheaper cost of funding by tapping into retail *Sukuk*. Based on the evidence gathered in Section 2.4, this may not necessarily be the case. As seen in the case of India and Malaysia, retail investors may not fully understand pricing dynamics and expect issuers to deliver higher returns. In the sophisticated western markets, where there is longer history of retail participation in the capital markets, there may be more favorable pricing for retail bonds. Inflation-linked *Sukuk* may provide better pricing for IDB, but this is untested in the *Sukuk* market.

2.6.3 *Diversification of Investors*

Sukuk are an attractive investment for fixed income investors. This may include pension and insurance company fixed-income divisions that look for stable investment, with medium to low risk, within a medium to long-term horizon. However, pension and insurance investors also have other dedicated investment sections that look for high-return investments. *Sukuk* may not necessarily have captured this investor group. In addition, *Sukuk* in the current market are focused on institutional investors who are dedicated to the bond markets. There

seems to be limited participation of non-bond investors, and even less participation of high net-worth individuals (HNWI) and retail investors. Although there seems to be an increased offering of *Sukuk* funds, again, the majority of investors are institutional investors. Fund managers and family offices often complain that it is difficult to get their hands on *Sukuk*.⁴³ Certain markets like Malaysia offers *Sukuk* funds to retail investors at an affordable minimum investment. The retail *Sukuk* in Indonesia and Malaysia received a lot of traction. As proven in India, retail bonds akin to *Sukuk* have a high potential for raising a large quantum of funds, although not necessarily at competitive pricing. One has to keep in mind, the problem of under-deployment of fund with this approach.

Table 8 shows the summary of the evaluation.

Research Objective	Do Sukuk meet the Objective?	Implication/Note
1. Off-Balance Sheet	No	Additional debt burden may affect AAA rating if not supplemented by capital or alternative funding.
2. Cost of Fund	<ul style="list-style-type: none"> Generally Sukuk offers a cheaper cost compared to funds. In emerging markets, the evidence shows that IDB may have to pay a higher profit rate to tap into retail investors. 	Depends on IDB's rating.
3. Diversification of investors	<ul style="list-style-type: none"> Current IDB distribution is focused on banks and institutional investors. Retail Sukuk promises diversification. 	Retail Sukuk market is still new. Investors are less sophisticated in emerging markets.

Table 8: Summary Evaluation of Sukuk against Research Objectives

In conclusion, the function of *sukuk* as part of IDB's global funding strategy is crucial. But, the current nature of *sukuk*, particularly in IDB MCs footprint means that *sukuk* cannot generate off-balance sheet funding for IDB projects and transactions involving MCs. *Sukuk*, when sold institutionally, may be able to deliver the lowest cost funding to IDB, which may be passed on to MC obligors (although IDB cost of financing to MC is higher than that of other MDFI). However, this low funding cost depends on IDB protecting its AAA rating. This means although *Sukuk* are a valuable funding tool for IDB, they must be complemented by other funding strategies including investment funds that draw global institutional investors.

⁴³ General sentiment gathered during National Bank of Abu Dhabi (NBAD) Islamic Finance Conference in 2011 from presentations of fixed income fund managers and family office managers.

Chapter 3 - Development Funds as Source of Funding for MDFIs

Since the 1990s, development banks have been expanding their presence the investment fund market. Funds allow MDFIs to take on different risk profiles without violating their direct mandates and attract private sector investors to long-term projects and risks that are not customary loan risks. This section surveys a small universe of funds, IDB funds and others, in order to examine the challenges for IDB to build its full investment portfolio.

3.1 Experience of other MDFIs in using development funds

As highlighted in Chapter 1, private investors are choosing many long-term, profitable projects and sectors due to financial liberation that is taking place in many emerging markets. This phenomenon has shifted many MDFIs' focus from financing government to financing the private sector.

(Perry, 2011) analyzed the trend of MDFI⁴⁴ funding to developing countries and found that funding the private sector increased rapidly while lending to governments was stagnant. Only during the recent financial crisis (2009), MDFIs re-focused on government lending for a short term period. After the crisis, government funding has been on a declining trend and private sector funding has been on an increasing trend. Among the MDFIs, it was highlighted that the European Bank for Reconstruction and Development (EBRD) and International Finance Corporation (IFC) were the leading MDFIs that fund the private sector.⁴⁵

Other MDFIs that were actively funding the private sector include the Inter-American Development Bank (IADB) group, the Corporación Andia de Fomento (CAF), the Asian Development Bank (ADB), and the African Development Bank (AfDB).

Figure 15 shows the total development-related operations - DRE (loan, equity and guarantee) of MDFIs to private sector firms in developing countries. The total funding increased from \$9.6 billion in 2003 to \$27.7 billion in 2008. In relative terms (private sector DRE to total DRE), the funding rose from 21% in 2003 to almost 40% in 2008. Loan is the most widely used funding option, followed by equity and guarantee.

⁴⁴ IFC, EBRD, ADB, AfDB, IADB, and CAF. He excluded the European Investment Bank (EIB) as it focuses on developed countries. He also excludes bilateral funding to private sector in developing countries, which he highlights has been growing at a fast rate.

⁴⁵ Refer to page 9, Figure 6 in (Perry, 2011)

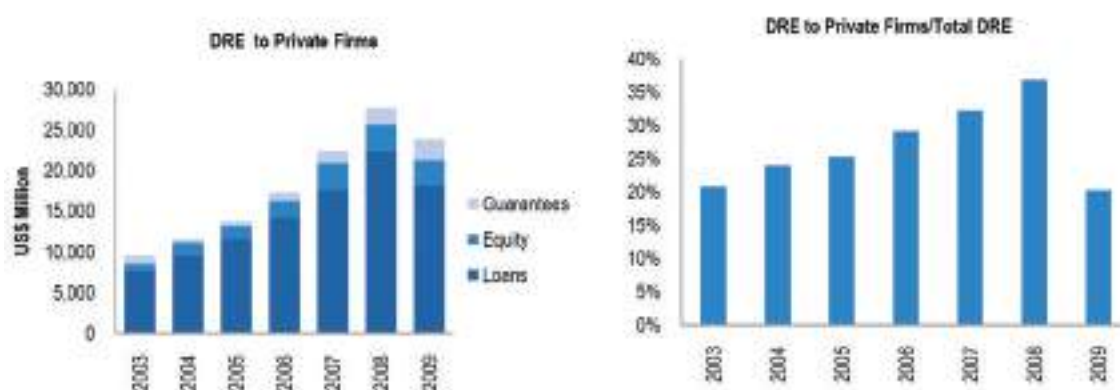


Figure 15: Development Related Operation (DRE) of MDFIs

Source: (Perry, 2011), page 6

3.1.1. *MDFI utilization of funds as a development finance tool*

An increasing number of MDFIs use the funds structure to finance their development activities. The most common fund structure used by MDFIs is the private equity fund where the investors take a minority interest in investee companies. (Chowdury, Orr, & Settel, 2009) reviewed eight MDFIs' use of private equity fund:

1. African Development Bank (AfDB)
2. Asian Development Bank (ADB)
3. European Bank for Reconstruction and Development (EBRD)
4. European Investment Fund (EIF)⁴⁶
5. Inter-American Investment Corporation (IIC)⁴⁷
6. International Finance Corporation (IFC)
7. Islamic Development Bank (IDB)
8. Multilateral Investment Fund (MIF)⁴⁸

⁴⁶ EIF was founded by European Investment Bank as a public private partnership. In 2000, EIB became the majority shareholder of EIF.

⁴⁷ IIC is a member of the Inter-American Development Bank Group; it is a separate legal entity with different shareholders.

⁴⁸ MIF is a fund under management of IADB and is not a separate legal entity.

MDFI	Acronym	Region	# PE Fund Investment (at 2007)	PE Fund Commitment (US\$m at 2007)	Primary Strategy
African Development Bank	AfDB	Africa	9	155	Infrastructure Development
Asian Development Bank	ADB	Asia	40	763	Financial Market Development
European Bank for Reconstruction & Development	EBRD	Central Europe & Asia	100+	1,590	Restructuring, transition, and efficiency
European Investment Fund	EIF	Europe	266	5,602	Support to SMEs, Entrepreneurship
Inter-American Investment Corporation	IIC	Americas	16	31	Support to SMEs, Entrepreneurship
International Finance Corporation ⁴⁹	IFC	Global	150	2,200	Financial Market Development
Islamic Development Bank	IDB	Islamic Countries	11	1,500	Infrastructure Development
Multilateral Investment Fund	MIF	Americas	40	119	Support to SMEs, Entrepreneurship

International Finance Corporation⁴⁹

Table 9: Summary PE Operations of Different MDFIs

Source: (Settel, Chowdhury, & Orr, 2009)

(Settel, Chowdhury, & Orr, 2009) highlighted that IFC (mid 1980s) and ADB (1983) are the earliest MDFIs that began private equity fund operations. Most other MDFIs began their PE operations in the 1990s (EBRD in 1992, EIF in 1997, for example). A number of MDFIs have formalized their private equity operations (have a dedicated group or entity); led by EBRD in 1997, IFC in 2000 and ADB in late 2002.

Table 9 lists the MDFIs' PE operations as at 2007. In terms of commitment amount, EIF has the largest commitment in PE funds, followed by IFC and EBRD. Although an early bird in the market, the ADB's charter restricts a tight ceiling on using equity, which does not exist

⁴⁹ From IFC website June 2012: IFC has 180 funds with \$3b total commitment.

with other MDFIs. Thus, although it has about 40 funds in its PE operation, it only has a committed fund of \$763m compared to IDB that only has 11 PE investments but with a \$1.5b committed amount. In relative terms (PE investment as % of total MDPI funding), EIF is still leading, but IFC seems to have the smallest percentage of PE investment. Refer to **Figure 16** for details.

The private equity funds of ADB, AfDB, IIC, IDB and MIF (clean energy) have mandates for infrastructure. EBRD, EIF and IFC's private equity funds do not focus on infrastructure in particular, but have a broader mandate for financial market development and the SME sector. In terms of performance, IDB has the best performing fund, while ADB's IRR was 50% of that of IDB. Some MDFIs like IFC does not disclose their return. The motivation behind MDFIs' increasing utilization of private equity funds is to encourage private investor participation, especially from pension funds and sovereign funds, since MDFIs' participation in the fund is viewed as a seal of approval for the relevant projects or investments. In addition, MDFIs are of the view that commercial fund managers are much more efficient in deploying the investment, compared to the longer process it takes at their own institutions. (Chowdury, Orr, & Settlet, 2009).

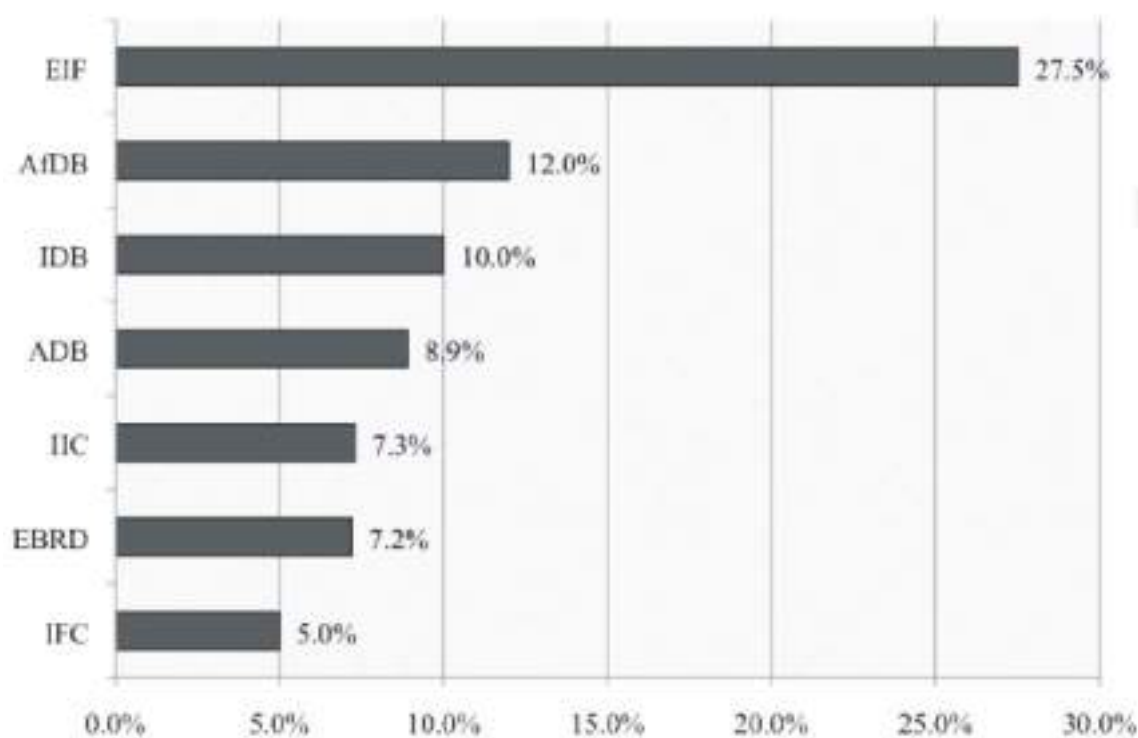


Figure 16: Private Equity Investment as % of Total Private Sector Investment

Source: (Settlet, Chowdhury, & Orr, 2009)

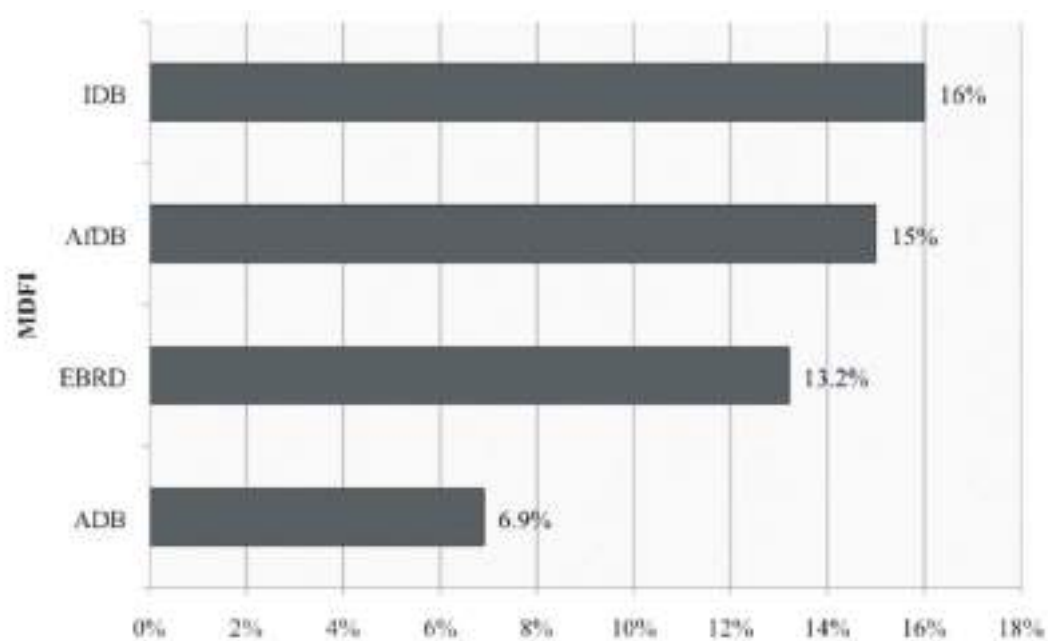


Figure 17: MDFI PE Investment Performance – IRR Net of Management Fee

Source: (Settel, Chowdhury, & Orr, 2009)

3.1.2. *Specific Examples of MDFI Funds*

3.1.2.1. *Multilateral Investment Fund (MIF)*

Managed from the Washington, D.C. headquarters of the IADB, the MIF is not an independent entity but a “trust fund” of the IADB. Established in 1993, the fund raised a US\$1.3 billion-dollar grant funded by 39 donors (member countries from LAC, North America, Europe and Asia). The focus was to support microfinance and the energy sector in Latin America and the Caribbean. The fund invests in private financial institutions (banks, cooperatives, MFIs or NGOs) that then lend the resources to micro and small businesses. So it does not lend directly to the end users, rather via intermediaries. It uses grants, lending, and equity investments as its financial instruments. Since its inception, the MIF has approved more than 1,000 projects worth USD 2.2 billion in all 26 developing countries of the IADB.

MIF has invested in four clean energy funds in Latin America. It invested \$10m in the \$32m FondElec Latin America Clean Energy Services Fund (FLACES) that played a fundamental role for clean energy development in Mexico. It also invested in the Central American Renewable Energy and Cleaner Production Facility (CAREC) – a \$17 million mezzanine financing facility that has invested in SMEs that use proven clean energy technologies. However, MIF feels that its energy funds are not performing as well as other private equity funds in the region. As the energy sector is still young, the MDFIs are still exploring the best financing method to manage the risks in the sector (Chowdhury, Orr, & Settel, 2009).

MIF has also worked with an arm of the Brazilian government to establish a fund of funds to develop the venture capital (VC) industry in Brazil. Instead of investing in high-tech companies, the fund provides equity to many SMEs in various sectors. As at 2007, MIF managed to develop about 50 fund managers to enable an active VC market in Brazil (Settel, Chowdhury, & Orr, 2009).

In 2010, the MIF had a portfolio of 659 active projects with a value of \$739m; 68% of which were grants, 27% equity investments, and 5% loans. Every dollar approved by the MIF leveraged more than US\$2 from partners in 2010. Since majority of the funding is via grants, the business model is not fundamentally commercial. (IADB, n.d)

3.1.2.2. *AIG African Fund Infrastructure Fund L.L.C. (the “Africa Fund I”):*

The Africa Fund I was established in March 2000 and domiciled in Mauritius. The Africa Fund I was structured as a private equity fund with a plan to acquire operating businesses, hold the investments for three to five years, and then exit by either initial public offering (“IPO”), private sale, or put back to the management or owners over a ten year period. The fund manager was Emerging Capital Partners, a part of Emerging Markets Partnership. The fund raised \$407 million from a mixture of institutional investors (AIG), development financial institutions (IFC, AfDB, DBSA, Proparco, EIB), and an energy company ‘El Paso Energy’. Some of the investors represented PPP investment bodies in their own right.

The investment commitment period was five years and had a 10 year term. Although this is called an infrastructure fund, it has a wider scope; it includes all sectors but real estate and financial institutions. The fund does not invest in a government controlled company or a start up. The fund’s investment ranges from US\$10 million to US\$50 million, in projects or companies having total valuations of US\$25 million to over US\$500 million. The limitation was 10–50% of a company’s equity. The fund was able to make equity, quasi-equity and convertible debt instruments. The target yield was 20–35% annualized. The fund was followed by Africa II (\$523 million) in December 2005 and Africa III (\$613 million) in July 2008 with similar terms and conditions.

3.1.2.3. *AIG Indian Sector Equity Fund (AISEF):*

Established by AIG in 1996, this was the first private equity fund focused on India. The fund was managed by AIG and a local partner, Infrastructure Leasing & Financial Services Limited (IL&FS). The \$100 million fund included the ADB as an investor with \$15 million, and attracted a blend of international investors, multi-lateral development agencies, two Indian state governments, and major Indian companies. The fund was domiciled in India under the Indian Trusts Act. The fund generated a 27% return. The fund led to changes in Indian tax laws and changes in local regulations governing funds like venture capital funds.

The fund made direct investments through equity and quasi-equity-related instruments in infrastructure projects (65%), new technology, and other growth sector opportunities in India. The fund had a 10 year life with a 5 year commitment period. The ADB and AIG co-sponsorship helped to give comfort to diverse investors who were new to the Indian equity market. This was the first fund to bring the largest US

pension investor CALPERS to the East Asian private equity market. The basic vehicle accommodates investments via tax treaty countries like Singapore and Mauritius. The fund was an early test of tax reforms introduced in 1996 that provided incentives for equity investment in infrastructure.

The fund had development effect on telecommunication, toll roads and clean energy. However, it did not have a vast impact on the water sector due to absence of an enabling environment. At the time when the Fund was set up, the private equity sector was at a very early stage, void of a clear policy and regulatory framework. The fund brought the following key benefits:

- i. **Tax Benefits:** In 1996, a new Section 10(23G) was introduced in the Income Tax Act that provides fiscal incentives for equity investments in the infrastructure sector.
- ii. **Fiscal Benefits for Funds:** The Securities and Exchange Board of India (SEBI) has recognized funds with a clear focus on the infrastructure sector as 'Venture Capital Funds' (VCF) and has permitted registration of such funds. By 2004, there were 50 private equity funds and VCFs established.

3.1.2.4. *Macquarie International Infrastructure Fund (MIIF)*

The movement to infrastructure investment received a boost when Australia privatized its pension fund management at precisely the same time that the state governments required massive reinvestment in domestic infrastructure. The leader in marrying infrastructure investment to pension funds was the Australian investment bank Macquarie. Subsequently, the bank has become a leading organizer of infrastructure investment on a global basis.

The Macquarie funds are bifurcated into both public offerings and institutional private placements. Macquarie has four (4) public funds, and twenty private funds. In some of the private funds, Macquarie worked with MDFIs and has attracted pension funds & other institutional investors.⁵⁰

- i. *Macquarie International Infrastructure Securities Fund ("MIISF"):* Macquarie vaulted into infrastructure fund leadership by taking advantage of the simultaneous privatization of Australian pensions and budget shortfalls in Australian states that required states to look at privatization or PPP for infrastructure. Macquarie manages a large number of domestic Australian funds and specialized global infrastructure funds. The MIISF is a fund investing in listed equities in the infrastructure field. The minimum investment is A\$20,000, but smaller allocations are possible via investor directed portfolio services ("IDPS"), which form part of the overall privatized pension schemes in Australia. The fund is a diversified global fund heavily weighted towards the US and other OECD countries, and particularly focused on electricity utilities which are known for their high dividend payouts. As an Australian fund, it is domiciled and regulated domestically. The fund is focused on institutional and large personal investors, but can also accommodate smaller investors. It is not a UCITS fund and cannot be easily marketed outside of Australia.

⁵⁰ Refer to <http://www.mirafunds.com/our-funds/private-funds>

- ii. *Macquarie International Infrastructure Fund* (“MIIF”): This Bermuda-domiciled fund is listed on the SGX and managed by a Macquarie subsidiary in Singapore. The fund pursues a blended strategy of buying direct stakes in operating businesses as well as listed securities. The fund is allowed to take on leverage in order to pursue its strategies, which have focused on Taiwan and China (although the mandate also allows a broader Asian footprint). On its website, the MIIF states: “Sustainable economic growth over time requires investment in new infrastructure and maintenance of existing infrastructure assets.”

The fund draws from institutional and retail investors as well as Macquarie’s own capital:

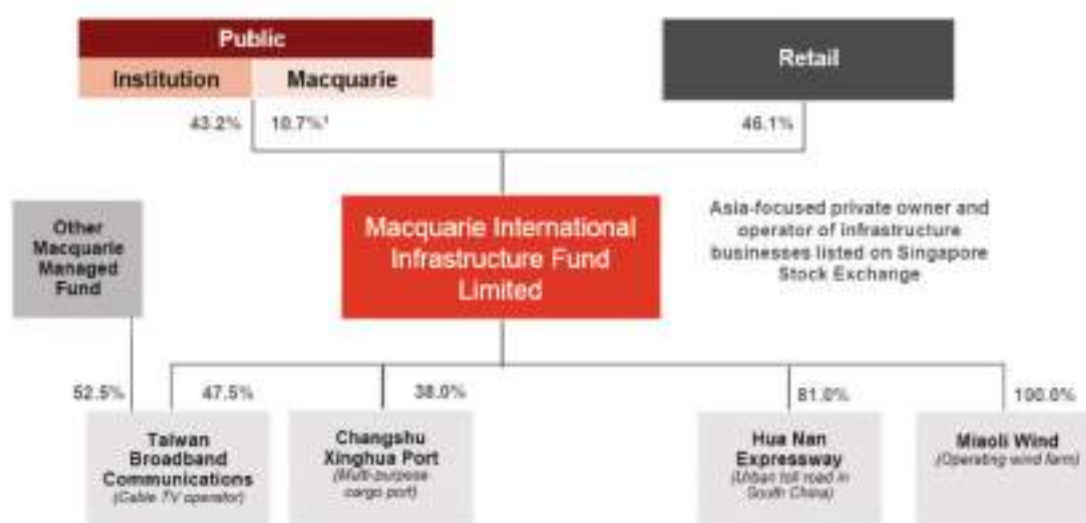


Figure 18: Macquarie International Infrastructure Fund II

Source: MIIF Full Year 2011 Results Presentation 22 February 2012⁵¹

The MIIF model has served Macquarie well globally, allowing it to balance institutional and retail investors. But the fund has traded at a discount to NAV which is often a problem with specialized, listed or exchange traded funds. The trade-offs to include retail investors and trade on an exchange may be the source of the discount, meaning that exchange buyers earn more than the original investors in terms of capital gains and dividends.

The following are examples of Macquarie’s private funds in which they worked with MDFIs:

1. **Macquarie Mexican Infrastructure Fund:** Established on Dec 20, 2010, the targeted size for this fund was \$1.1 billion. The Inter American Development Bank (IADB) provided a US\$150m loan to the fund. This drew further contribution from private Mexican pension funds (known as Siefors), the National Infrastructure Fund (Fonadin), and other local and international capital sources.
2. As highlighted in Chapter 2, Macquarie Capital Group Limited (Macquarie), State Bank

⁵¹ Accessed at: <http://www.macquarie.com/mgl/miif/investor-centre/corporate-information>.

of India (SBI) and International Finance Corporation (IFC) established a joint venture in 2008. The JV established two different funds.

- a. Macquarie SBI Infrastructure Fund (MSIF) – A US\$910 million, unlisted private equity infrastructure fund, MSIF was closed to investors in October 2010. The fund targets investors located outside of India to invest in infrastructure and infrastructure-like assets in India.
- b. SBI Macquarie Infrastructure Trust (SMIT) is a US\$260 million unlisted private equity infrastructure fund targeting local investors. SMIT was closed to investors in March 2011.

Both funds, MSIF and SMIT co-invest in India. The offshore fund (MSIF) was established first, followed by the onshore (SMIT) establishment.

3. More recently, in July 31, 2012, Macquarie established a \$625 million, 10-year close-ended fund, known as The Philippine Investment Alliance for Infrastructure (PINAI). It will invest in unlisted equity and equity-linked infrastructure projects and businesses in the Philippines (both greenfield and brownfield projects). The core investors are Asian Development Bank, the Philippines' state pension fund Government Service Insurance System (GSIS), Dutch pension asset manager Algemene Pensioen Groep NV and Macquarie Group Ltd. (MQG). GSIS, the lead investor, committed \$400 million. (Bloomberg, 2012)

3.1.2.5. Other Observations Related to MDFI Funds Operation

(Chowdury, Orr, & Settel, 2009) examined the preference in fund manager selection and the level of involvement in a fund by different MDFIs. Some MDFIs (like IFC and AfDB) prefer to use a new manager (localized) for each fund to support the development of the local market and development agenda. Some other MDFIs, like ADB for example, prefer to use a repeat manager with a proven track record for their funds. As far as the involvement in the fund is concerned, some MDFIs prefer to be closely involved in the fund's governance. IDB and IFC, for example, closely oversee the investment policy and sometimes even take some share in the general partner position. Another group of MDFIs prefers the hands-off approach. AfDB and EBRD, for example, limit their involvement to a fund's advisory board.

(Settel, Chowdhury, & Orr, 2009) noted that there is a collaboration among MDFIs, and bilateral development organizations in supporting peer funds, or sharing information on new funds coming to market. They highlighted, "For example, the Asian Development Bank often co-finances funds with European bilateral development finance institutions that like to take part in development transactions in Asia, but have less access to deal flow than ADB. Thus, when ADB discovers a promising private equity fund, it often passes information to the Association of European Development Finance Institutions (EDFI), an umbrella organization of DFIs in Europe. EDFI shares the information with its member organizations." They emphasized that MDFIs also co-finance with public pension funds and sovereign wealth funds.

ADB, in the evaluation of its private equity fund operation, highlighted that it was able to bring CALPERS to the East Asian market in 1997 when it invested \$25 million in the Lombard Asian Private Investment Company which was a regional SME fund. (Asian Development Bank, 2008)

The operation of MDFIs in PE funds is not without challenges. The biggest challenge is to find the fund managers willing to work in less mature markets, thus limiting a fund's investment in low income countries. IDB's Infrastructure Fund for example was only able to invest about 7% in very low income countries. ADB also faces similar challenges.⁵² IFC's approach to work with local general partner may be an alternative solution to this. Besides the negative perception drawn by the high return on the PE portfolio, MDFIs also need to create a developmental benchmark to complement the traditional financial measure of PE fund performance.

3.1.2.6. Summary of Selected MDFI Funds

	AfDB Infrastructure Fund (Africa Fund)	AIG Indian Sector Equity Fund (AISEF)	IaDB Multilateral Investment Fund
Year Established & Manager	<ul style="list-style-type: none"> Year 2000 Emerging Capital Partner (part of EMP) 	<ul style="list-style-type: none"> Year 1996 AIG & Infrastructure Leasing & Financial Services Limited (ILFS) 	<ul style="list-style-type: none"> Year 1993 Managed by IaDB
Size & Investor info	<ul style="list-style-type: none"> \$407m Core Investors : AIG, IFC, AfDB, El Paso Energy, DBSA, Proparco, EIB 	<ul style="list-style-type: none"> \$110m ADB (\$15m), 10 foreign investors & local investors (State Government & corporate) 	<ul style="list-style-type: none"> \$1.3b 39 donors (member countries from LAC, North America, Europe and Asia)
Investment Aim	<ul style="list-style-type: none"> Private Equity Fund Infrastructure but wide meaning Invest in companies & not projects 	<ul style="list-style-type: none"> Private Equity Fund Hybrid: Infrastructure (65%) & new technology 	<ul style="list-style-type: none"> Trust Fund: Microfinance & clean energy (for SME) Latin America and the Caribbean
Performance	<ul style="list-style-type: none"> Target: 20-25% return Two follow up funds -Africa II: December 2005 - \$523 million. Africa III: July 2008 - \$613 million 	<ul style="list-style-type: none"> ILFS managed portion (\$40m) generated 27% return with 3.6 multiple. Development effect on telecommunication, toll road and clean energy sector 	<ul style="list-style-type: none"> Since inception >1,000 projects (mostly grants) Total USD 2.2 billion in all 26 IADB countries.

3.2 The IDB Experience

IDB has built a diversified experience with funds over the past 40 years. This experience ranges with challenges in the development of suitable governance models, and the proper location of the funds from the perspective of which part of IDB actually manages the funds. For instance, the historical fund strategy of IDB is concentrated in the Treasury, which is not

⁵² (Perry, 2011) also reported that MDFIs private market funding are concentrated in the middle income countries – 80% on average during 2003-2009. In terms of per capita amount, the upper middle income countries have received the highest support from MDFI. However, if MDFI funding is analyzed as a proportion of GDP, the low income countries have received the highest support.

directly aligned with IDB's expertise. With the expansion of the IDB Group into specialized companies like ICD and IDB's own affiliated asset management company (ASMA Capital Partners), the capacity for IDB to properly manage funds is improving exponentially. This means that IDB will be in an increasingly better position to place its fund business closer to the project finance and business risk-taking skill-sets of its appropriate units. Another unusual feature of IDB's funds is that not all of them are truly commercial: some, like the Islamic Solidarity Fund for Development ("ISFD") are designed to provide concessionary funding to projects in Least Developed Member Countries ("LDMC"), while others are designed to focus on *awqaf* (even the ISFD is structured as a form of *waqf*).

3.2.1 *Investment Deposit Scheme of 1980 ("IDS"):*

This is not strictly a fund, but an unrestricted *Mudarabah* placement. The scheme is fundamentally short-term and invested in trade finance transactions. The typical deposit is US\$250,000 with a target yield of 7%. The size of a deposit restricts it to inter-bank, corporate or high net worth depositors. The structure as a "deposit" means that the funds raised in this project are treated as part of IDB's Ordinary Capital Resources. The Bank deducts an administrative charge covering its administrative costs. Except for the deposits made by IDB staff, profits on the underlying transactions are shared with the depositors according to a published profit sharing ratio ("PSR").

Although a *Mudarabah* has features of an investment fund, this is treated as an on balance sheet liability of IDB. As a result, the IDS affects IDB's leverage. The restrictions could be modified for more than trade finance, but the longer term for non-trade deals would change the nature of the depositors or the obligation of IDB to cover redemptions in the short term (the classic mismatch of deposit to lending maturities in conventional banking). Because it is a direct placement with IDB, the concept faces difficulties attracting depositors from IDB's usual orbit.

3.2.2 *Unit Investment Fund (UIF)*

The UIF was established in 1989 as a USD *mudarabah* fund domiciled in Bahrain. Listed on the Bahrain Stock Exchange ("BSE") in 1996, the fund subsequently changed the *mudarib* from IDB to the ICD as part of IDB Group's efforts to put all private sector activities under one umbrella. The Fund launched with US\$100 million, and was US\$325 million when it listed.⁵³ The unit price of the fund during listing was \$1.00 per unit. The minimum investment is \$100,000.⁵⁴ Prior to listing, IDB provided liquidity by offering to buy-back units at particular intervals as a market maker. The fund may invest in member and non-member countries, private and public sectors. The fund securitized some of IDB's leases and *Murabaha* receivables. The UIF also complements project and trade finance operations at IDB. The fund is meant to have tenors between five and ten years. The fund has given different quality returns over its life. In order to pay a steady dividend, the UIF established a Capital Preservation Account to which it transfers 5% of the net income of the fund before the *mudarib*'s share; and then a Dividend Equalization Account to which an amount, distributable to the unit holders above

⁵³ Refer: <http://www.isdb.org/irj/portal/anonymous?NavigationTarget=navurl://041e8c7942edf8df96e55bb9fd863099&LightDTNKnobID=328409947> for list of investors in the fund.

⁵⁴ Refer http://www.bahrainbourse.net/bhb/market.asp?page=market&sec=Mutual_Funds

the amount actually distributed, is transferred. When the UIF liquidates, any excess balance in these two accounts will be granted to IDB *Waqf Fund* and not shared with the unit holders of record on the date of dissolution.

This vehicle is an open-listed fund that allows investors to manage their own liquidity by trading units on the BSE. The funds are channeled directly to IDB's project. The name is neutral which could make marketing to non-Islamic investors easy. However, Bahrain is not yet formally established as a global fund center, which may affect the attraction to the global institutional investors. Finally, at liquidation, the reserve accounts will go to IDB's *Waqf Fund*, which will put off non-Islamic investors who would expect that any residual cash or asset would revert to them at the termination of a fund.

3.2.3 *Islamic Solidarity Development Fund (ISFD)*

Established by IDB as a form of *waqf* in 2007, the sole focus of the fund is alleviation of poverty in least developed member countries or LDMCs. The fund's financing is completely on concessionary terms with modest service charges, grace periods of seven to ten years, and repayment periods of up to thirty years. A key role of the ISFD is to promote co-financing and to make investment into LDMCs easier for other development financiers as well as commercial investors. The ISFD is structured to deliver specialized assistance in line with IDB's Millennium Development goals and projects like the Sustainable Villages Programme. In programs like this and the Microfinance Support Programme for Poverty Reduction (US\$500 million five year initiative, US\$100 million earmarked by the ISFD to seed projects) or the Vocational Literacy Programme for Poverty Reduction (another US\$500 million five year initiative, US\$100 million earmarked by the ISFD to seed projects), the ISFD makes investments which are not strictly commercial. The ambition of the ISFD is to raise US\$10 billion. But the process is akin to the trust fund process at the World Bank and involves organizations like the Earth Institute at Columbia University in New York, the Qatar Red Crescent Society, and the Arab Bank for Economic Development in Africa. The ISFD has raised US\$1.6 billion of US\$2.6 billion pledged. At the end of 1432H/2011G, the ISFD had received and invested US\$1.6 billion generating an income of US\$31 million.⁵⁵ IDB has structured the ISFD to have an exceptionally low overhead in order to stretch each of its dollars for development purposes.

The ISFD has three challenges to attract investors from outside of the IDB orbit. Foremost, the structure as a *waqf* means that funds will not be recovered by investors, and returns do not have to be commercial for the satisfaction of investors. The non-commercial structure restricts investor interest in the ISFD to charity-oriented parties from IDB member states. Finally, the explicit use of the word "Islamic" along with "solidarity" does not attract secular investors from outside of the IDB orbit.

⁵⁵ Over US\$18 million of the income comes from interbank placements and US\$12 from investments in government sukuk. As a result, the fund is entirely non-commercial and generates virtually none of its income from its work.

3.2.4 *Awqaf Property Investment Fund (APIF)*

Established in 2001, this is a trust fund⁵⁶ managed by IDB (as Mudarib). The investors are mainly *Awqaf* ministries and some Islamic banks.⁵⁷ The fund allowed two classes of investors; Class A – the main authorized capital and Class B – in the form of *Ijarah, Muqaradah* certificates. The fund may also raise funding via syndication and co-financing. IDB provides a 50% purchase undertaking for Class A shares from Year 4 onwards. From the *waqf* revenue, the *Mudarib* is paid 20%, and up to 20% may be transferred to reserve before making dividend distribution to investors.

The aim of the project is to develop greenfield projects and develop existing *waqf* properties to transform them into income-generating assets. Since its inception, APIF has funded 47 projects worth US\$1billion in 22 countries. At the end of 2010, APIF had \$71.8 million capital and access to an IDB line of financing for \$100 million and a technical assistance pool of \$200,000.

However, IDB staff highlighted that *Awqaf* Boards (i.e. the beneficiaries) prefer grants more than marketbased funding. This leads to limited funds that the fund may provide, as it would be difficult to entice banks to provide funding for charitable activities. In Chapter 5, the report will highlight how IDB may use its MCPS to coordinate with countries like Singapore to share their experience in commercially managing their *Waqf* lands and mosques.

IDB also established a *Waqf* Fund in 1979 that pools IDB's non-compliant income. The fund is used to provide scholarships, grants, technical assistance etc. Currently the *Waqf* Fund is managed by the Treasury and earns a low return. An internal evaluation suggests that it would be better for the *waqf* fund to invest in infrastructure projects that generate much higher returns that could be re-injected into the fund. Some of the *waqf* fund was invested in the IDB Infrastructure Fund (IIF) and enjoyed a high return.

3.2.5 *IDB Infrastructure Fund (IIF):*

The IIF was established in 2001 to support infrastructure projects in MCs. The General Partner and Manager is the Bahrain office of Emerging Markets Partnership. The fund and the fund manager are regulated by the Central Bank of Bahrain. The fund has a US\$730.5 million private equity fund with a Complementary Finance Facility for US\$200 million. The Lead Sponsors are a number of sovereign wealth funds and pensions; Dar Al-Maal Al-Islami Trust ("DMI"), the Government of Brunei, the Saudi Pension Fund, Public Investment Fund (Saudi), Khazanah (Malaysia), and the Kingdom of Bahrain.⁵⁸

The fund takes only minority stakes in private sector infrastructure companies involved in brownfield⁵⁹ development, expansion, restructuring, and privatization. Investments may go

⁵⁶ Thus no separate domicile for the fund. The main US\$57m capital is also known as Class A shares

⁵⁷ Refer to <http://www.isdb.org/irj/portal/anonymous?NavigationTarget=navurl://097e223be0761cdd343b213dfd855b77> for list of investors.

⁵⁸ IDB Fund of Funds Concept Note p3.

⁵⁹ The fund's aim was to invest in brownfield project. However sometimes due to investor persistent recommendation, the fund invested in some greenfield projects that led to a write off of about \$60m.

up to US\$150 million, but the actual range has been between US\$10 million and US\$73 million. The fund has a broad definition of infrastructure and includes power, telecommunications, transportation, energy, natural resources, petrochemicals, water, and related sectors.⁶⁰ The term of the fund is ten years, renewable for three years. The fund was fully committed to twelve entities and includes publicly traded companies in the MCs. In 2006, the fund returned US\$420 million to investors. In 2010, the annualized return was 21%.⁶¹ The fund will be fully divested in August 2012.

Domiciled in Bahrain, the fund required a royal decree to approve the GP/LP (General Partner/Limited Partner) structure as it did not exist in the local law. The fund attracted conventional and Islamic investors from IDB member countries. But it did not attract conventional investors from outside of the MC footprint.

IDB committed \$100 million to the fund and took an active role in the fund via the establishment of Policy Management Company (PMC); a specific company established to oversee governance & investment policy of the fund. The lead sponsors of the fund served as board members on PMC. Separately, PMC is also entitled to share of performance fee (Chowdury, Orr, & Settel, 2009).

IDB launched a \$2 billion IIF II in June 2012. Originally, three fund managers were short-listed for the second fund. However, with the establishment of ASMA,⁶² IDB's asset management company, IDB will self-manage the IIF II. ASMA has legal registration in Dubai and is an asset management company. However, IIF II will continue to be domiciled and managed out of Bahrain. The first closing of \$800m has already received commitment from anchor investors.⁶³

3.2.6 IDB-ADB Islamic Infrastructure Fund

Established in 2009, the fund is focused on PPP in twelve (12) common MCs⁶⁴ of IDB and ADB. CIMB Standard, a joint venture between Standard Bank and CIMB Group is the manager. The fund is domiciled in Labuan and has a target of US\$500 million for investment. IDB has been hopeful that this fund would successfully attract a wider universe of investors than the prior fund. The fund has committed US\$110 million in five projects in four MCs. The ADB has highlighted a number of problems with the legal infrastructure, lack of bankruptcy laws, and issues relating to corruption in some environments.

This fund model uses the established Labuan jurisdiction, which is well understood in Asia and the GCC. The manager is a joint venture of two well-known banking groups. But the

⁶⁰ Refer to <http://www.empglobal.com/portfolio.xml?f=fund&q=1005&id=1005&view=fund&media=history> for the list of investee companies.

⁶¹ From IDB's internal evaluation, this was the only high performing IDB fund. Without the \$60m write off due to investment in Greenfield projects, the fund would have had a higher internal rate of return.

⁶² ASMA is both an Arabic word meaning "highly exalted" and an acronym for Asia Middle East and South Asia.

⁶³ Interview with Zaffar Saleem of Islamic Development Bank.

⁶⁴ Afghanistan, Azerbaijan, Bangladesh, Indonesia, Kazakhstan, Kyrgyz Republic, Malaysia, Maldives, Pakistan, Tajikistan, Turkmenistan and Uzbekistan.

insertion of the word “Islamic” in the name seems to have made it difficult to market the fund to pension funds and institutional investors from outside of the IDB/ADB footprint.

3.2.7 Summary of Selected IDB Funds

	Unit Investment Fund (UIF)	IDB Infrastructure Fund	IDB-ADB Islamic Infrastructure Fund
Year Established & Manager	<ul style="list-style-type: none"> Established 1989, no domicile, listed on BSE 1996 IDB is Mudarib, 2008 enter into sub-Mudarib with ICD 	<ul style="list-style-type: none"> Year 2001 Domicile in Bahrain Emerging Markets Partnership (Bahrain) 	<ul style="list-style-type: none"> Year 2009 Domicile in Labuan CIMB-Standard is manager
Size & Investor info	<ul style="list-style-type: none"> Authorized-USD500m, Initial \$100m, Increased to \$325m in 1996 20 institutional investors from 11 countries. Minimum 100,000 unit. \$1/unit 	<ul style="list-style-type: none"> US\$730.5m private equity US\$200m complementary finance Lead Sponsors Dar Al-Maal Al-Islami Trust (“DMI”), Gov. of Brunei, Saudi Pension Fund, Bahrain, Tabung Haji Consortium 	<ul style="list-style-type: none"> Target: \$500m Core equity: IDB \$150m, ADB \$100m, CIMB \$7m, Standard \$5m
Investment Aim	<ul style="list-style-type: none"> Income Fund Securitizes IDB’s lease and installment sale assets. Complement IDB’s project & trade finance operations. 	<ul style="list-style-type: none"> Private Equity Fund Minority equity (<40%) in private sector infrastructure companies 20% in listed companies 	<ul style="list-style-type: none"> PPP infrastructure projects in 12 common member countries of IDB and ADB
Performance	<ul style="list-style-type: none"> 2010 - funded 257 financing operations for \$2.43 billion 2010 - \$19.95m dividend, 5% annualized return, \$3 million capital gain on IDB Invested amount 	<ul style="list-style-type: none"> Best performer among IDB Funds - 21% annualized return, \$71.5m dividend and \$20m capital gain (2010) Follow up fund - Infrastructure Fund II - US\$ 2 billion (June 2012). 	<ul style="list-style-type: none"> Approved five projects for \$110 m Difficult to entice investors due to use of “Islamic” in the fund name

3.3 Islamic Funds Market

According to Ernst & Young, the Islamic funds market has grown to US\$58 billion AuM at the end of 2010. However, since the Islamic funds market only started growing commercially in the early 2000s, it only represents 5.6% of the overall Islamic financial system. In terms of asset classes, equity funds represent almost 40% of AuM at 2010, followed by commodities (15%) and alternative investment & feeder fund (13% - included in other categories in **Figure 21**).

In absolute terms, the allocation for alternative investments remains small at US\$7.8 billion AuM. This gives two impressions. On one hand, the allocation to emerging market and infrastructure products can grow substantially. On the other hand, investors may actually be looking for managers to move their funds in investments outside of IDB's MCs for asset diversification and political risk management purposes.

The Islamic funds market is highly fragmented and two thirds of the funds are institutional.⁶⁵ Depending upon the strategy pursued by IDB, some Islamic funds and some managers of Islamic funds may be attracted to co-invest in IDB's development funds, but their role for IDB would not be meaningful in terms of investment volume.

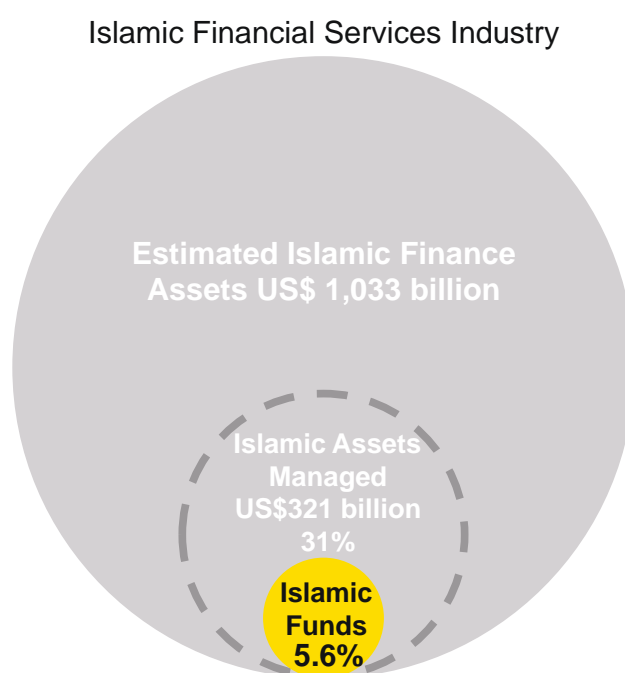


Figure 19: Components of Islamic Financial System 2010⁶⁶

Source: (Ernst & Young, 2011), p10

⁶⁵ Refer page 9 of (Ernst & Young, 2011). Retail funds are defined as funds that have a minimum initial subscription of US\$2,000 or less

⁶⁶ Other AuM include off balance sheet direct investments managed by banks and investment companies and restricted profit sharing accounts

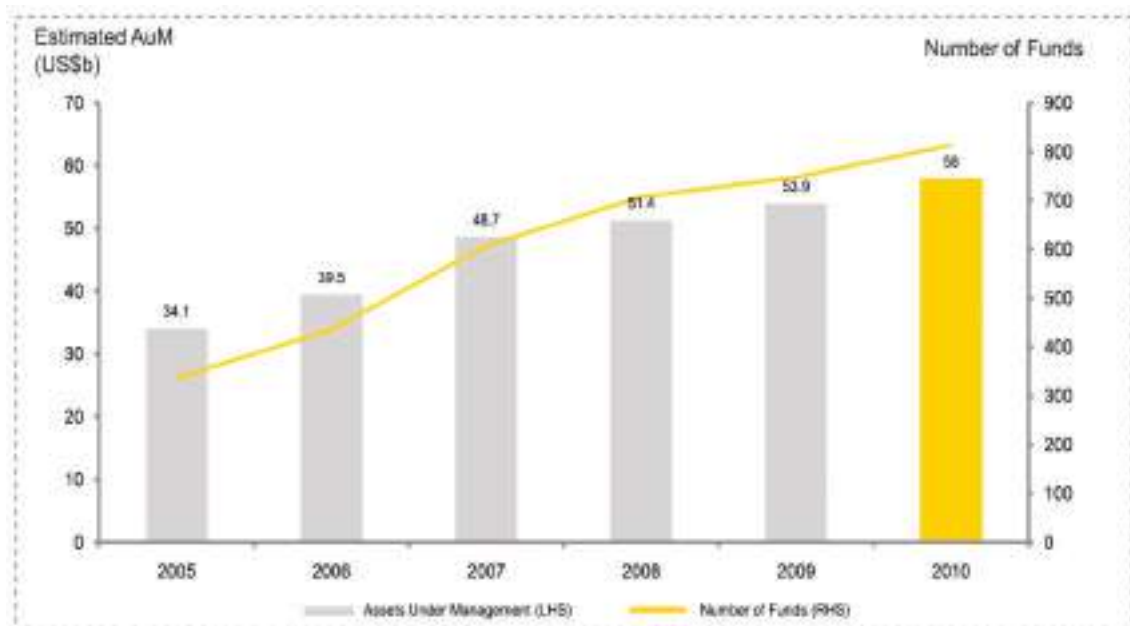


Figure 20: Growth of Islamic Funds Market

Source: (Ernst & Young, 2011), p7

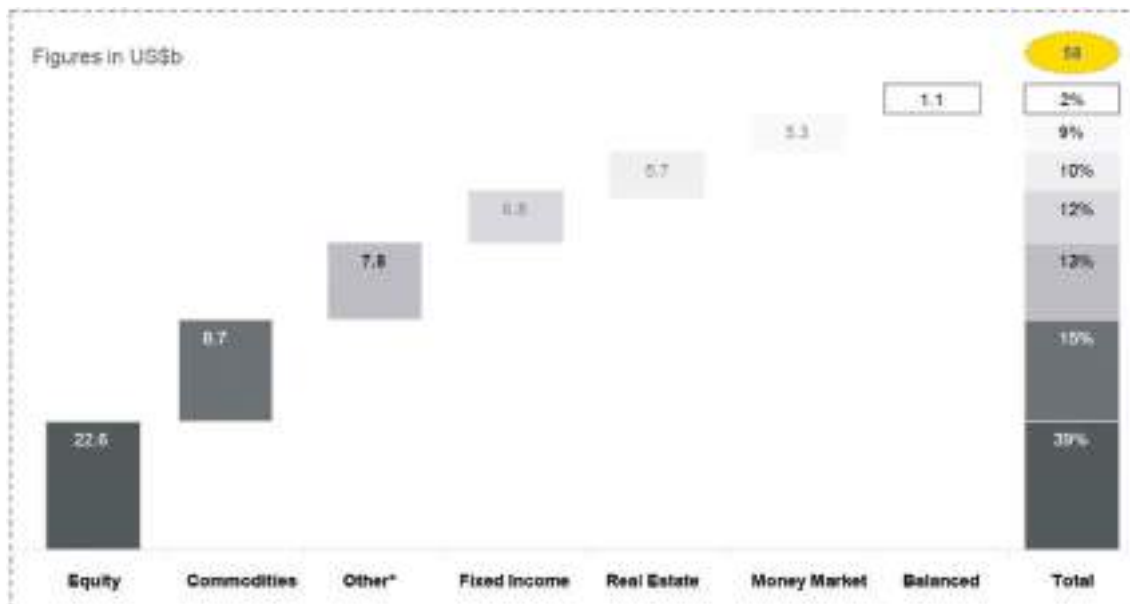


Figure 21: Different Asset Classes in 2010

Source: (Ernst & Young, 2011), p13⁶⁷

⁶⁷ Others include alternative investment and feeder funds.

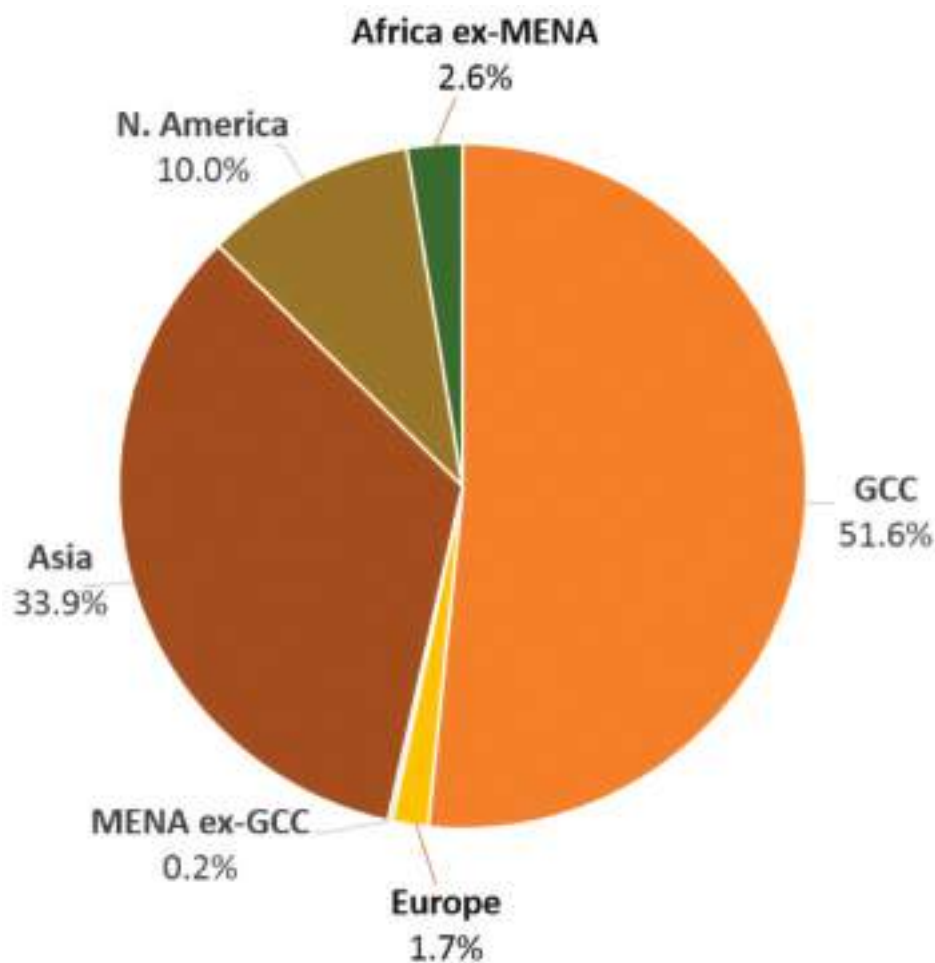


Figure 22: Breakdown of Shariah-compliant fund assets by region⁶⁸

Source: (GCC Mutual Fund Industry Survey, 2011), p119

Another issue for IDB to consider when analyzing the Islamic funds sector is the degree to which any Islamic fund has successfully attracted non-Islamic investors.

Figure 22 shows three important statistics:⁶⁹

1. The first is that many Islamic funds are likely to invest in their own markets. Hence, the fact that over 85% of the funds are in the GCC and Asia, where respectively Saudi Arabia and Malaysia are the most dominant markets for Islamic funds.
2. The majority (11.7%) of the rest of the assets are in North America and Europe.
3. Even the assets in Africa are in a relatively small number of countries (Egypt, Morocco, and South Africa).

The quantum of assets in North America merits consideration. The single largest Islamic

⁶⁸ Based on fund manager location; December 2011.

⁶⁹ Bloomberg data for Shariah largely omits funds domiciled in Bahrain.

funds group is the Amana funds. With over US\$3 billion invested, Amana is fundamentally a domestic US fund manager. The name 'Amana' not only has Arabic and Islamic connotations, but also Hebrew and Judeo-Christian connotations. The funds' primary manager is not an "Islamic" company. Even though the funds' trustees are majority Muslim and the funds are *Shariah*-compliant, the funds sold their compliance softly for many years, allowing them to attract socially responsible investors, church investors, and faith (Christian) based pension funds as well as conventional pensions. Now that the Amana funds are well established with twenty-six years of operation, the manager is raising the awareness of their Islamic profile to a higher level.⁷⁰

Islamic exchange traded funds exist in several markets: Malaysia, Singapore, London, and Luxembourg. Listed Islamic REITS exist in Malaysia, Singapore and Dubai. There has been a regulator sponsored push to develop both products since the mid-2000s. But many developments have been set back by the financial crisis of 2008 as well as the lack of investor education. Nonetheless, the factors that drive global institutional investors to allocate funds to infrastructure ETF and REITs will become prevalent as more pensions and *takaful* investors seek the same income benefits and cost structures inherent in these structures. Interestingly, an ETF exit for a well performing IDB emerging market fund might well attract non-Islamic institutional investors.

Another area in which Islamic funds have been active over the years is the single asset private business fund. Many Islamic banks operate leasing funds, and over the years a number of Islamic banks have developed trade finance funds. The leasing and trade funds have generally been geared either to high credit quality, international trade or leasing in the developed countries. Leasing funds provide medium term fixed income investments and are able to expand "secure" credit delivery into emerging markets.

Trade finance funds allow for short-term self-liquidating real trade transactions. Trade funds tend to replicate the characteristics of traditional money market funds. Yet IDB has demonstrated in the past that short-term self-liquidating trade between, and to, MCs allows for the expansion and improvement of trade, providing financing where it is not always accessible from conventional banks.

The newly established Investments Department (IDBi) in IDB is expected to substantially contribute to new directions in funding development. This includes the attraction of new investor types to IDB and expanding the capacity of IDB to serve its MCs.

The Islamic funds market is immature with thin capital. It is dominated by numerous small offerings sponsored by banks. The market has several challenges to overcome in the development of skills, improvement of governance, and evolution of investor goals for asset allocation. In summary, IDB should take stock of the existing Islamic funds industry, as well as development funds. As a leader, IDB is in a position to establish new trends in the Islamic industry serving development in Member Countries.

⁷⁰ For more information, see <http://www.amanafunds.com/retail/news/20110906amanx25thanniv.shtml>.

3.4 Evaluation of Funds against Research Objectives

3.4.1 Off Balance Sheet Funding

The commonly cited motivations behind MDFIs increasing utilization of private equity funds are to encourage private investor participation and efficient capital deployment by the commercial fund manager. In addition, compared to issuing bonds (or Sukuk in IDB's case), the funds approach also allows MDFIs to expand their activities without increasing their balance sheet burden. As MDFIs normally limit their investment to 20% of the fund size, this allows MDFIs to attract other investors to fund various projects. What is crucial is the monitoring of the fund performance to ensure sustained confidence of private investors in these types of investments.

3.4.2 Cost of Funds

Sukuk have the advantage of providing cheap funding to member countries as IDB's cost of funds is low, backed by its AAA rating. As for the funds model, the fund itself may choose to focus on either debt, equity or mixed funding to member countries. Debt would always have the advantage of being cheap in cost compared to equity. However, one has to keep in mind that during a financial crisis, or difficult times, member countries still have to pay the cost of debt funding as these are not related to their performance. Equity in contrast, will always cost more than debt. Nonetheless, as equity investment takes higher risk, and will be directly affected by the performance of a project, the investee will have more resilience to macro and cyclical shocks. IFC uses the private equity funds to implement its partnership approach to funding, where IFC provides active advice and hand-holding (i.e. true partner) instead of just sitting on the board of the investee companies (Wilton, Emerging Market Private Equity: The Opportunity, The Risks & Ideas to Manage Them, 2012).

There are two views on the optimal scenario to use private equity funds in MDFI operations. On one hand, IFC views private equity funding (by taking minority ownership interest) as a way to manage risks in countries where the legal system does not easily support enforcement. With IFC's close involvement in the management of the companies, they put in place proper governance and internal control to ensure the success of the investee companies.⁷¹ IFC's private equity funds have outperformed the market benchmark.

On the other hand, ADB which suffered a low return compared to market performance, is of the view that private equity should be used sparingly. For high risk frontier countries (like Afghanistan), ADB suggests the use of debt and technical assistance. Whereas for middle tier countries (like Philippines), which warrant equity funding, the MDFI private equity fund should focus on under-served sectors that are not targeted by traditional PE (Private Equity), like municipal infrastructure and technology intensive sectors - clean energy for example (Asian Development Bank, 2008).

By diversifying its investments, a fund may be able to provide funding to MCs at a relatively

⁷¹ IFC has developed the Environmental, Social and Governance (ESG) toolkit to systematically assess and manage risks in prospective investment and monitor existing investment. Refer to <https://www.estoolkit.com/Default.aspx> for further details.

lower cost, meanwhile offering investors reasonable returns. Developmental projects vary in terms of risk-return profiles. Some offer high risk-adjusted returns, some don't. By carefully selecting the portfolio projects, high-return projects would subsidize low-return ones. In this manner, a fund may be able to offer low-cost funding to governmental projects without jeopardizing returns to investors.

3.4.3 Diversification of Investors

Sukuk attract fixed income institutional investors and the market just started tapping into retail investors. In contrast, relative to the *Sukuk* market, there is higher retail participation in the funds sector (although institutional investors still represent 2/3 of the funds investors). In other words, there is a more flexible avenue to capture diverse investors using the funds market. For example, at the same time that Macquarie began their private equity investment in Australia in infrastructure, Australia inaugurated private pension based on the American 401K model. This requires the individuals to be responsible to manage their own pension investment. Macquarie saw this as an opportunity to package the infrastructure investment into investments for the private pension market.

Table 10 shows the summary of the evaluation.

Research Objective	Do Funds meet the Objective?	Implication/Note
1. Off Balance Sheet	Yes	<ul style="list-style-type: none"> Expand activities without debt burden Manage charter restriction, if any
2. Cost of Funds	<ul style="list-style-type: none"> Fund may use debt or equity funding Private equity investors require higher return 	<ul style="list-style-type: none"> Although debt is cheaper, it places Obligor under stress during crisis Although equity is more expensive, return is based on performance, thus less stress for investee during crisis
3. Diversification of investors	<ul style="list-style-type: none"> Flexible avenue to capture diverse investors 	<ul style="list-style-type: none"> Effect of co-mingling retail & institutional investor is less clear

Table 10: Summary Evaluation of Funds against Research Objectives

In conclusion, the funds sector provides off-balance sheet financing that would allow IDB and its peers to expand their mandates. Funds can be structured in such a way that if the underlying sector performs exceedingly well, investors would successfully achieve their high return targets. However, the fund sector is not always geared towards income delivery except in the case of product-specific concepts like trade finance and leasing funds. Benevolent

funds are especially placed to allow low-cost or no-fee funding to LDMCs. Fund strategies would allow portfolio diversification or even singularity to achieve a wide variety of investor goals and thereby assist IDB to adapt its funding to different MC needs or financing strategies. In **Chapter 4** we will analyze various investor segments further.

There are a number of useful lessons learned which can be applied to an investment partnership strategy for using funds to supplement IDB's capital and balance sheet. IDB's own track record is instructive as to the steps that should be repeated or avoided in the process of launching various funds. What is less clear is the degree to which mingling 'retail' and 'institutional' investors in a fund is an appealing concept or whether or not it leads to a dilution of strategy execution. In a similar vein, the execution of a listing strategy threatens to dilute a fund from the perspective of the founder investor's returns if the market in which a listing takes place is subjected to a negative secular trend, perhaps delinked from actual projects. The following chapters will examine, in further details, the structure and components of an IDB 'development fund'.

SWOT Analysis for Selected Infrastructure & Development Funds

Fund	Strength	Weakness	Opportunity	Threat
Investment Deposit Scheme (IDB)	Direct relationship with depositor	Direct obligation on IDB. Difficult to market outside of IDB footprint.	Support of specific short-term operations like trade finance.	Increases IDB's leverage and has limited flexibility for application of funds.
Unit Investment Fund (IDB)	Listed, open ended fund	Residual cash reserves go to charitable trust, not investors	Able to make longer term investments	Placed with IDB - increases IDB's liabilities
IADB Multilateral Investment Fund	Able to make development-driven decisions as core mandate	Not fully commercial	Able to seed promising projects, allowing them to become commercial	Subject to negotiated mandates by member states
ISFD/APIF/Waqf (IDB)	Able to provide concessionary finance and co-invest	Beneficiaries prefer grants than commercial funding	Able to seed projects that need help to be "commercial"	Not interesting to international investors, unappealing to secular trust funds

AIG Indian Sector Equity Fund	Brought a marquee of international investors	Certain sectors (water) did not achieve development effect	Development of PE market in India	In initial year, difficult to obtain transactions – unfamiliarity and large transaction size
Macquarie MIISF	Easy for domestic Australian investors to buy units	Only buys listed equities, not truly investing in development	Asset allocation model can capture growth opportunities from emerging markets	Allocation over-weighted to one sector in OECD countries and cannot intervene to improve performance of investee companies
Macquarie MIIF	Wide investment mandate, able to leverage and fund equity	Listing allows shares to be discounted due to uncorrelated events	Wide mandate and ability to leverage	Leverage may harm returns if underlying investments fail to perform
AIG Africa I	Clear investment mandate	GP/LP structure limits investor rights	Capacity to raise significant pension assets	Limited flexibility to change course
IDB Infra (2001)	Known GP and IDB role. Best performer among MDFI funds	GP was unable to attract investors from outside	Bahrain capacity as fund center and IDB footprint as attractive market due to fund's high returns	Investment in areas beyond original fund mandate
IDB ADB Infra (2009)	Strong sponsors in IDB and ADB	Use of word "Islamic" does not attract investors	Investment in high growth markets.	Inefficient bureaucracy; – invest in bonds and not projects

Chapter 4 - Structuring Considerations - Domicile

Introduction

This chapter addresses two main components; investors and fund domiciles. The investors segment reviews market developments, investor interests and expectations in different fund classes. The domicile section will focus on finding the jurisdictions that facilitate a broad fund strategy. After elaborating on the domicile selection and evaluation criteria, the chapter will perform a SWOT analysis on the individual domiciles and conclude the chapter with evaluation of the different jurisdictions.

4.1 Market Development and Investors

This section leverages off of published studies including Towers Watson 2011 *Global Alternatives Survey*, and 2012 Preqin Global Infrastructure Report. These surveys and reports provide extensive descriptions of key market developments especially for infrastructure funds, and highlights investors interest & expectations in different funds.

Asset class	Total AuM	Average	Smallest	Largest	Pension / total AuM
USD millions					
Real Estate	1,120,906	15,787	59	88,508	49%
Fund of Hedge Funds	407,912	5,827	1	32,923	38%
Private Equity FoF	378,217	6,410	120	34,305	56%
Infrastructure	226,422	5,146	10	92,152	61%
Commodities	178,062	6,595	66	83,149	25%
Total	2,311,519	8,530	1	92,152	47%

Figure 23: Snapshot of Alternative Asset Classes

Source: (Towers Watson, 2011), p58

Towers Watson surveyed 197 fund managers who were managing 271 alternative investment funds with US\$2.3 trillion asset under management at the end of 2010. From the total AuM surveyed, real estate is largest asset class, representing almost 50% of the total AuM. This is followed by Fund of Hedge Funds, Private Equity, Infrastructure and Commodities. However, pension represents the largest investor group in infrastructure; representing about 61% of the AuM. This is followed by private equity, real estate, hedge fund and commodities. The following sections will focus on the infrastructure market, followed with a relatively shorter discussion on the trade finance and socially oriented funds market.

4.1.1 Infrastructure Funds

This section leverages from the Preqin 2012 Global Infrastructure Report. Preqin was founded in 2002 and operates out of New York, London and Singapore. Its infrastructure database tracks 600 listed and unlisted infrastructure fund, 350 infrastructure fund managers and

1,600 active infrastructure investors. The Preqin 2012 Global Infrastructure Report benefits from different segments of the database.

4.1.1.1 Growth Trend

Majority of the unlisted infrastructure fund were launched after 2004, as an offshoot of private equity funds. **Figure 24** shows the number of funds that have come to market at the beginning of each year with the capital amount targeted. As at January 2012, there were a total of 144 unlisted infrastructure funds that came to market with a target of US\$93.2 billion capital commitment.

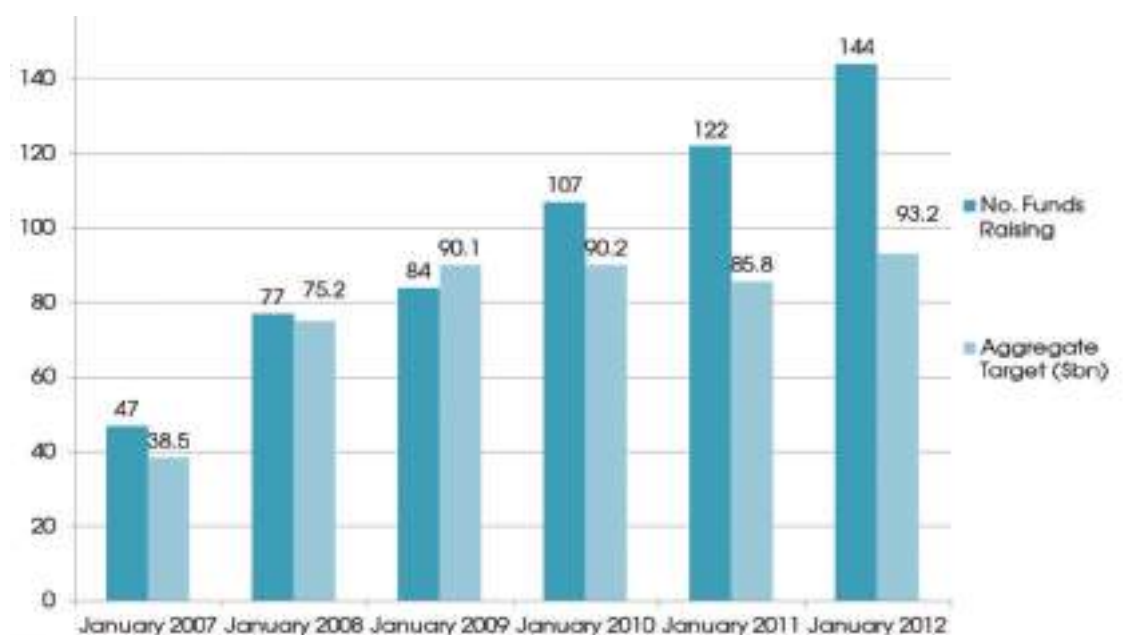


Figure 24: Unlisted Infrastructure Fund in Market over Time

Source: (Preqin, 2012), p16

Figure 25 shows the number of funds that had their final closing at the end of each year since 2004, with the committed capital (commonly known as fundraising). Fundraising was on a growing trend since 2004 and peaked in 2008. There was a big drop in 2009 due to the financial crisis but it recovered in 2010. In 2011, fundraising fell compared to 2010 due to investor caution and economic uncertainty. However, compared to 2009, there was an 85% increase in 2011. The average fund size raised in 2011 was US\$575 million (compared to US\$776 million in 2010, and US\$414 million in 2009). The largest fund raised in 2011 was for US\$3.31 billion by ArcLight Energy Partners that closed in November 2011. The fund exceeded its targeted fundraising of US\$2 billion.

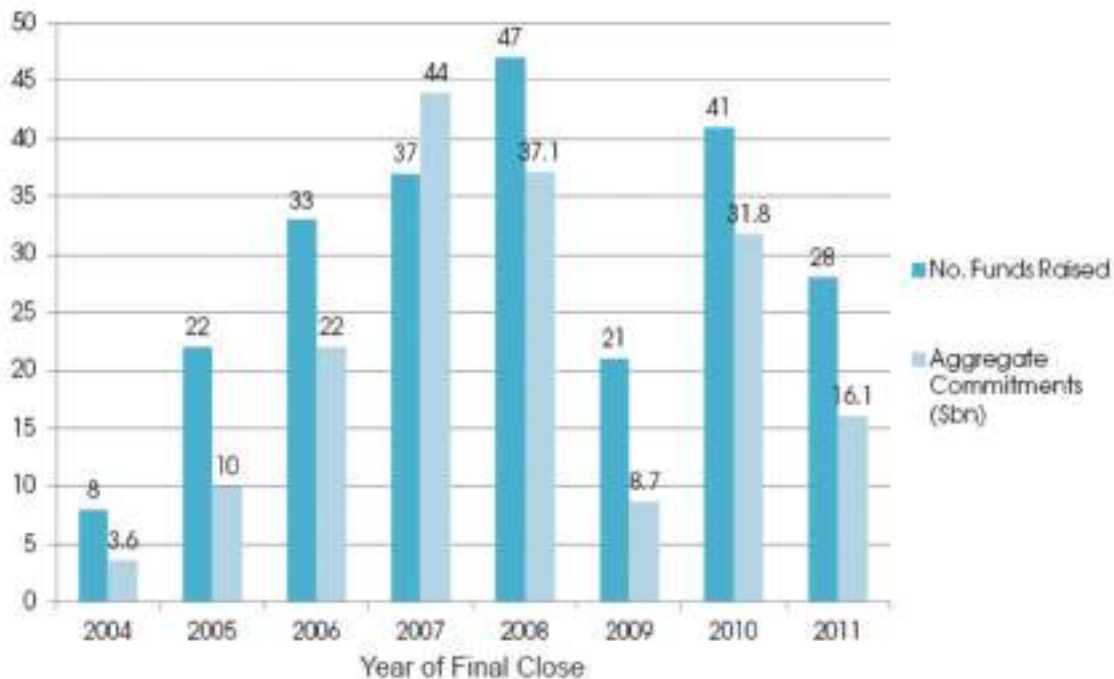


Figure 25: Unlisted Infrastructure Fundraising Annually

Source: (Preqin, 2012), p15

The Asset under Management (AuM) for unlisted infrastructure fund is defined as the uncalled capital commitment (dry powder) plus the unrealized value of the investment portfolio. As at June 2011, the AuM stood at over US\$170 billion. **Figure 26** provides the detail of both components. **Figure 27** shows the breakdown of dry powder according to the fund size.

Between 2003 and 2007, the average size of funds kept on increasing due to increased investors demand globally, especially as governments used more PPP funding for infrastructure projects. Since 2006, mega funds (US\$2 billion and more) started entering the market, contributing to the high dry powder (uncalled capital) of the AuM until 2009. After the financial crisis, the target size of funds has become smaller, contributing to more constant dry powder in the AuM. The 37% increase in the AuM in June 2011 (compared to June 2009) is mainly due to fundraising and investment of these funds in different portfolio. The unrealized equity values increased from US\$92 billion in December 2010 to US\$106 billion in June 2011; a 13% increase. It is quite common to find funds that hold interim closing, allowing them to make investment before the final closing (thus increasing the unrealized equity value).

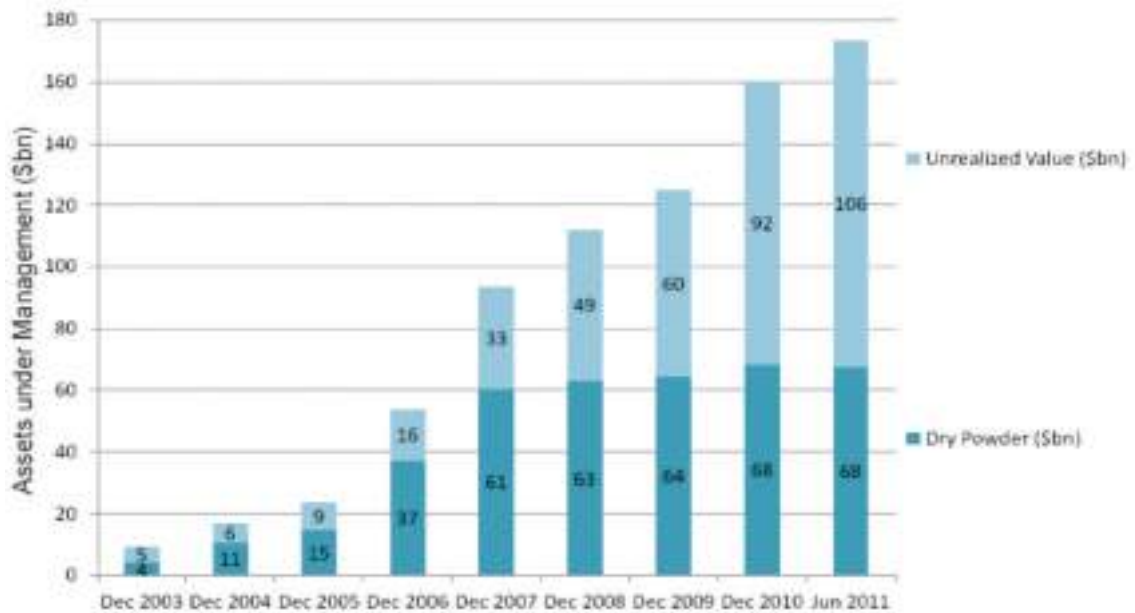


Figure 26: Unlisted Infrastructure Fund Asset Under Management

Source: (Preqin, 2012), p13

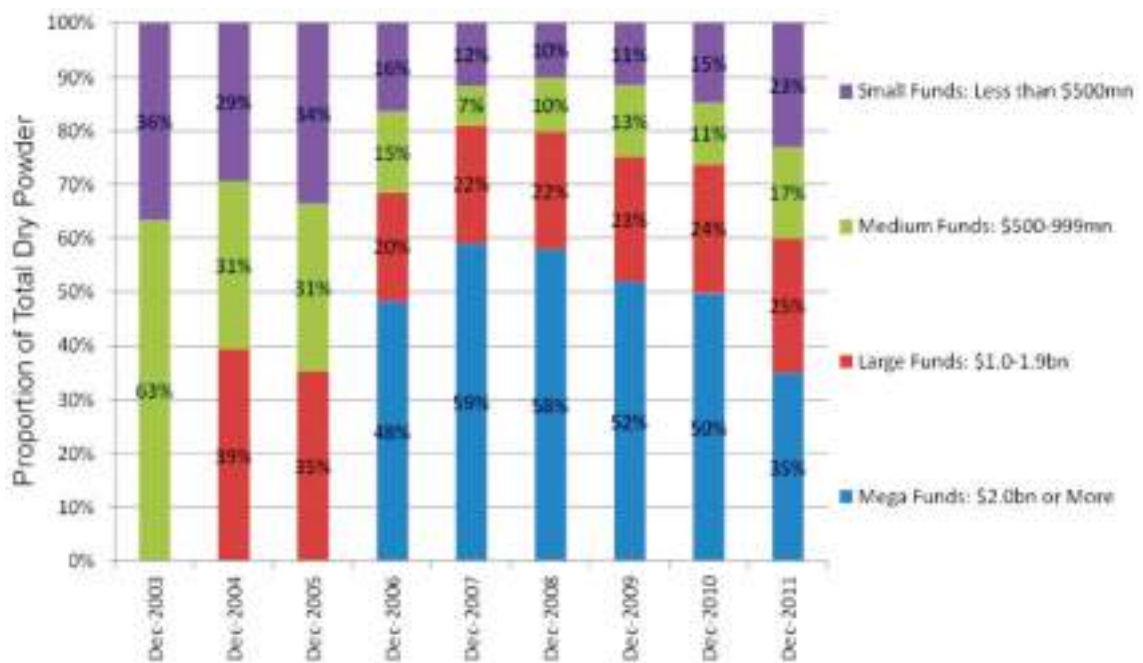


Figure 27: Dry Powder according to Fund Size

Source: (Preqin, 2012), p13

4.1.1.2 Investors

Based on 1300 active investors, Preqin summarized the role of different investor groups in unlisted infrastructure funds (**Figure 28**). The top investor groups are:

- i. Pensions (public + private + super annuity) = 41%;
- ii. Financial Institutions (Bank, Insurance & Asset Managers) = 25%; and
- iii. Foundations & Endowments = 11%

Three out of the top 10 global infrastructure investors in Preqin's database are Canada's public pension institutions; Ontario Municipal Employees Retirement System (OMERS) with US\$15.1 billion current commitment to infrastructure, Canada Pension Plan (CPP) with a US\$9.4 billion commitment, and Ontario Teachers' Pension Plan with US\$7.9 billion commitment. Appendix 1 lists the top 10 institutional investors in infrastructure funds – global investors, public pensions, non-pension global investors. SWFs only represent 3% of investors in infrastructure funds, as many SWFs prefer to make direct investments, instead of investing in funds.⁷²

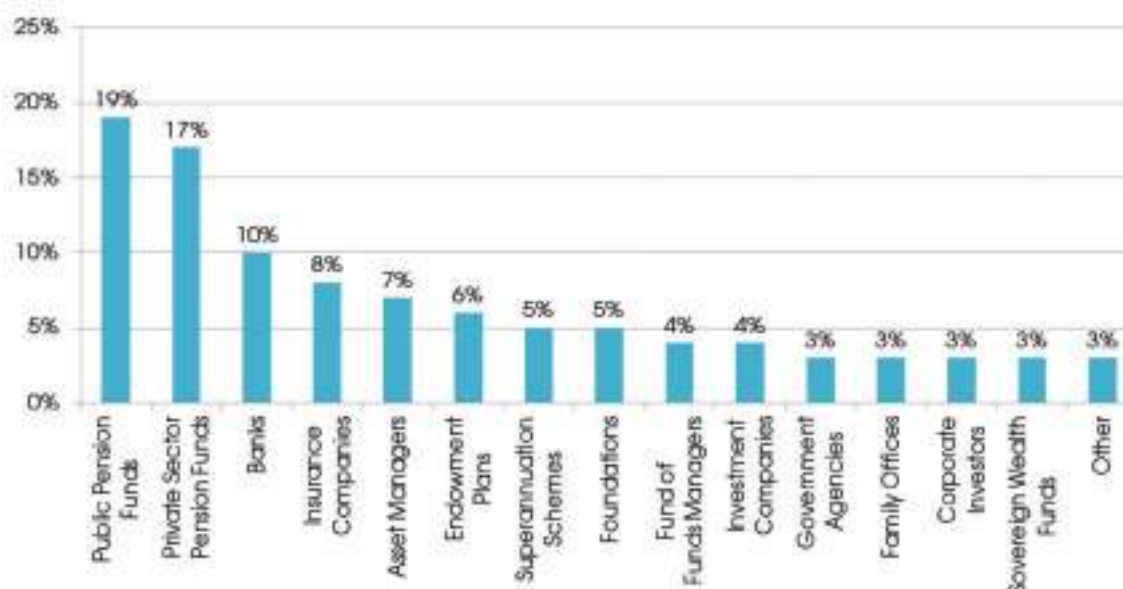


Figure 28: Investors in Unlisted Infrastructure Fund

Source: (Preqin, 2012), p31

Based on the active investor analysis, Preqin also reported that 44% of the investors have a dedicated allocation for infrastructure investment while 27% invest via private equity and 13% invest via real estate funds.

Besides the existing investors, Preqin also interviewed additional 150 investors who are considering investment in infrastructure. 47% of these investors are from pensions (public & private), followed by endowments (13%), insurance companies (11%) and

⁷² In a dedicated section for SWF, Preqin highlighted that aggregate SWFs investment in infrastructure has increased from US\$3.5 trillion in 2010 to US\$3.98 trillion in 2011. However, 50% of SWFs prefer to make direct investment, 38% mix both direct investment and investment through fund, while only 14% invest solely through funds.

asset managers (9%). This shows that pensions will continue to be a key investor group in infrastructure funds.

In a separate report titled '2012 Global Private Equity Report', Preqin tracked different groups of investors in the private equity sectors. Since private equity funds also invest in infrastructure, the investor groups in private equity will also be of interest. Besides pension, insurance companies, foundations and endowments, family offices also seem to have a large allocation to private equity (29% targeted allocation in the long run). Recently closed PE funds (2009-2011) investors also include HNWIs. Appendix 2 lists the top five PE investors in different categories – endowment, foundations & family offices, public pension, private pension etc. Most of the endowments are US university endowment funds. In the infrastructure pension investor list (Appendix 1), Calpers did not appear, but a number of Canada-based pensions were active investors. On the contrary, Calpers and other US-based public pension were 4 out of 5 top investors in private equity (refer Appendix 2). **Figure 29** shows that most investors in traditional infrastructure funds are located in Europe (42%) and North America (30%).

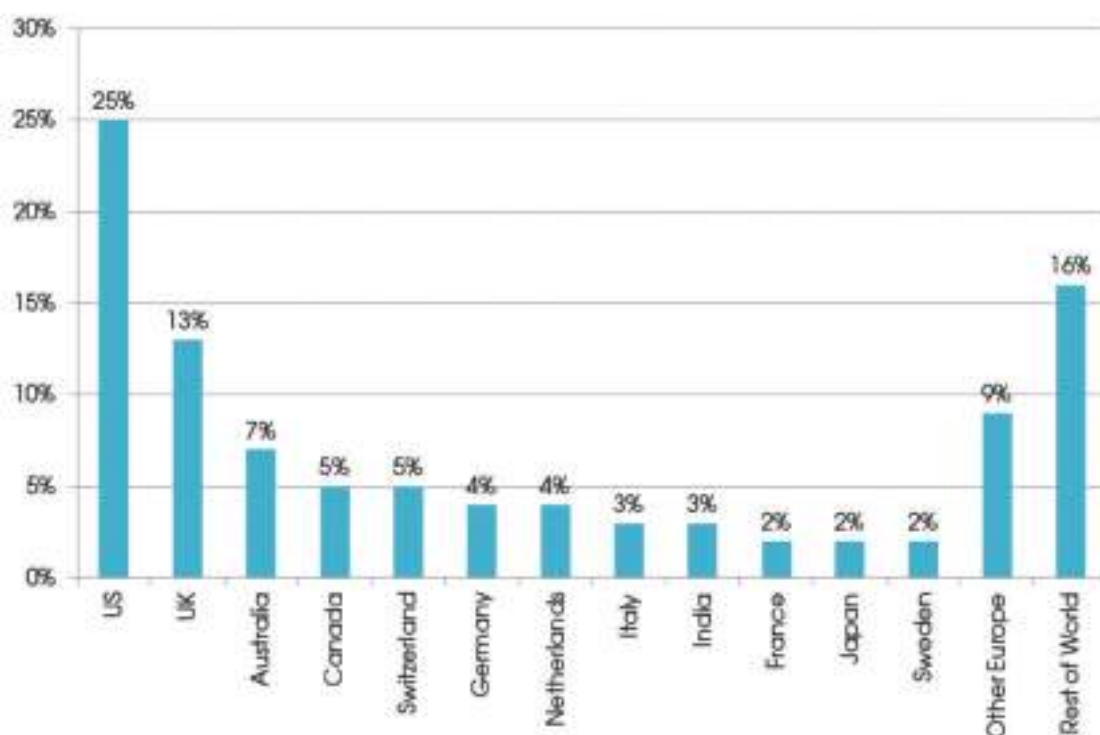


Figure 29: Infrastructure Investors Location

Source: (Preqin, 2012), p31

Previously, infrastructure investment was reserved for large institutional investors due to entry barriers (like management fee, large minimum commitment size, liquidity issues). With the emergence of Fund of Funds and specialist funds, smaller investors are able to gain exposure to infrastructure investment. According the Preqin database, 22% of infrastructure investors have AuM less than US\$1 billion, and 63% have AuM less than US\$10 billion. The infrastructure fund of funds is still at its infancy as the first fund was only launched in 2008. Based on Preqin's database, as at January 2012, there

are only 17 infrastructure FoFs (all are close ended) of which 11 have had a final close and raised US\$3.7 billion. Refer to **Figure 30** for the trend of FoFs. 14 of the funds are based in Europe, two in North America and one in Korea (the largest FoF with the size of KRW1.2 b/US\$1.2b).

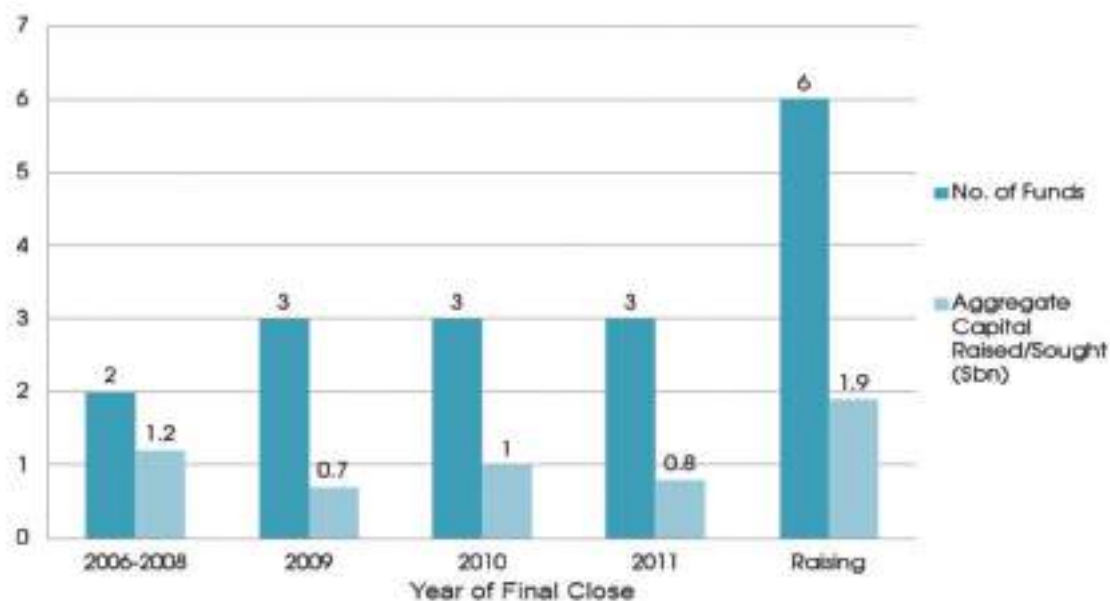


Figure 30: Infrastructure Fund of Fund

Source: (Preqin, 2012), p49

A greater challenge is to understand the role of investors from different classes such as SWFs and retail investors. The empirical evidence is that SWFs will selectively invest in development finance when it fits a particular criterion. The same applies to SWF investment in Islamic financial products. The criteria that needs to be presented to SWFs include security of investor rights; capacity to achieve a high yield; and, diversification of risk into asset classes or geographic sectors that are underrepresented in their existing portfolios. On one hand, SWFs should be expected to make investment decisions which mirror those of other institutional investors. On the other hand, institutional investors that are not explicitly termed as SWF are, in fact, SWF. These would include state pension funds like CALPERS, EPF, and similar entities.

State-controlled institutional investors are obliged by state policy to make certain types of investments. As a result, Malaysia's EPF has a formal mandate to buy *sukuk*. Similarly, CALPERS has a mandate to invest in the renovation and improvement of infrastructure in the State of California. Therefore, IDB may discover that specific fund objectives will match mandates of various SWFs and state-controlled institutional investors.

The retail side of the equation is more complicated to analyze. In a developed country like Australia, Macquarie was able to sell infrastructure funds to self-directed retirement funds. Infrastructure became an expertise that Macquarie parlayed into a global fund management franchise. But on the global scale, Macquarie's delivery has varied, with

institutional investors almost always more important than retail investors. What is difficult to determine is whether this is because it is too difficult to sell infrastructure funds to retail investors, or because as an investment manager, Macquarie prefers to sell funds to institutional investors because it can achieve scale faster.

Both retail and institutional investors are challenged by the risk and reward problem that has framed investing since 2001. Generally, the yield curve for most major currencies has flattened. At the same time, risk premiums have flattened. The meaning in many markets is that investing in apparently high risk portfolios yields no better than the risk-free alternative, which, in turn, yields almost nothing. This investing reality means that some investors aggressively seek risk and yields.⁷³ Both seem to be more easily found in emerging markets.

The appetite of retail investors for securities and investments in emerging markets is largely untested. But the general preference for retail investors is to buy whatever is familiar, mainly from their home market. The development of a retail investor class is still conceptual in most emerging markets, and some middle income countries like Malaysia have a well defined retail investor class. Others, like Turkey, have not yet seen the successful emergence of a retail investor class. Some emerging markets like Nigeria have a relatively active stock and fund market, but a small investor class. One should be able to conclude that such investments in domestic markets led by IDB would prove attractive to both local market retail investors as well as some Muslim retail investors from external markets.

4.1.1.3 *Investment of the Funds*

As investors are mostly from the western market, it's imperative to examine where the funds are invested. In 2011, there were 224 investments made by different funds (compared to 256 in 2010).⁷⁴ The biggest challenge for the investment of infrastructure funds is to secure long-term debt during financial crises. Europe is naturally the most popular investment target (104 deals – 49%) followed by North America (49 deals – 22%). Refer to **Figure 31** for the investment region and **Figure 32** for the industry sector. The core infrastructure investments (energy, transportation, telecommunication and utilities) are the most attractive sectors; representing 88% of investments made in 2011. Social sectors such as education and healthcare are also attracting investment. In 2011, the investment preferences were secondary infrastructure (41%), followed by brownfield (32%) and greenfield investment (27%).

⁷³ Remarks by Datin Maznah Mahbood at the Global Islamic Finance Forum, Bank Negara Malaysia, September 18, 2012.

⁷⁴ Preqin tracks a total of 2000 deals that the infrastructure funds have made over the years.

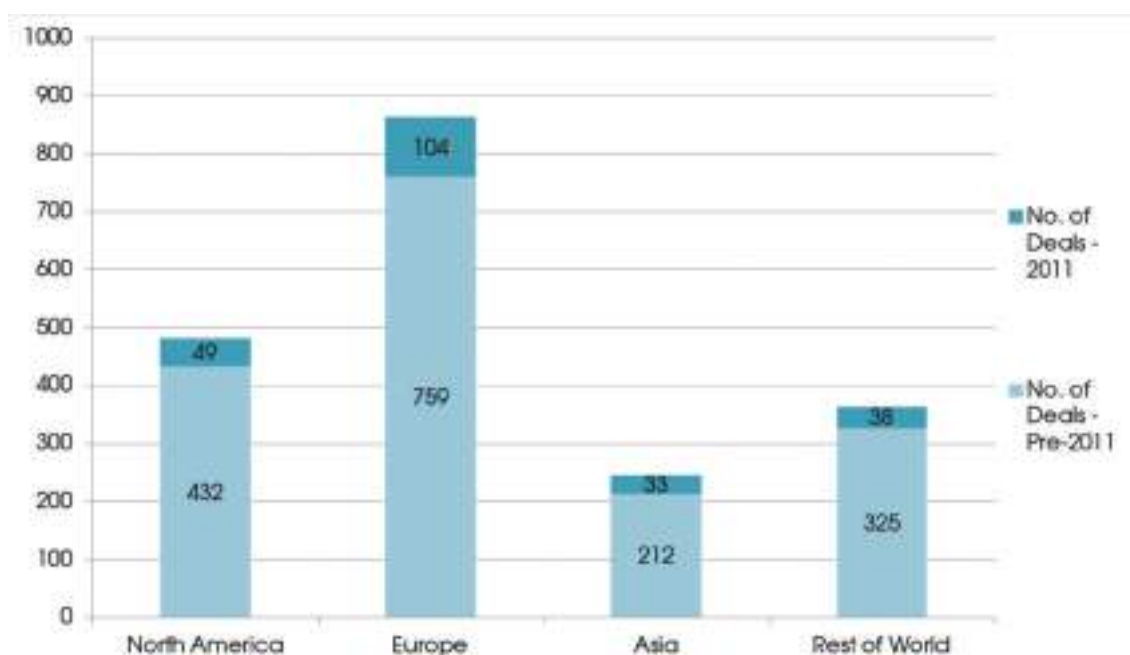


Figure 31: Infrastructure Fund Investment Target

Source: (Preqin, 2012), p26

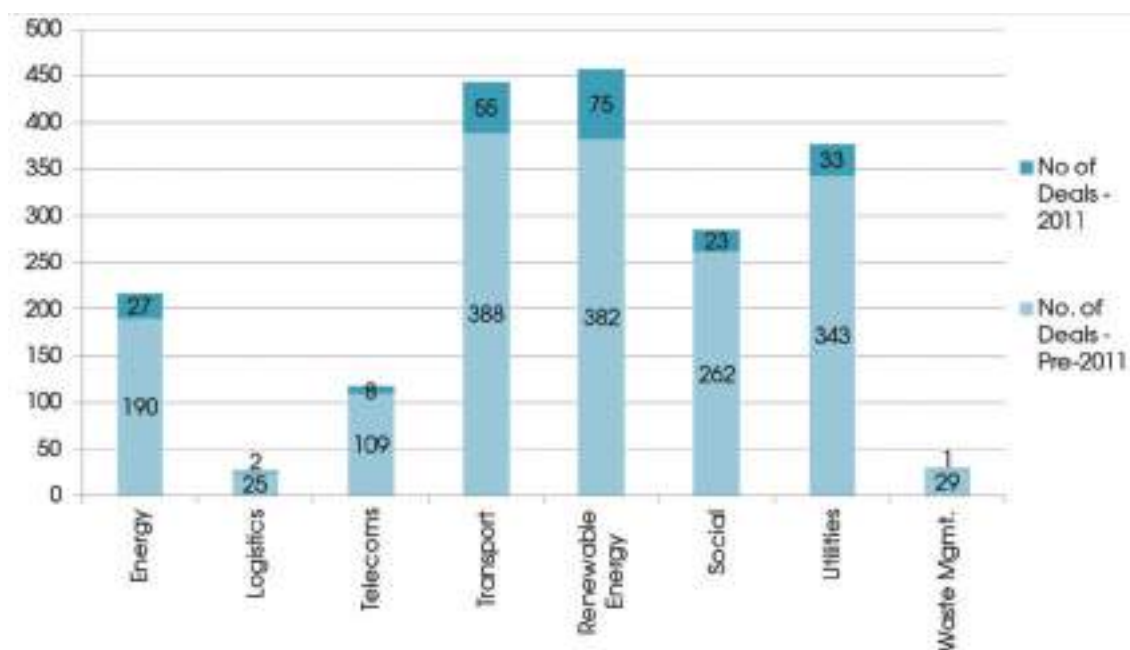


Figure 32: Infrastructure Fund Investment by Industry

Source: (Preqin, 2012), p27

4.1.1.4 *Infrastructure Funds in Emerging Markets and IDB Target Investors*

Even if the preponderance of financial capacity is in the OECD countries, the Milken Institute has mapped several trends which point to a long term shift.⁷⁵ According to

⁷⁵ Accessed at www.milkeninstitute.org/presentations/slides/2940GC11.pdf

data collated by the Milken Institute, commitments in the emerging markets show a sustained positive trend since 2002. The Asian financial crisis led to a declining trend that lasted for five years, and the graph shows a dip from 2008 (Refer to **Figure 33**). (Asian Development Bank, 2008) highlighted that Asia is a dominant target for private equity investment. For example, PE investment in Asia jumped from \$2.2 billion in 2003 to \$23.1 billion in 2007. Nonetheless, many of these funds are focused on India and China. ADB also highlighted that an important source of equity for Asia are pension and insurance funds in developed economies that search for higher return.

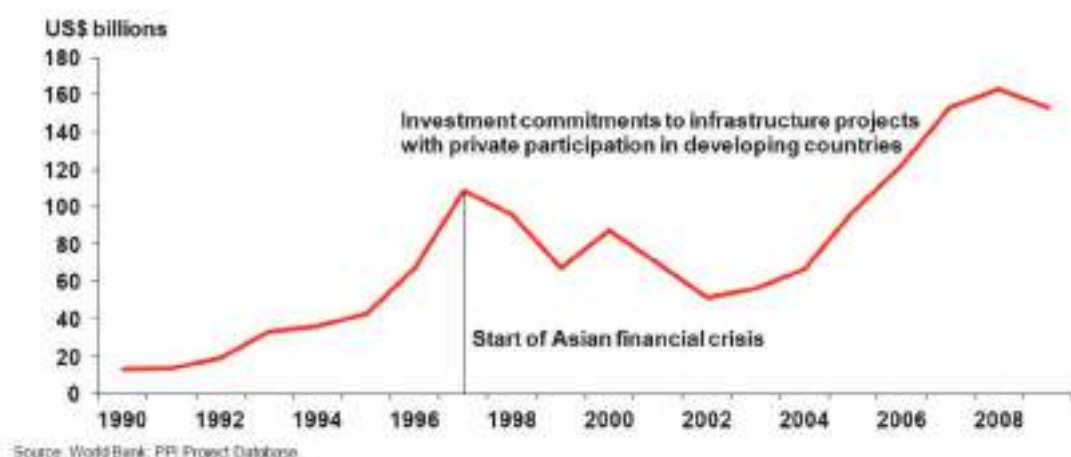


Figure 33: Asian Infrastructure Spending

Source: (Milken Institute, 2011), p12

Currency wise, for international funds, dollar is the leading choice, followed by the Euro. Even for investment in Africa, Novare noted that a vast majority (91.4%) of the mutual funds that they surveyed were denominated in USD. Novare discovered that South Africa (a major source of funds in its own right), British Virgin Islands, Jersey, Malta, Guernsey, Netherlands, US, Luxembourg and Mauritius were popular jurisdictions: twenty five percent of the funds were UCITS III compliant. Certain jurisdictions that have developed domestic market like Australia, Korea and Malaysia have also witnessed local currency issuances.

In their *Middle East Fund Survey*, Advent-MEED Insight noted that a top concern of fund managers is the weak and non-transparent regulatory framework in most MENA countries.⁷⁷ This means that attracting non-MENA investors into MENA domiciled funds may prove difficult. Another two issues that the survey identified were the concern of distributors about the long term performance of MENA fund managers, and the shortage of Islamic finance specialists in a market that increasingly requires *Shariah*-compliant structures.

⁷⁶ Investing in Africa: Funds and Managers Survey, Novare ® Investments Africa Report 2010. Accessed at: www.novare.co.za/uploads/files/File/Africa%20Survey%202010.pdf

⁷⁷ Middle East Fund Survey, Advent MEED insight, distributed electronically on November 11, 2012.

4.1.1.5 Investors' Reach Out

IDB would like to achieve two goals which are not consistent with one another. The first is to build MCs' market capacity by developing fund tools that result in introducing modern capital market and fund technology into the MCs and attracting local market investors. The second is to attract new capital from outside of the IDB orbit.

The first goal means that IDB will work with MC authorities to structure funds that attract domestic retail investors as well as institutional investors and high net worth individuals ("HNWI") or family offices. The MCPS has resulted in commitments of US\$4 billion in association with a diverse group of development finance entities, mostly from the MCs, including the Arab Fund for Economic & Social Development, Arab Bank for Economic Development in Africa, the Kuwait Fund, the OPEC Fund for International Development, the Saudi Fund for Development, and the ADB. The next stage of this program is to determine how to broaden the universe of participating partners.

The second goal means that IDB must evolve a clear "secular" presentation to attract global institutional investors. This investor class normally makes large placements, prefers discretion, and is not necessarily desirous to commingle its funds with retail investors. Periodically, institutional investors find retail investors to be part of their exit strategy.

Conventional investors are important in this process because the Islamic fund sector has not demonstrated scale. (Ernst & Young, 2011) demonstrates the thinness of the Islamic market. Despite achieving US\$58 billion of assets under management (of which US\$7.8 billion are in non-conventional assets), the typical fund is small with less than US\$75 million under management.⁷⁸ As a result, IDB cannot rely on the *Shariah-compliant* fund sector to be its main source of capital. Indeed, *sukuk* issuers are equally reliant on investors from outside of the "Islamic" orbit. Therefore, the fund process requires a clear appeal to a diversified universe of investors for whom serving the emerging markets is important, and for whom *Shariah*-compliance might not be a top priority, and on certain occasions, may even be a discouragement.

Conventional investors for the emerging markets must be divided into three constituencies. The first are sovereign wealth funds, state pensions, and other investors from IDB member countries. These investors already have a good exposure to *Shariah* compliant investing. Indeed, they may have mandates to allocate portions of their portfolios to *Shariah*-compliant investments, or negative mandates: "not to exclude" *Shariah*-compliant investments from their asset allocation strategies. Many of these investors participated in IDB's previous funds.

The second universe of conventional investors is both private equity and asset managers who have ethical guidelines to consider. According to the *GCC Mutual Fund Industry Survey 2011*, since 2008, there has been investor migration to either safety or

⁷⁸ Keep in mind that the average UCITS fund may be of a similar scale to the average Islamic fund, according to PWC.

higher yielding fixed income.⁷⁹ This means that the basis exists to attract non-Islamic investors, who are domiciled in the GCC, into the *Shariah*-complaint space. A number of these managers have exposure to the Islamic investing sector and are open to *Shariah*-compliant proposals offered to their core investment mandates. The second universe, however, is not particularly significant in the potential volume of investment funds to be allocated to projects in the IDB space.

The third, the conventional investor universe, however, is the greatest challenge. On one hand, this might be the largest pool of funds available. On the other hand, the universe is composed of large western pension funds like CALPERS and CALSTERS, TIA-CREF, which are based in the US, Japan, UK or European countries. These investors have less exposure to emerging markets, but substantial capacity. This pool has frequently been important for various global emerging market funds, even if the actual investment is not significant for the funds. These funds often have staff who lack familiarity with Islam or are influenced by negative press and images resulting from the last eleven years of conflict arising from the September 11, 2001 attacks. As a result, this universe may have strong, unstated objections to investing when the investment fund or terminology explicitly states “Islam” or “Islamic” or visible *Shariah*-compliant terminology.⁸⁰ Moreover, many western state pensions have explicit secular mandates. As a result, co-investing with IDB in infrastructure or development activities may meet the mandate. But, investing in a fund that uses the word “Islamic” in its name or marketing may be deemed to violating the mandates.

The proposal to take advantage of a UCITS jurisdiction is based on the two primary benefits of UCITS. On one hand, UCITS-compliance opens access to the retail and institutional investor markets in Europe. Often UCITS funds are passported into non-UCITS jurisdictions like Bahrain and Malaysia based on agreements between the UCITS host jurisdiction and the non-UCITS jurisdiction’s regulator. On the other hand, UCITS structures do not put off or impede institutional investors from co-investing. Unlike the relatively more burdensome SEC fund rules in the US, which are restrictive on cross-border sales and distribution, UCITS provides “right touch” oversight whilst facilitating cross-border sales and distribution to multiple types of investor.

In summary, the IDB fund’s target investors will most naturally be pensions as they look for long-term stable income generating investments. Other investors should include insurance companies, foundations, endowments and family offices besides SWFs. Keep in mind that private equity and real estate funds also have allocations for infrastructure investment.

⁷⁹ Gokkunt, Giyas, editor, GCC Mutual Fund Industry Survey 2011, p. 21. The Asset Magazine also concurs with view that “Islamic” is not a disqualifying factor for conventional investors. See Cruz, Bayani S., UCITS key for Asian managers to reach outside, February 2012, accessed at www.theasset.com.

⁸⁰ These investors may also wish to avoid being named on various websites like www.shariahfinancewatch.org and www.creepingsharia.wordpress.com. These are sites which are part of movements which have sought to ban Shariah in US courts with some success at the state legislative level, although they were unable to win their cases in court challenges.

As a general concept, there is a growing body of institutional investors who seek to invest in emerging markets in order to enjoy ongoing fixed income from stabilized infrastructure or capital gains from participating in the development of new projects of different types. “It is not possible to achieve inclusive and sustainable growth without the creation of enabling infrastructure in an economy.”⁸¹ Section 5.3 will examine some steps that IDB may take to create an enabling investment environment for investors. **Table 11** shows the infrastructure fund SWOT analysis as a summary.

Strengths	Weaknesses	Opportunities	Threats
Substantial OECD pension money is flowing to the sector.	Lack of clear definition	Asian pension investor capacity is growing	“Islamic” is not exactly SRI and may not be “politically correct”
Increasing trend of MDFI funds to the sector	Lack of clear regulation, tax and investment process in many investee countries	Africa and MENA are not really on the investor road map	Risk of policy changes at the investee level
Infrastructure growth is good proxy investment for growth in BRIC & N-11 ⁸²	Managers are concentrated in US and UK; Australian firm is biggest manager	Infrastructure is key to growth	Poor corporate governance in many investee markets
Demand trend trumps multiple crises since 1997.	Developed markets demand crowds out emerging market needs	More scope for increased investment from OECD pensions	Deal flow takes time to build, giving investors time to go elsewhere
MDFI experience with PPP is improving	Long duration to achieve goals and risk of overoptimistic projections	Develop new investor classes	Local currency paybacks against USD or international currency obligations

N-11⁸²

Table 11: Infrastructure Fund SWOT Analysis

⁸¹ Sinha, U.K., Milind Barve, S. Naganath, and P.K. Nagpal, Report and Recommendations of the Committee on the Launch of Dedicated Infrastructure (DIFs) by Mutual Funds, Securities & Exchange Board of India, Mumbai, July 23, 2007. Accessed at: www.sebi.gov.in/commreport/difreport.pdf

⁸² BRIC = Brazil, Russia, India and China. N-11 = Next 11 emerging economies after BRIC

4.1.2 Trade Finance Funds

(Towers Watson, 2011) categorized commodities as one of the alternative investment asset classes. Investment in commodities provides investors diversification as it has a negative correlation to investment in stocks and bonds. In the conventional market, a commodities fund may use derivatives on commodities collateralized with bond investments (PIMCO).⁸³

Besides collateralized commodity-linked funds, the market has also seen a number of trade finance funds. According to Jacques-Olivier Thomann, the managing director of BNP Paribas (Geneva), trade finance funds have a huge potential in the market; especially due to the Basel requirements and liquidity shortages amongst European banks. He added that the annual turnover of trade finance activities is between US\$12-US\$14 trillion. Thus the initial size of the trade finance funds market may be a few billion dollars which will eventually grow to US\$100 billion market. BNP Paribas launched a trade finance fund in March 2012 following in the footsteps of Trafigura, an independent oil trader that established its own hedge fund, Galena, in 2003 (Miles, 2012).

Galena already has an existing commodity trade finance fund which has been growing annually at 7.9%. In 2012, Galena launched a new investment vehicle to expand this activity. The initial fund size is US\$1 billion targeted at pension, sovereign wealth funds, family offices and supra-nationals. Galena aims to expand the fund to US\$4 billion by the end of 2013.

4.1.3 Socially Oriented Funds

For socially oriented funds, IDB may leverage on Singapore's experience in launching and administering an onshore retail *waqf* fund known as the Mosque Building and Mendaki Fund (MBMF). The fund was established through an amendment of a parliamentary act – the Administration of Muslim Law Act (AMLA) in 1975 - to allow collection of donations to construct mosques and new housing. The initial focus of the fund was on mosque building with an SGD0.50 contribution each month. In 1984, the fund expanded its operations to include support to the Mendaki Foundation that focuses on education and social program to uplift the disadvantaged segment amongst Singapore Muslims. The contribution rates have been revised a few times.⁸⁴ Currently the deduction is tiered according to the salary level, and there is a clear division between the mosque building and the Mendaki component as illustrated in **Table 12**.

⁸³ Refer <http://investments.pimco.com/Products/pages/287.aspx>

⁸⁴ In 1977 the contribution was raised to SGD1, then to SGD1.50 when the Mendaki component was added in 1984. This was revised again to SDG2 in 1991 and in 1995 a higher rate was introduced for those earning more than SGD1,000.

Total monthly wage (S\$)	Total monthly contribution (S\$)	Mosque building & religious education component (S\$)	Mendaki component (S\$)
1,000 and below	2.00	1.00	1.00
1,001-2,000	3.50	2.25	1.25
2,001-3,000	5.00	3.60	1.40
3,001-4,000	12.50	8.00	4.50
Above 4,000	16.00	10.75	5.25

Table 12: Tiered Salary Contribution in MBMF in Singapore

Source: (Jamil, 2009)

In 2008, the fund's mandate was expanded to include *madrasah* education enhancement (improved curriculum, IT services and teacher training).⁸⁵ This required an increase in the salary contributions. Therefore the public required that the fund be subject to external audit and publication of financial statements for transparency. IDB could use its reverse linkage strategy to transmit this experience of Singapore to other member countries in order to properly manage *waqf* and charitable activities.

At a recent event for private equity investors, the rock and roll musician Bob Geldof, who is known for his charitable actions in Africa, pitched the private equity community to turn their attentions to Africa. Geldof's appeal was to an attentive audience. Instead of calling the fund a '*waqf* fund', just branding it as an endowment fund may attract non-Islamic investors as well. A number of specialized development entities are focused primarily on emerging markets. These include bodies like the Bill and Melinda Gates Foundation, the Soros Economic Development Fund, the Agha Khan Fund for Economic Development, and the Norwegian Investment Fund for Developing Countries. All these funds seek social and intangible benefits in addition to financial returns. As a result, they are willing to make smaller investments, investments in areas that do not have the same initial financial dynamics that attract traditional lenders and institutional investors.

4.2 Investors' expectations

This section will examine three sub-issues related to investors' expectation:

- i. **Financial measures:** Reviewing issues related to fund performance, benchmark and fee. This will also include a brief overview of profit equalization reserves (PER) and whether or not this will be relevant to an IDB Fund.

⁸⁵ This allows central pooling of resources which gives more efficiency to the collection and management of the funds. It also relieves the madrasah from fund raising and focus on improving the education and its service provision.

- ii. **Non-financial measures:** Reviewing issues related to fiduciary ratings and other non-financial risk management tools. This is important to provide confidence to investors that their investment in new markets are properly invested and safeguarded. The section will summarize IFC's approach in working with local partners and the ESG toolkit that it has developed to properly identify and manage investment risks. Risk management will be applicable not only to commercially oriented funds, but also benevolent funds.
- iii. **Liquidity:** This brief section will examine the growth of the listed infrastructure funds and other measures that may be put in place to deal with liquidity concerns.

4.2.1 *Investors' expectations - Financial Measures:*

4.2.1.1 *Infrastructure Funds – Benchmark & Performance:*

For investors of infrastructure funds, the challenge is that the risks and cash flows for projects are inverted. When the risks are highest, during the primary (construction) phase, the cash flows are negative. But once the project is operational and cash flows are attractive, the risks are significantly lower. This inverted cash to risk profile is called the "J-curve". Primary market investors are growth oriented. Secondary market investors are income oriented, and seek cash returns that are more like those from income generating real estate or fixed income instruments like bonds and structured notes.

In their 2007 analysis of infrastructure investment, Lazard Asset Management pointed out that infrastructure has two prospective homes on the risk reward scale. Mature infrastructure in developed markets or well-ordered emerging markets should enjoy a higher return compared to traditional fixed income investments. But development infrastructure entails greater risks and may require higher leverage. As a result, infrastructure under development should enjoy a return like the one achieved with private equity or hedge fund investments.

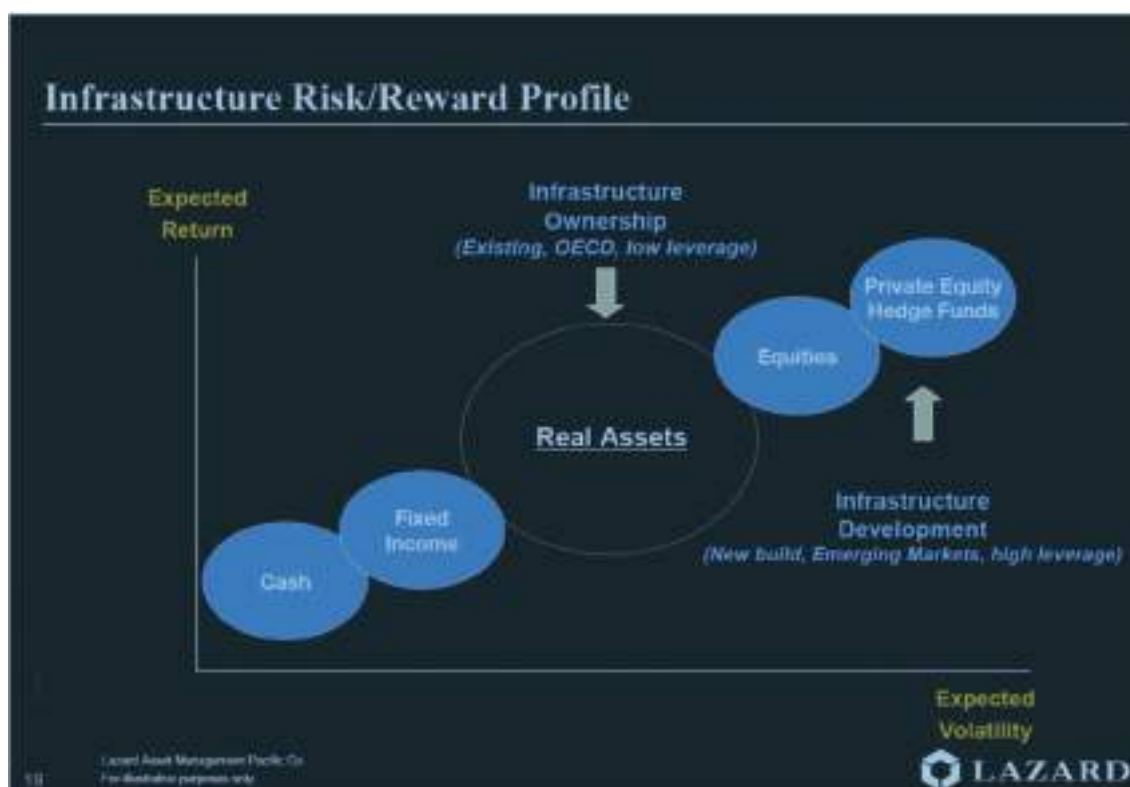


Figure 34: Infrastructure Risk Reward Profile

Institutional and pension investors have typically looked at infrastructure and development as a form of private equity investment.⁸⁶ This is consistent with PPP approaches. Yet, as investors move from equity markets to private equity, benchmarking these investments correctly becomes more difficult. Also, beyond the performance benchmarking, an issue has emerged for many Islamic investors relating to the fiduciary behavior and performance of managers: This causes many investors in the Islamic and emerging markets to seek the establishment of a fiduciary benchmark in order to rate the competence and performance of the fund manager.

According to the Food & Agricultural Organization (“FAO”) of the United Nations:

“There is currently no established benchmark for infrastructure investments.” Establishing a means to engage the quality of performance to investors, according to the FAO means examining:⁸⁷

1. Absolute returns;
2. Inflation plus margin – for instance, a consumer price index (“CPI”) with a factor added to it;
3. Bond yield plus margin;

⁸⁶ According to the Investment Company Institute, only 13% of mutual fund assets reside in Africa, Asia, Pacific and only 16% fit into non-traditional, non-classified asset classes. This demonstrates an opportunity for all forms of funds, private and public. Accessed at: http://www.ici.org/research/stats/worldwide/ww_09_11.

⁸⁷ FAO.

4. Inflation-linked bond index return plus margin;
5. Bespoke blend of equity, real estate, bond and private equity benchmarks;
6. Listed infrastructure index or global equity index or blend of the two; and,
7. Peer groups of unlisted infrastructure funds.

Traditional standards of performance benchmarking, including measurements of Alpha and the Sharpe Ratio, may not properly help investors understand what their risks are in infrastructure and emerging markets. For instance, the simple act of investing in these markets may be an Alpha strategy, but how is that Alpha correctly compared to the Alpha gained in peer infrastructure or emerging market transactions. The Sharpe Ratio has its own difficulty in the sense that the selection of the correct risk-free benchmark may prove impossible and may actually cause a distortion in understanding what is actually happening at the fund, or asset level. Therefore, thought has to be given to the development of properly calibrated alternative benchmarks.

Australia has unlisted infrastructure data for over seventeen years, and the emerging markets and global infrastructure investing markets are now able to show at least five years of data, if not ten. Therefore, one should see the existence of a clear “infrastructure benchmark” or a family of benchmarks, which are distinct from the MSCI Emerging and Frontier market equity indexes. Even the specialized MSCI Infrastructure Index’s self-description demonstrates the problems with the indices designed in the developed countries:

“The MSCI Infrastructure Indices are free float-adjusted market capitalization-weighted indices comprised of listed infrastructure companies based on the Global Industry Classification System (GICS®). MSCI further aggregates GICS® sub-industries into Infrastructure Sectors: Telecommunication Services, Utilities, Energy, Transportation and Social Infrastructure sectors. Infrastructure Sectors are not official GICS® sectors but aggregated subsets of GICS® sub-industries based on the MSCI Infrastructure Indices Methodology.

In addition to the free float-adjusted market capitalization-weighting scheme, a sector capped version of the indices is also available for clients who desire a benchmark with more balanced sector distribution. The capped weighting is designed to reduce excessive concentration in large sectors, such as Telecommunication Services and Utilities, but without over-inflating a small sector, such as Social Infrastructure.”⁸⁸

Foremost, the index cannot capture unlisted infrastructure, sukuk or infrastructure debt, and is not dedicated to emerging markets. This leads to:

“...benchmarking alternative investments in comparison with traditional asset class benchmarking. Furthermore, unlisted infrastructure as an asset class is still

⁸⁸ Accessed at: <http://www.msci.com/products/indices/thematic/infrastructure/>. Dow Jones with Brookfield has developed a competing approach with similar criteria - Dow Jones Brookfield Global Infrastructure IndexSM, see: www.djindexes.com/.../downloads/.../Dow_Jones_Brookfield_Global, as has Standard and Poors, see: <http://www.reuters.com/finance/stocks/overview?symbol=IGF.P> and Credit Suisse, see: www.holtindex.credit-suisse.com/pdf/CSRTEI.pdf.

developing in terms of performance data availability and investor expectations. Consequently, investors have had to adopt a range of less-than-perfect benchmarks.”⁸⁹

One of the main challenges in this process is that infrastructure investment practice is still highly evolutionary, and a very diverse universe of investment styles and asset types are lumped together as infrastructure. As shown throughout this study, “infrastructure” and “development” investments by institutional investors are frequent synonyms with “infrastructure” the preferred term in the market, particularly as one moves to debt and unlisted investments.

According to Colonial First:

“Single-asset class + margin or CPI plus margin and absolute return benchmarks are the best alternatives among current benchmark options. However, as the asset class develops, we expect blended asset class plus margin benchmarks and relative performance measures to become more prevalent.”⁹⁰

Based on the Australian experience, and focusing on unlisted infrastructure, Colonial First proposes a composite index construction as follows:

- Core infrastructure should return from around 8% to over 10%.
- Growth-oriented infrastructure should return between 10% and 14%.
- Diversified infrastructure funds returning from 9% to 13%.
- Greenfield infrastructure returns being at least 14% or above.⁹¹

Given IDB’s work with leading development organizations like the ADB, IDB might wish to collaborate to construct country infrastructure and development investment indices. These indices should consider the blended methodology proposed by Colonial First. The indices should probably be focused on specific investee countries and regions (India, the “Stans”, Indonesia, ASEAN ...) and then be aggregated to an IDB footprint index. Otherwise, the best measure is absolute return as compared to any other fund.

Prequin analyzed the performance of 108 unlisted infrastructure funds. **Figure 35** shows the performance of the funds in comparison to matured funds that were launched earlier. Funds that were launched between 1993 and 1999 had a median IRR of 9%. Funds that were launched between 2000 and 2005 had the highest IRR (21%). Funds that were launched between 2006 and 2008 had an IRR of less than 10%.

⁸⁹ *Setting the goalposts: A review of infrastructure fund benchmarks*, Colonial First State Global Asset Management, November 2010, accessed at www.cfsgam.com.au/Research.aspx.

⁹⁰ IBID. (Colonial First).

⁹¹ IBID. (Colonial First).

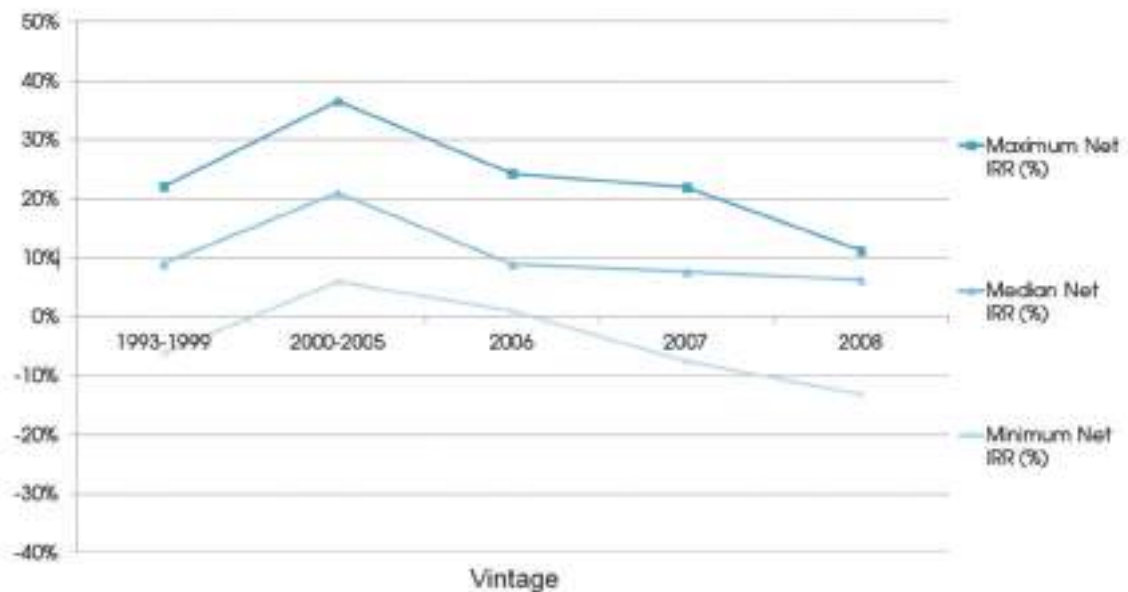


Figure 35: Performance of Unlisted Infrastructure Fund

Source (Preqin, 2012), p29

Investors in infrastructure look for stable diversified return and as tool for hedge against inflation. It is not meant to be a high risk-high return investment strategy. Nonetheless, over the recent years, infrastructure funds have outperformed private equity and real-estate funds. Refer to **Figure 36** for illustration.

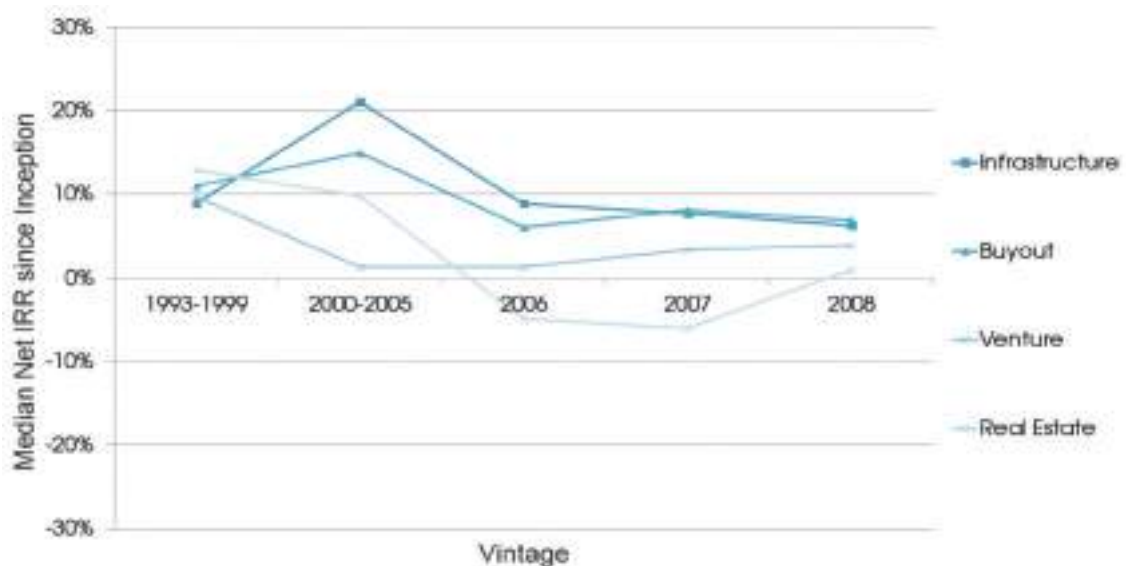


Figure 36: Performance of Infrastructure vs PE vs Real Estate Fund

Source (Preqin, 2012), p.30

In a separate survey by (EMPEA & Collier Capital, 2011), they surveyed 156 institutional investors active in the private equity market. More than 54% of the investors expect an annual net return of 16% from their emerging market portfolio.

4.2.1.2 *Other Funds Performance:*

Trade finance funds returns are normally related to the Libor market. Nonetheless, Latin America Export Finance Fund managed by Crecera Finance in San Francisco has managed to post a 9.3%, 5 years compounded annual return (CAR). Similar funds managed by Octagon Asset management and IIF Capital have also enjoyed similar performance. Although some trade finance funds are able to attract investors, these US-based funds were finding it difficult to attract investors despite their good performance (McAuley, 2012).

As for the benevolent fund, since the aim is to assist and make below market return, the non-financial measures will be more crucial for these investors.

4.2.1.3 *Smoothing of Return:*

Many Islamic banks use profit equalization reserves (PER) to smoothen the payment of returns to 'profit sharing investment account' (PSIA) holders. Since PSIA is based on *Mudarabah*, the depositors will be exposed to the performance of the bank rather than enjoying a predetermined return. Therefore, when the bank is enjoying high performance, it will allocate some of the return to the PER (which has both the bank and the depositors portion) before making a distribution to the depositors. During rainy days, the bank will use these reserves to pay the market return to investors.

In the banking market, PER is put in place to ensure that the depositors are paid the market return and minimize actual exposure to the bank's performance. In a funds setting, PER may not be directly relevant as the investors understand the risks of investment and do not require payment of pre-determined return. In cases where the fund uses debt instruments, it may set up a financial services reserve account to ensure it can meet the debt payments. Rather than income-smoothing mechanisms, investors value proper investment decision and risk management to safeguard their investment.

4.2.1.4 *Investment Term:*

Investors in emerging markets often have shorter horizons than is required for assets to be created in the same markets. Emerging market-domiciled investors frequently prefer investments between three and five years with some willing to stretch to seven or ten years. IDB's first infrastructure fund had a ten-year initial investment period and allowed for an extension of three more years. Global pension and life insurance companies are comfortable with longer terms due to their business models which require long term capital gains and a steady income to meet the need of pensioners, annuitants and beneficiaries. Global institutional investors also dislike reinvestment risk. As a result, a ten year horizon is best to attract global investors, but requires work to attract investors from the local emerging and investee markets.

4.2.1.5 *Management Fee:*

Since the mid 2000's, investor representatives have been advocating a significant

change in fee structures.⁹² (Probitas, 2007) also raises the question of the costs to invest. The typical general partnership structure is based on an annual fee assessed against assets under management. This might be between 1–2% p.a. Then there is a carried interest or participation in profits which may be anywhere from 10–30% of absolute performance against a performance barrier.⁹³ Prequin, in its survey of investors, highlighted that the most common reason cited for misalignment of interest between the GP (General Partner) and the investors are a high management fee, paying a fee on un-invested capital, carry structure and the poor structure of the performance fee (for example, the performance fee is based on capital appreciation and not above certain clear hurdle rates).

Table 13 summarizes the common structure for different fees charged by funds and the changes that investors are increasingly expecting fund managers to make.

Type	Common	Recommended
Management	Committed funds	Invested Capital or NAV
	1 – 2 %	Approach actual management costs
Hurdle rates	8%	Link to fund strategy
	Cash flow	European waterfall: LP recovers all capital before it is eligible (to be clarified)
		Catch up after return of capital
		Only if GP achieves Alpha at a high level
Transaction fees	Cut to manager	None to manager or
		Transparency
Bidding PPP/PFI projects	Costs to investors	Split costs between manager and investors

Table 13: Investors' Concerns on Fee charged by Funds

⁹² In addition to Risk Metrics, see Towers Watson, A fairer deal on fees: Our thoughts on alignment of manager fees, 2007 - www.familyofficesummit.com/digital_assets/5487/A_fairer_deal_on_fees.pdf

⁹³ Op. Cit., Probitas.

4.2.2 *Investors' expectations - Non-financial measures:*

This section will examine two approaches to manage risks in a fund; fiduciary rating and the IFC's Approach in Managing Risks in the PE Fund.

4.2.2.1 *Fiduciary Rating:*

In western countries, fiduciary ratings are now delivered by fund rating companies. These generally cover investments managed by a regulated entity like a bank, an insurance company, a registered investment company (mutual fund), or a registered investment adviser. The rated investment must have a minimum track record, typically three years.⁹⁴

In order to be eligible for a fiduciary rating the same portfolio management team, and its senior manager should be in place for at least two years. Turnover in the management team or by the senior manager leads to lower ratings. Rated managers must have a minimum quantum of investments under management across all classes.

The manager is rated for his performance in a particular type of asset class and actual management skill in the class (i.e. is not tracking and is not over-weighted in cash). If the manager fails to adhere to stated investment objectives then the manager will face deductions from the fiduciary rating. The manager must show "style consistency".

The rating services also examine the manager's expense ratios/fees relative to peers. Fiduciary ratings also examine the risk-adjusted performance of a manager relative to its peers. The measures applied for risk-adjusted performance are the fund's Alpha and Sharpe Ratio.

In the studies seeking to establish a pan-African fiduciary rating agency, the distinction is made between operational risk, which tends to relate to fraud, and fiduciary risk, which relates to failing to perform ones duties properly. Refer to **Table 14** for details.

The International Islamic Rating Agency ("IIRA") has added a specific approach to the fiduciary ratings in order to capture the unique characteristics of Islamic finance.⁹⁵ The IIRA method builds on the manager or bank's credit rating as well as the unique fiduciary score that IIRA creates. The former is the capacity of the manager to perform its financial obligations. The fiduciary score is driven by analysis of the corporate and *Shariah* governance, i.e. the manager's transparency and disclosure, compliance with *Shariah* as the manager is governed by it, and, as with conventional, the manager's actual peer adjusted performance quality.⁹⁶ For project level managers, IDB may apply IIRA fiduciary manager ratings.

⁹⁴ This discussion is derived from Fiduciary Score® methodology Updated March 26, 2011 and accessed at www.fi360.com/fa/help/pdfs/methodology.pdf

⁹⁵ The IIRA has developed its rating approach jointly with its technical partners and shareholders, JCR-VIS Credit Rating Company of Pakistan and the Malaysian Rating Corporation.

⁹⁶ Accessed at <http://www.iirating.com/ratingfiduciry.asp>. Also see: <http://www.fa-mag.com/component/content/article/1022.html?issue=51&magazineID=1&Itemid=27>. Also see: www.jcrvis.com.pk/Images/FR-Methodology.pdf.

Definition	Under Credit conditions	Under Fiduciary conditions
Risk in general Danger of future negative deviation from expected return	Probability of impairing the obligation of result outside financial risks (credit and market)	Probability of impairing the obligation of means outside financial risks (specific and systematic)
Operational risk Probability of loss resulting from inadequate or failed internal processes, people and systems or from external events.	OpRisk Meaning All non-financial residual danger causing an implementation shortfall in meeting an obligation of result	OpRisk Meaning Inadequate means, resources or practices to meet contractual expectations of investors
Impact of loss on:	The institution's shareholders' equity. Little effect on depositors	The investor's equity. Little effect on management shareholders
Risk traceability	Clear by values, fraud or disaster to replace or recover ex-post, with an expected return that must be attained regardless of the loss incurred	Confusing with few available measurements of practice shortfalls affecting expected returns (beside attribution and transaction cost analyses)
Distinguishing OpRisk	Easier to isolate against financial risks (credit or market)	Complex to isolate with systems and processes embedded in investment making
Compliance & risk control driver	Fear of capital loss drives governance behavior	Compensation and remuneration drive practices
Fraud & legal or regulatory breach	Lower visibility of breach with potential impact on creditworthiness	High visibility of breach of fiduciary duty with direct impact on trustworthiness

Table 14: Operational Risks under Credit and Fiduciary Conditions

Source: Establishment of a Pan-African Fiduciary Rating Agency Project No. 2007/146028 ⁹⁷

4.2.2.2 IFC Approach – Local Partner & Environmental, Social and Governance (ESG) Screening:

IFC has been investing in the private equity market since the 1990s, but reorganized its operation into a dedicated department in 2000. The return on IFC's PE fund (exclude real estate, debt and listed equity funds) from 2000-2009 was 18%, compared to the 16% top quartile Cambridge Indices – Emerging Markets. Prior to the reorganization, IFC return on the 1990s funds was 4-5% and the top quartile was 11.9%.

To support the development agenda, IFC prefers to use first time fund managers and has considerable investment in Africa. It highlights that there are three widely held misconceptions about investment in emerging markets:

- A minority position in emerging market is risky due to lack of proper legal systems, governance and transparency.
- There is an exit constrain for emerging market PE.
- Small companies are risky and it's double the risk when these companies are in emerging markets.

IFC refutes all of the above perceptions and its fund performance supports its view. Based on 150 IFC PE Funds as of March 2009, it conducted a comparison of its top 10 and bottom 10 funds. First time funds were equally represented in the top and bottom

⁹⁷ Accessed at www.acpbusinessclimate.org/PSEEF/Documents/Final/fiduciary_rating_en.pdf

sample. And both segments have funding to countries with less than \$1,000 per capita income (IDA), with the top 10% having higher amount of funding to IDAs.

	IRR as of March 2009 (simple avg %)	Development Impact Score (1 to 3, 3 = Highly Successful)	First Time Funds %	IDA % (< \$1000 GDP per capita)	Average Deal Quality Score (Max = 1, Min = 0)
Top 10%	46.6%	2.1	53%	27%	0.97
Bottom 10%	-38.3%	0.14	53%	13%	0.17

Table 15: IFC Fund Performance Comparison

The final column in **Table 15** measures the quality of IFC's general partners. IFC assigned a score between 0 and 1 to reflect the extent to which the GPs have met the critical success factors for emerging market PE success. Most of the factors evaluate whether the GPs are locally based, their experience in PE and managing business etc.⁹⁸ The top 10% not only delivered superior financial returns, but also had a higher development impact. The difference between the two groups was the quality of the GPs. The top 10% have better GPs as reflected in the higher score in the final column. Thus, IFC advocates that the success recipe for successful PE operation in emerging market is to ensure that the GP is properly evaluated and selected.

IFC arrived at this approach from the experience that the IFC's CIO gained while he was with the World Bank's pension fund private equity investment. David Wilton found that GP teams with high number of investment bankers tend to use leverage as their strategy to improve the IRR. While GP teams with former company managers tend to focus on revenue growth and improved efficiency to build a higher IRR. Since in many emerging markets there is limited leverage available, it is vital to have GPs with the proper skills needed to improve the investee company. This is basically the crux of IFC's strategy. It is recommended that IDB works with IFC to leverage from its experience in choosing a local partner with the right skill set to manage the PE investments.

Besides the local partner approach, IFC has also developed an online toolkit to help fund managers and other stakeholders evaluate the environmental, social and governance risks and opportunities of different investment portfolio. It involves a four step process:⁹⁹

- i. Users will answer screening questions on the website that will generate risks and opportunities appraisal questions.
- ii. Then the user collects information to these questions offline.

⁹⁸ Questions that IFC evaluated: was the GP locally based?; were a meaningful number of staff local nationals?; did the team possess experience that would enable them to add value to companies such as prior experience in running companies, as entrepreneurs or as consultants?; did someone in the team have prior experience in private equity?

⁹⁹ <https://www.estoolkit.com/HelpVideo.htm>

- iii. Next, the user inputs the answers to the risks and opportunities appraisal questions online.
- iv. The system will then generate an action plan which the fund managers will keep to monitor the risk and opportunities in the investment.

IFC implements its performance and environmental standards in the toolkit. This enables the local GP to effectively implement the required performance standard. IDB is also recommended to work with IFC to adopt similar approach. This toolkit will benefit the commercially oriented funds. It may also help put in place proper risk management approaches to the socially oriented funds.

4.2.3 Investors' expectations - Liquidity:

Funds, unlike listed investments, lack the same liquidity profile. There is not necessarily a ready market for these instruments, and the underlying investments are not necessarily easy to monetize. Even when there is a secondary market, these types of investment may not trade, or may trade at a wide bid-offer spread. This section will examine the trend in listed infrastructure funds and briefly discuss whether alternative liquidity measures are needed.

The listed infrastructure funds market started much earlier than the unlisted funds market. The first listed infrastructure fund was pioneered in Australia in the mid-90s. Since then, infrastructure funds have been listed in London, New York, Toronto and Singapore. The market for listed infrastructure funds grew actively since the 2000s and peaked in 2008. Since then, a number of funds have been delisted which brings the active listed funds to 41 in 2011. Kotak India Infrastructure Fund was the only fund launched in 2011; listed on LSE. Most of the listed infrastructure funds are in Australia (32%), Canada (24%) and the US (19%). The majority of listed funds are managed by a single vehicle except for Macquarie that manages three funds (Preqin, 2012)

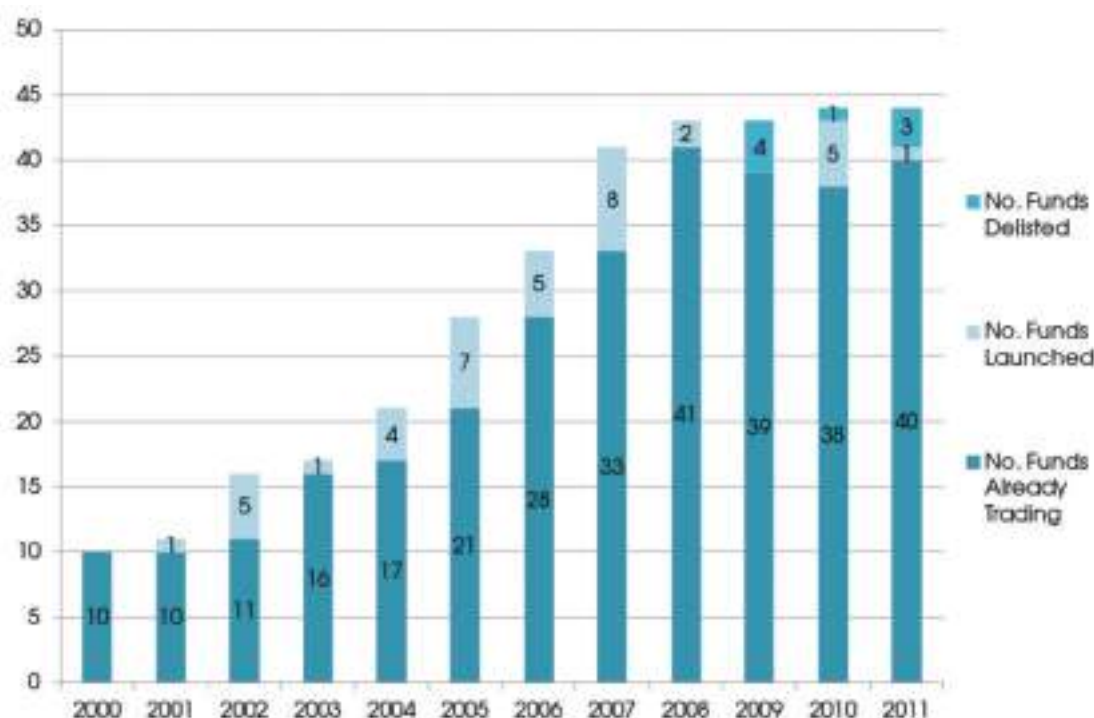


Figure 37: Listed Infrastructure Funds

Source: (Preqin, 2012), p55

Listed funds obviously have the liquidity advantage, thus investors may adjust their committed amount at a short notice. When funds list, the units are liquid, but the price is not necessarily the NAV, but whatever the market demand establishes and this could be a discount or a premium. And from time to time, the market may not have demand for securities. However, listed infrastructure funds have a higher correlation to the overall equity market – thus limiting the diversification benefit that the unlisted infrastructure asset class brings.

Investors in the unlisted infrastructure funds are normally investors looking for long term investment and not necessarily looking for liquidity before maturity. The historical trade-off for private equity is that the payoff is long term and the investor's liquidity preference is subordinated to the investor's preference for a high return on the investment. Normally, if these investors want to exit the investment, they will have to find investors in the secondary (mostly OTC) market.

In the private, unlisted funds market, some fund sponsors provide liquidity facilities whereby the sponsor provides credit against a pledge of securities. Effectively, this makes the sponsor the investor of the last resort. This means that the sponsor may lack capacity to provide the facility. The sponsor's capacity is prospectively limited by country risk, obligor credit or investment risk, or even securities laws in the sponsor's domicile.

Therefore, some funds arrange for secured liquidity facilities to be provided by third party lenders. Even these facilities have limits. And during a crisis such as the 2008 financial crisis or the 2012 Eurozone crisis, some lenders may not be able to honor their commitments.

A distinctive form of liquidity feature is a unit purchase pledge often organized by the fund sponsor. Buy-back features often have a specific limit on the volume of units on specific dates subject to notice. Sometimes these features are successful especially if the fund is performing. But, a number of cases have been documented in which a fund underperformed and the liquidity feature prompted a run on the fund with the investors attempting to treat the sponsor as the residual equity owner.

UCITS or transferrable securities vehicles are an alternative to listing, but have some of the same risks as listing in terms of the price of the units. Generally, UCITS-governed funds will transfer at NAV if there is a buyer in the market.

Another tool to manage liquidity risks is to build cash reserves for allocated purposes.

In addition, the fund may also apply an exchange traded fund (ETF) strategy. A group of investors that have the fund shares will deliver the shares in return for units in the ETF. The holders of the ETF units may trade this for cash in the secondary market. This will provide liquidity for the fund.

In India, the infrastructure funds are structured via a mutual fund vehicle to tap into retail investors. The committee recommended that the Development Infrastructure Fund (DIF) should be given 24 months listing option to avoid negative trading during the investment phase. Besides the grace period for listing, the committee suggested that the fund is allowed to buy-back the units from the market if the DIF is not able to fully deploy the fund. The committee also recommended that the full drawdown is done at the closing to avoid operational complexity with multiple drawdowns in the retail market.

4.3 Domicile Selection

The top jurisdictions for Islamic funds were used as a basis to select the first group of domiciles to be analyzed.

Table 16 lists the domiciles of choice for Islamic funds by (Ernst & Young, 2011).

Jurisdiction	AuM (US\$)	Number of Funds
1. Saudi	\$19.9b	225
2. Malaysia	\$5b	171
3. Caymans	\$4.13b	57
4. Bahrain	\$1b	46
5. Singapore	\$0.72b	10
6. DIFC	\$0.51b	14
7. Luxembourg	\$0.48b	29
8. Dublin	\$0.22b	8
9. Mauritius	\$0.14b	3
10. Malta	Application of Islamic Funds under review	

Table 16: Domiciles of Choice for Islamic Funds

Source: (Ernst & Young, 2011), p.37

Among the top five jurisdictions, only Saudi Arabia is a purely onshore focused jurisdiction. This means that Saudi Arabia lacks the regulations and structures that would facilitate outbound investments into the international markets. Therefore Saudi Arabia is excluded from the analysis.

Besides the Islamic funds, the domiciles for infrastructure funds were the next selection criteria. These tend to be domiciled in five jurisdictions reflecting certain forms of expertise: Australia on the ASX, London, Singapore, Korea and Toronto. The listed infrastructure funds have an interesting dynamic: they tend to be in jurisdictions with a Real Estate Investment Trust ("REIT") vehicle allowed under local law and regulation. This is partially because infrastructure funds have copied REIT dynamics as income dispersing funds and the stapled operating, management company concept (which will be discussed below).¹⁰⁰ The ASX reflects the unique position of Macquarie as an organized fund and the size of the domestic infrastructure fund business. Yet, Australia is not a tax efficient international jurisdiction. London and Singapore compete with Australia for the global business. Korea and Toronto

¹⁰⁰ Infrastructure Funds: Managing, Financing and Accounting in Whose Interests? Risk Metrics Group, 2008. Accessed at: www.maynereport.com/images/2008/09/01-13GEDV97N00.pdf.

reflect domestic fund dynamics and are less international than the other jurisdictions. Since Singapore already overlaps with Islamic funds domicile above, this means only London will be added to the jurisdiction list.

Finally, the analysis will also include Qatar Financial Center (QFC) to test additional GCC domicile, and two other offshore jurisdictions; Jersey and Bermuda; as these are used in *Sukuk* and other Islamic finance transaction. The final list of jurisdiction analysis will include:

1. Malaysia
2. Luxembourg
3. Caymans Island
4. Mauritius
5. London
6. Singapore
7. Bahrain
8. Dublin
9. DIFC
10. Jersey
11. Bermuda
12. QFC
13. Malta

We have ignored a large number of centers for one of two reasons. They are like Saudi Arabia, fundamentally a domestic market catering to its own needs. This will surely be the case for both Mumbai and Jakarta, both aspiring to become international as opposed to domestic financial centers.

Other important centers like Tokyo, Hong Kong, Bahamas and Panama are considered in this study. These centers are typically peripheral to the Islamic finance market: either they have not done the footwork to attract the Islamic funds market or they have not yet built a track record with GCC investors.

Other planned financial centers like Istanbul and Amman have not yet put all of the pieces to their puzzle in place and are not yet ready to be considered. A challenge for many emerging market cities to truly internationalize will be their ability to manage the pull between serving transient global capital and fulfilling domestic financing demand. Larger countries like India, Turkey, Nigeria and Saudi Arabia will be more like the United States than the United Kingdom as robust domestic needs will shape regulation and financier focus.

4.3.1 Evaluation Criteria

The research objectives are three fold; off balance sheet financing, efficient cost of fund and diversified investor reach. Among these objectives, domicile does not affect the first two factors directly, while the last factor may be used to evaluate the domiciles. Therefore, the domiciles will be evaluated based on two groups of criteria; breadth of investors reach and business factors. These factors will be assigned numerical values and applied to each jurisdiction discussed in this chapter as summarized in [Table 17](#)

Evaluation Criteria	Brief Explanation
A. Breadth of Investor Reach	Primary evaluation criteria – 100% weight
i. Master-Umbrella-Feeder (MUF)	Allows multiple structuring tools to capture broad investor group (fund of funds tool)
ii. Global investor Recognition	Qualitative evaluation whether it is widely used by international investors.
iii. Islamic Investor Recognition	Qualitative evaluation whether it is already used by Islamic funds/investors
iv. UCITS	Provides European passport to reach global investors
v. Number of Funds (Volume)	Quantitative evaluation as a proxy for international investor recognition. Not all international jurisdictions have big volume. E.g. Jersey is internationally recognized, but has a smaller market share compared to Caymans or Luxembourg
vi. Tax Treaties	Higher number of tax treaties facilitate free movement of funds between jurisdiction, thus allowing broader group of investors
vii. Listing	Whether or not a fund may be listed; used as a proxy to measure capacity to support liquidity.
viii. Cross Registration: Managers & Funds	Whether jurisdiction recognized non-registered manager and companies as local domicile. Positive scores recognize this, thus enhances free movement of fund and potential liquidity
ix. Unrestricted Placement	Whether retail placements are available and facilitated. <ul style="list-style-type: none"> • Positive: Retail available – broader investor group • Negative: Only private placements
x. ETF and/or REITs	Availability of ETF/REITs provides an alternative tool for liquidity and attract different investor group.
xi. AAOIFI/IFSB Recognition	Enhances Islamic investors' confidence
B. Business Factors	Secondary evaluation criteria – 50% weight
i. Low or no tax	Lower taxes are better.

ii. Establishment Costs	Lower costs are better. Usually costs below \$30K are an advantage (positive). Costs higher than \$50K is a disadvantage (negative).
iii. Director Residency Requirement	Whether local directors are required. If yes, a negative, since this will increase cost.
iv. Require Local Fund Admin services	Whether fund admin services must be local. If yes, a negative since this will increase cost.
v. Time to Market	<ul style="list-style-type: none"> Positive: < 2 months Negative: > 6 months

Table 17: Domicile Evaluation Factors

Scale	-1	0	1	2
Definition	Doesn't support	Neutral	Benefit	Optimal benefit

Table 18: Definition of Scale used for Evaluation

The breadth of investors reach will be the primary criteria and will receive 100% weighting based on the scale in Table 18. Business factors are secondary evaluation criteria and will receive 50% weighting. Breadth of investors covers 11 different aspects that examine which domicile allows reaching out to the largest group of investors. The business factors cover 5 aspects related to the cost of setting up and running a fund in the different domiciles. All these factors are summarized in Table 17.

Evaluation Criteria	Brief Explanation
A. Breadth of Investor Reach	Primary evaluation criteria – 100% weight
xii. Master-Umbrella-Feeder (MUF)	Allows multiple structuring tools to capture broad investor group (fund of funds tool)
xiii. Global investor Recognition	Qualitative evaluation whether it is widely used by international investors.
xiv. Islamic Investor Recognition	Qualitative evaluation whether it is already used by Islamic funds/investors
xv. UCITS	Provides European passport to reach global investors

xvi. Number of Funds (Volume)	Quantitative evaluation as a proxy for international investor recognition. Not all international jurisdictions have big volume. E.g. Jersey is internationally recognized, but has a smaller market share compared to Caymans or Luxembourg
xvii. Tax Treaties	Higher number of tax treaties facilitate free movement of funds between jurisdiction, thus allowing broader group of investors
xviii. Listing	Whether or not a fund may be listed; used as a proxy to measure capacity to support liquidity.

A key factor for jurisdiction is the type of structure that it can support. To build a program, there are a number of concepts to consider: one-off funds to purpose, structured from time to time; fund of funds; feeder funds; and umbrella funds. The expected strategy should also contemplate mixing the different concepts into a complex architecture managed by IDB, but delivering simpler fund offerings to purpose as required. In order to do this, the key concepts of collective investments need to be defined:

- i. *Collective Investments*: A collective investment scheme is a pooled investment and may also be called a “unit trust” or a “mutual fund”. These programs are meant to enable investors with common interests to work with a common manager through the same legal entity. These funds may be private or public funds. An IDB-approved fund is likely to be a private fund. But strategically, sub-funds may be mutual funds or unit trusts under local market regulations which are open to retail investors. All of the jurisdictions surveyed treat any form of fund as a collective investment scheme. Regulators often are concerned about three other forms of fund vehicle that are less common.
- ii. *Fund-of-Funds*: A *fund-of-funds* (“FOF”) is an investment fund that invests in other investment funds. The investee funds may be managed by the sponsor or selected from the market as “best of breed”. Instead of selecting its own portfolio constituents, the FOF evaluates and approves managers of various investment classes. The FOF then buys units in the approved funds. As a result, the concept is frequently called a *multi-manager investment strategy*. Regulators like Malaysia’s Securities Commission often restrict FOF from investing in other FOF. In other words, the Malaysian regulations are meant to assure that an FOF strategy does not have multiple underlying FOF. The proposed IDB structure will not apply a FOF strategy although elements of the strategy may appear to do so for tactical reasons.
- iii. *Feeder Fund*: A feeder fund is similar to an FOF. Except that a feeder fund exists in one jurisdiction with the purpose of investing in a master fund which may be in a different jurisdiction. A master fund normally receives investments from feeder funds in jurisdictions that may pose cross registration or tax challenges for the master fund. The master fund is often an offshore fund, whereas the feeder fund is normally an onshore fund. Master–feeder fund structures are meant to assure that master funds reach more investors than their domicile facilitates. Master–feeder structures are often meant to reduce tax,

manage different regulatory risks for the master fund, and improve the master fund's economies of scale for the fund. Master-feeder structures are also characterized as *hub and spoke* structures. A feeder fund differs from a fund-of-funds strategy as the feeder is not responsible for investment execution. The master fund is the asset manager.

- iv. *Umbrella Fund*: An umbrella fund is a collective investment scheme that offers its members a choice between several distinct sub-funds. Each sub-fund follows a unique strategy. Investors are often able to switch between sub-funds subject to an executed exchange at the prevailing NAVs of each fund. An umbrella fund is similar to an FOF, but instead of the umbrella fund's manager allocating money, the investors direct funds to the sub-fund that suits their investment goals.

Generally, a fund company is a limited purpose company or SPE as discussed in 2.4.1. A well-structured regime for SPEs and their ease of formation and cost efficiency are important factors in the determination of establishing a fund. The following section will examine individual jurisdictions before conducting the overall evaluation of all jurisdictions, and the friendliness of each jurisdiction to SPEs will be an important factor.

4.4 SWOT Analysis of Individual Jurisdictions

4.4.1 Malaysia

Malaysia possesses onshore and offshore capacity, although the market is overwhelmingly domestic. The offshore capacity in Malaysia is available through both Labuan and the Malaysian International Islamic Financial Centre. Both are increasingly used for cross border investments. Integrating the MIFC, Bursa Malaysia, and the Labuan offshore center, Malaysia fulfills the largest universe of potential needs. Important recent developments for Malaysia include understandings with both Luxembourg and Ireland, which have recently been tested so that Malaysian managers are able to access UCITS platforms and appeal to European retail and institutional investors. A hub of Islamic finance innovation and talent development, Malaysia has not yet built a deep recognition as an offshore center for international investors.

Malaysia has an efficient trust law and low cost SPV process that is fast and efficient. The regulators are well coordinated in their efforts to build a well-governed edge for Malaysia's established Islamic finance hub.

Unlike smaller countries, for instance Luxembourg or Bahrain, Malaysia is prospectively its own biggest threat in that the offshore business must compete for talent and attention with the vibrant domestic business.

Already a large domestic Islamic fund market and the leading global center for *sukuk*, Malaysia presents one of the leading English law derivative jurisdictions to organize funds. The strategic location and abundance of talent rank Malaysia as a top choice.

Malaysia	
Strength	Weakness
<ol style="list-style-type: none"> 1. Integrated Islamic supervision, tax & regulatory infrastructure including Malaysia Int'l Islamic Fin. Centre (MIFC) 2. Developed IF market, education (INCEIF), professional services (legal, accounting, IT, ...) – Enforceability, standardization 3. 170+ Islamic Funds with \$5.1b in Assets 4. Labuan Islamic Financial Services & Securities Act 2010 (LIFSSA) 5. Labuan based funds have attractive regulatory costs: MYR 5,000 – non-Labuan operating funds pay MYR 10,000 6. Taxes: Zero on capital/income/dividends – exemptions to 2020 – no withholding tax – advanced tax ruling availability 7. 64 Double Tax Agreements 8. Labuan IBFC to raise non-MYR capital 9. Islamic ETFs traded on Bursa Malaysia 	<ol style="list-style-type: none"> 1. High volume – low market capitalization transactions 2. Less familiar to global institutional investors for cross border investing 3. Has yet to overcome some negative perceptions from GCC.
Opportunity	Threat
<ol style="list-style-type: none"> 1. Heart of ASEAN 2. Proximity to Indonesia and Pakistan (largest Muslim populations in world) as well as India & China 3. Largest Sukuk market - 65% of global 	<ol style="list-style-type: none"> 1. Competes with own onshore market 2. Competes with major offshore centers

4.4.2 *Luxembourg*

One of the few offshore centers that is not a sunny island, the Duchy is taking the Islamic capital market business seriously and has established good relationships with different Islamic financial centers, notably Bahrain and Malaysia. Luxembourg is also a member of important Islamic financial service capacity building bodies. As the world's number two funds center and a UCITS compliant jurisdiction, Luxembourg offers an almost perfect environment in which to introduce global institutional investors to Islamic funds.

The business environment is constructive, makes it easy to market in Europe, and a large number of tax treaties facilitate cross-border fund business. The main challenge for civil law Luxembourg is its relatively high cost of doing business.

Luxembourg	
Strength	Weakness
<ol style="list-style-type: none"> Hub for international funds distribution: Domicile of 75% of cross-border funds and second largest investment fund center after the US (\$2 trillion AUM) Part 1 of the 2010 UCI Law governs UCITS (Undertakings for Collective Investments in Transferable Securities) <ol style="list-style-type: none"> Applies to MM & Equity IF HSBC Amanah's UCITS domicile Multiple legal forms Sub funds No issue/redemption restrictions No dividend distrib. restrictions Eligible for EU Passport, et. al: 700 Lux. funds registered in Bahrain Active government support for Islamic finance: Central Bank is a member of the IFSB and IILM 30+ Islamic Funds with \$0.58 AUM Easy to do business: No IF-specific requirements; No residency requirement for directors; Minimum prospectus content; Quick launch (6-8 weeks once submitted). Reasonable costs: Euro 2,650-5,000 annual license fee; and Euro 6,000 min. cost to establish fund Tax Authority gives clear tax guidelines: No dividend withholding tax and No corporate income or business tax. 	<ol style="list-style-type: none"> Higher cost of business vis-à-vis others No specific IF tax provisions Required services for UCITS: <ol style="list-style-type: none"> Depositary Central Admin. Agent Auditor Min. Euro 1.25 m capitalization within 6m Reporting requirements Annual subscription tax (0.05% of NAV) Companies registered in Luxembourg City may be taxed at a combined 28.80% rate <ol style="list-style-type: none"> May be offset by an extensive participation exemption regime
Opportunity	Threat
<ol style="list-style-type: none"> Microfinance Investment Vehicle (MIVs) Door to Europe & int'l cross-border sales Possible dual tax treaty benefits (SICAVs) Tax authority has issued two tax guidelines covering <i>Murabaha</i> & <i>Sukuk</i> transactions Possible to re-register or acknowledge fund company form another jurisdiction. 	<ol style="list-style-type: none"> Competes with offshore centers globally. Trapped between European giants France and Germany with own views on taxes and offshore centers.

4.4.3 Cayman Islands

With 70% of the world's hedge funds domiciled in the Cayman Islands and over 9,000 registered funds of all types, the Cayman Islands are a leading global fund hub. Based on English law, the Cayman Islands are one of the most popular destinations for GCC and Islamic investors to structure funds and securities. The Cayman Islands allow appeals of local law decisions to the Privy Council in London. The ease and cost of doing business are favorable, and this, along with easy to use trust and companies laws. The Cayman's top legal firms have all opened offices in London and the GCC. But the talent universe is somewhat limited and funds are restricted to accredited investors. Another issue that surfaces from time to time is the impact on the Cayman Islands from various pressures from the United States.

Cayman Islands	
Strength	Weakness
<ol style="list-style-type: none"> 1. Flexibility of Investment Fund Regime 2. Mutual Funds Law (2009 revision) <ol style="list-style-type: none"> a. Licensed: least common overall b. Administered via existing Cayman Island administration. c. No \$100k minimum investment. d. Alternative Investment Funds established as open or closed ended variants of unit trusts, companies, or limited partnerships. 3. Dual Arabic registration for IF products 4. 57 Islamic Funds with \$4.13 b (AuM) 5. 20-50 yr. profit/income/capital gains, tax breaks. 6. 17 tax info accords including USA & UK 7. Expedited business processes and reasonable costs: 3-5 week timeline to launch Licensed funds: US\$10k-20k establishment costs; \$3,000 registration fee and \$3,000 annual licensing fee; No requirement for local audit sign-off and No requirement for local service providers 8. One-stop shop service providers: 31 law firms, 35 accounting firms, 148 admin., 259 licensed banks, 81 corp. serv. prov., 106 trust cos. 	<ol style="list-style-type: none"> 4. Same administrators oversee many funds – Agency issues 5. IF treated same as conventional funds 6. Viewed in negative light as a tax haven 7. \$100,000 minimum investment and local audit sign-off for CIMA-registered investment funds

Opportunity	Threat
<ol style="list-style-type: none"> 1. Recognized Fund & Trust industry 2. Umbrella Funds are allowed: funds with “segregated cells”. 3. Possible to re-register or acknowledge fund company form another jurisdiction. 4. Multiple classes and currencies are permitted. 5. Unlimited cap on fund equity. 6. Popular jurisdiction for Sukuk and Private Equity Funds 7. Aircraft and Ship Registration hub 	<ol style="list-style-type: none"> 1. Other offshore centers 2. Impositions by US to tighten regulations

4.4.4 *Mauritius*

Although far from anywhere, Mauritius has built a good international funds business leveraging tax treaties with India and many African countries. These have already allow the blended law (Mauritius has both civil and English law environments due to having been ruled by both Britain and France at different times). As a result, the bi-lingual island has attracted a significant amount of global institutional investor activity.

Mauritius	
Strength	Weakness
<ol style="list-style-type: none"> 1. Government actively supporting IF: Bank of Mauritius (Central Bank) is associate member of IFSB and founding member of IILM 2. 3 IF with \$0.14 b (AUM) 3. Taxation: two tier tax system according to fund type: 3% for GBL 1 funds and 15% for GBL 2 funds 4. 36 Tax treaties 5. Free repatriation of investment funds 6. \$10,000 annual license fees 7. 4-6 weeks to fund launch timeline 	<ol style="list-style-type: none"> 1. Liquidity 2. Distance to most markets
Opportunity	Threat
<ol style="list-style-type: none"> 1. One of few countries with a tax treaty with India. 2. Good treaties with most of Africa 3. HSBC Amanah uses it for many funds 	<ol style="list-style-type: none"> 1. Other offshore centers. 2. Trained manpower

4.4.5 London

On one hand, London is the leading global financial center. London has a long history supporting the Islamic financial services industry and hosts five Islamic banks as well as large number of asset managers currently serving the Islamic market and among the top global asset managers. All leading and many mid-tier UK law firms are well represented in the GCC, Africa, Asia, and the Americas.

Progressively, over the early 2000s, the UK regulatory and tax authorities have worked carefully to facilitate a well governed environment for Islamic financial institutions, funds, and securities. A notable outcome is that the London Stock Exchange hosts a large volume of *sukuk* and can support *Shariah*-compliant ETF and other securities.

On the other hand, London is a high cost center.

London	
Strength	Weakness
<ol style="list-style-type: none">1. Global Financial Center2. Long regulatory familiarity with the Islamic finance business and funds.3. One-stop shop for ancillary services<ol style="list-style-type: none">a. 20 law firms specializing in IFb. Training, advisory services, auditing4. 34 IF with \$0.3 billion (AUM)5. Home to 5 fully <i>Shariah</i>-compliant banks	<ol style="list-style-type: none">1. High cost of doing business2. Unfavorable onshore tax treatment3. Onshore market
Opportunity	Threat
<ol style="list-style-type: none">1. Deep fund and fund management infrastructure2. 31 <i>Sukuk</i> worth \$19 b listed on LSE3. 1st Corporate <i>Sukuk</i> issued in 20104. ETFs traded on LSE	<ol style="list-style-type: none">1. Competes with offshore centers2. Managers may move to lower cost venues or closer to clients

4.4.6 Singapore

A leading global financial center, Singapore has been making a concerted push to expand its market share in Asia. This has included a progressive series of regulatory and practical decisions to facilitate Islamic finance including various tax waivers and qualifications to attract *sukuk* investors.

With a strong talent base and good treaties with India, Singapore is a high cost provider. The island state enjoys a good reputation for governance.

Singapore	
Strength	Weakness
<ol style="list-style-type: none"> 1. Stability, transparency, reputation, volume 2. Global Financial Center 3. Government revised regulatory framework & tax structure to facilitate IF 4. 10 Islamic Funds with \$0.72 b (AuM) including Islamic REIT 5. Offshore Funds tax exempted if 80% funds from foreign investors 6. Reasonable costs: SGD 4,000 annual license fee 7. Expedited business processes: 14-21 day fund launch timeline 	<ol style="list-style-type: none"> 1. Onshore Funds subject to 20% taxation 2. Local audit sign-off requirement
Opportunity	Threat
<ol style="list-style-type: none"> 1. Large domestic pensions and SWF 2. 700 fund managers with SGD400 b (AUM) 3. Advantageous tax treaties with India, Japan and other countries 4. Government revised regulatory framework & tax structure to facilitate IF 	<ol style="list-style-type: none"> 1. Other offshore centers <ol style="list-style-type: none"> a. Mauritius (for India) b. Malaysia (more human resource) 2. Rising cost of doing business

4.4.7 Bahrain

The long standing hub for Islamic finance in the GCC and a global leader, the Central Bank of Bahrain has assured that the island is well regarded as a properly governed financial center. Bahrain has good relationships with London, Luxembourg, Malaysia, and Bermuda. Bahrain hosts two exchanges and has a deep pool of human talent. But Bahrain is frequently in intense competition with neighboring offshore centers. Bahrain continues to serve as a key intermediary center for Saudi Arabia and Kuwait.

Although a civil law center, Bahrain has a trust law for financial transactions. Along with the capacity to create a low cost company, the Bahrain financial trust law has proven as a useful tool for funds, *sukuk* and is expected to support more product innovation as the overall business climate in Bahrain recovers.

Bahrain has a large number of Luxembourg-registered funds. In order to sell these, the CBB requires a local selling agent registered in Bahrain. Until IDB's first infrastructure fund, Bahrain fund companies did not normally take form as partnership. The Bahrain fund company must be managed by a domestic fund manager unless the management is provided by a manager from a reputable regulated jurisdiction. If the fund sponsors are not in Bahrain, they must appoint a Bahrain based administrator. Direct investment in assets, as well as *Shariah*-

compliant leverage, are permitted.

Bahrain	
Strength	Weakness
<ol style="list-style-type: none"> 1. Long established hub of Islamic Finance and home to many IF Institutions as well as important industry capacity builders like AAOIFI, IIRA & IIFM 2. 46 Islamic Funds with \$1 billion AUM 3. Bahrain registered funds are tax-exempted 4. Dual Taxation agreement with Bermuda 5. Reasonable cost of doing business: BHD 2,000 annual fee per retail CIU and per each additional sub-fund 	<ol style="list-style-type: none"> 1. Small scale operations, liquidity can be thin 2. Time to market is slow: 3-6 month application process
Opportunity	Threat
<ol style="list-style-type: none"> 1. Reasonable cost of doing business 2. Large number of well-trained competent professionals 3. Good and deep relations with regulators and banks in Saudi Arabia and Kuwait 	<ol style="list-style-type: none"> 1. Dubai has competed aggressively to move business from Bahrain 2. Arab Spring

4.4.8 *Dublin*

The Irish Republic hosts an efficient offshore fund center and has a large number of tax treaties, which include key home states for global institutional investors as well as important target markets in IDB's MCs. But Dublin is an expensive center to do business. Ireland is a major UCITS center and one of the top jurisdictions for aircraft financing and leasing. Ireland has a good trust law suitable for international funds, securities, and cross border transaction management.

Dublin	
Strength	Weakness
<ol style="list-style-type: none"> 1. EU member, support for IF; hosts 24 Islamic Funds with \$0.22 b (AUM) 2. UCITS: governed by EU laws; also allow Non-UCITS which is governed by Irish law; allows Qualifying Investor Fund 3. 62 double tax treaties including US, UK, Turkey, the UAE, Bahrain & Kuwait 4. Alternative Investment Funds established as open or closed ended variants of unit trusts, companies, or limited partnerships 5. Tax laws amended to accommodate IF 6. Irish domiciled funds not subject to tax 7. Possible dividends & withholding tax exemptions for non-Irish residents 8. Fund Timeline Launch: 5-12 weeks 9. Annual license fee per fund <ol style="list-style-type: none"> a. Min. Euro 2,000 per fund b. Max. Euro 4,250 includes 5-sub 	<ol style="list-style-type: none"> 1. Bound to EU Listing Directives 2. Local annual audit requirement 3. Semi-annual and Annual audited financial statement requirement 4. Two local Irish resident directors required 5. Extensive regulatory reporting disclosures 6. Fund promoter must be regulated by a supervisory authority recognized by IFSRA 7. Irish investment funds must appoint Irish Administrators (management cos.) 8. UCITS Investment Companies managed by non-Irish UCITS management cos. must have a min. capital of Euro 300,000 9. 20% withholding tax on dividends 10. 12.5% tax on investment management services
Opportunity	Threat
<ol style="list-style-type: none"> 1. Gateway to Europe & cross-border sales 2. Centre of excellence for aircraft finance and leasing transactions 3. Possible to re-register or acknowledge fund company form another jurisdiction. 	<ol style="list-style-type: none"> 1. Luxembourg (direct competitor) 2. London and other offshore centers

4.4.9 DIFC

Already an offshore center, Dubai has created the DIFC to be an internationally recognized center in compliance with a wide number of international regulations. The DIFC has enjoyed a strong growth since its inception early this century. The Government of Dubai has given strong support allowing the DIFC to increase its intermediary market share in the GCC and beyond. The DIFC is working hard to assure that the center builds a reputation as a well regulated and properly governed financial center. Dubai's excellent infrastructure and links to the rest of the world also help to attract talent and business to the center.

Dubai International Financial Center ("DIFC")	
Strength	Weakness
<ol style="list-style-type: none"> 1. DIFC has special rules for Islamic finance and requires a Shariah Supervisory Board, this allows it to host 14 Islamic Funds w/\$0.58 b AUM 2. Double Taxation Treaties 3. English law allowing trusts among other benefits. 4. 2 months fund launch timeline with reasonable costs including \$12,000 annual license renewal fee 5. Mutual Recognition Models: Islamic Product "Passportability" 	<ol style="list-style-type: none"> 1. Has not yet established Investor Confidence (but working on it) 2. Shallow liquidity 3. Rising cost of talent
Opportunity	Threat
<ol style="list-style-type: none"> 1. Standardization 2. Govt. intent to regain investor confidence 3. Reasonable depth of talent pool, recently lower costs of operating 4. Global transportation hub 5. Free Zones have established a name in the market 	<ol style="list-style-type: none"> 1. Abu Dhabi is building own financial center and is major source of investment flows) 2. Bahrain is a leading competitor

4.4.10 Channel Islands (Jersey)

The Channel Islands host over £22.2 billion AUM in conventional funds. And, they have a long tradition supporting both GCC and Islamic funds. Both Jersey and Guernsey are used, but the former is somewhat more popular than the latter for GCC investors. They offer efficient services in an English law environment and several of their law firms with trust services have established offices in the GCC. However, funds domiciled in the Channel Islands have to engage two resident directors.

An English law center, disputes decided in local court may be appealed to the Privy Council in London.

Channel Islands (Jersey)	
Strength	Weakness
<ol style="list-style-type: none"> 1. English Law jurisdiction with a long history of serving Islamic investors. 2. No requirement for local service providers 3. No requirement for local audit sign-off 4. One stop shop for Fund ancillary services: 10 law firms; 30 administrators; 15 trustees; 15 audit firms 5. 12 Double Taxation treaties 6. 28 Tax info exchange agreements 7. £2,000 minimum application fee; £2,000 - £20,000 annual fee 8. 0% tax on investment management companies 	<ol style="list-style-type: none"> 1. Slow to market: 8-12 month fund launch timeframe 2. Two Jersey-resident directors required 3. All “collective investment schemes” are regulated
Opportunity	Threat
<ol style="list-style-type: none"> 1. English and trust law 2. Umbrella funds are allowed via segregated cells. 3. Multiple asset classes and currencies are permitted. 4. No cap on investment company capital. 5. Companies migrate to and from the jurisdiction. 	<ol style="list-style-type: none"> 1. London, Cayman & Luxembourg 2. Relative high cost of doing business, 3. Difficult to access

4.4.11 Bermuda

This offshore center hosts a number of leading infrastructure funds and has established relationships with the international investor community. Although Bermuda is new to the GCC market, it has made up for lost time by adding to its rulebook to govern *Shariah*-compliant funds, and has a cooperation agreement with Bahrain. Like other English law jurisdictions, Bermuda has an established trust law.

Bermuda	
Strength	Weakness
<ol style="list-style-type: none"> 1. Over 2000 funds listed on Bermuda Stock Exc. (BSX) 2. BMA issued Guidance Notes on “Islamic Collective Investment Schemes” – covers disclosure, role of Shariah Boards 3. Modern Corporate & Trust laws benefits – Bermuda SPV and Trust can combine to create “off balance sheets” or bankruptcy remoteness structures 4. No exchange controls for non-residents 5. No restrictions on repatriation of funds 6. No stamp duties 7. Largest off shore re/insurance domicile – 1200 int’l re/insurers are licensed 8. May adopt secondary non-Roman script 	<ol style="list-style-type: none"> 1. Lesser well known profile for Islamic investors
Opportunity	Threat
<ol style="list-style-type: none"> 1. Access to US and European investments 2. Bahraini cooperation: <ul style="list-style-type: none"> - Double Tax agreement with Bahrain (opportunities for investment into GCC) 	<ol style="list-style-type: none"> 1. Luxembourg and Cayman Islands 2. Trained human resource

4.4.12 Qatar Financial Center (QFC)

It remains unclear how important a role the QFC can play in the global and Islamic funds market. Although the “offshore” center has grafted English law along with trusts into a civil law context, the cost and process for establishing SPVs is not attractive to many investors. One of the key issues that needs to be achieved domestically is a coordination of laws to validate that QFC entities can do onshore business, and to facilitate clarity about how *sukuk* are to be issued.

Beneficial tax treaties are in place with the UK, Malaysia and Singapore. The fundamental beneficiaries of QFC are most likely to be businesses seeking opportunities in Qatar or Qatari institutions looking to invest outside. Among the latest developments in Qatar is the closer connection between the Central Bank and The Qatar Financial Center Regulatory Authority (“QFCRA”) which has created an almost unitary regulatory environment as the Governor of the Central Bank is also the Chairman of the QFCRA.

Qatar Financial Center ("QFC")	
Strength	Weakness
<ol style="list-style-type: none"> 1. QFC funds are not subject to taxation 2. Double Taxation agreements including UK, Malaysia, Singapore 3. Advanced tax rulings 4. Reasonable cost to establish fund: \$10,000 annual fee after \$2,000-10,000 registration fees 	<ol style="list-style-type: none"> 1. High cost of doing business 2. Not a tax haven: 10% income tax on asset management company profitability 3. SPV rules may be too complex 4. Liquidity issues
Opportunity	Threat
<ol style="list-style-type: none"> 1. Can draw on domestic market 	<ol style="list-style-type: none"> 1. Bahrain and Dubai 2. Attracting and retaining talent can be difficult

4.4.13 Malta

Another UCITS center, Malta has a strong universe of tax treaties and has recently begun to court the Islamic market. Malta is a civil law country that has reference to English law. Currently, Malta lacks the level of human resources that will help it to be competitive, but this may change given the island's focus on serving the Islamic market.

Malta	
Strength	Weakness
<ol style="list-style-type: none"> 1. EU member, Maltese UCITS platform as a EU passport <ol style="list-style-type: none"> a. Total of 45 UCITS (03/2010) b. EU UCITS Directive 2. UCITS not investing in Maltese real estate are exempt from income & cap. gains tax 3. Double taxation treaties w/ 50+ countries: Malaysia, Kuwait, Qatar, UAE, UK, USA 4. Fund Service Providers <ol style="list-style-type: none"> a. 15 Administrators; 5 Trust Comp., 12 law firms, 4 auditors 5. Reasonable cost to establish: Euro 2,000 application fee and Euro 2,500 annual fee 6. Acceptable time to market: 2-4 months fund launch timeline 	<ol style="list-style-type: none"> 1. Local audit sign-off requirement 2. Local resident director requirement 3. Maltese investment companies income tax of 35% but 6/7th of tax is refunded to shareholders

Opportunity	Threat
<ol style="list-style-type: none"> 1. Links Europe with MENA investors 2. Possible to re-register or acknowledge fund company form another jurisdiction. 3. Long ties to Libya 	<ol style="list-style-type: none"> 1. Not easily accessible 2. Human resources

4.5 Evaluation of Different Jurisdictions

The evaluation of jurisdictions takes into account the capacity of a jurisdiction to attract or serve a broad universe of investors, develop a business climate that facilitates a diverse structuring toolkit, and ease of doing business factors. In the analysis of the applicable jurisdictions, the question is whether English or civil law is better for the purpose of the fund structuring.

As a general rule, the choice of law is meant to give investors protections that they believe are necessary when placing their money with a manager who will have full discretion according to the investment policy. But a legal venue is only as good as its courts, lawyers, and regulatory framework. Hence, if the regulator is a light touch regulator, investors may discover that courts in the fund's jurisdiction have limited incentives to adjudicate disputes which appear more over application of policy than fraud or some egregious wrongdoing by one party or another.

English law and its derivatives govern the largest number of funds. There are some features of English law like the *trust concept* that make organizing funds easy. And the historical election of English courts, as well as courts in the Cayman Islands, Channel Islands, and Singapore to hear cases that are not truly domestic cases has made many investors prefer English law. One element of English law that bolsters investor and investee comfort with it, is that it is factually the “common law” and derived from the *urf* or habits of the people. The fundamental essence of the common law is that actions and behaviors are generally presumed to be permitted unless explicitly forbidden, or in the case of a fund, unless excluded from the fund management documents.

Civil law, however, has a different premise. Generally, the lawfulness of an action is defined in civil law. This means that that the vast universe of un-contemplated behaviors is prospectively unlawful until explicitly contemplated in the law. As a general rule, this has meant that civil law jurisdictions have not been as liberal in the development financial markets as English law jurisdictions. As a result, civil law jurisdictions have generally lagged the English law markets. Nonetheless, important civil law jurisdictions like Luxembourg and Bahrain have proven able to compete effectively in their capacity to host funds and provide investors with the protective frameworks that they seek. As a result, this study neither prefers civil law nor English law. Indeed, the expected approach is to look a master feeder framework that supports both legal environments.

The next issue which rises prominently in the fund domicile SWOT analysis is the “cost of regulation”. As can be expected, certain countries are better regulated with armies of competent central bankers and capital market regulators scrutinizing the market, whereas

others are laissez-faire, charging funds, managers and investors fees and taxes that quite logically correlate to the cost of delivering a particular standard of governance to the market. Some countries can provide the same quality governance at a lower cost, and this too shows up in the SWOT analysis. Other countries think that the proper governance of funds requires employment of their nationals as fund directors and branch offices of various vendors in their country to provide various fund level services. All of this comes at either a financial cost or a reputational cost.

Another factor that this study emphasizes is the benefit of the European fund program UCITS. The European investor market under common regulation represents both a major investor universe for IDB funds; and it is the market that shows the second largest desire to invest in global infrastructure, an area that clearly overlaps with the focus of IDB's prospective investments in MC operations and infrastructure. But UCITS has requirements which may not always suit the flexibility that IDB requires:

- UCITS investments are not able to invest in all markets;
 - UCITS investments have counterparty risk limits;
 - UCITS does not accept direct investment in precious metals or other commodities or other nonfinancial assets;
 - UCITS limits concentrations and imposes the “5/10/20/40” diversification rule; and
 - UCITS does not permit most derivatives and forbids uncovered short;
- UCITS have a limit on absolute value at risk (“VAR”) requiring a monthly 99 % confidence, and a limit of 20%:
 - UCITS also have relative VAR with the same confidence levels; and,
 - Relative VAR has to be less than 2 times the benchmark;
- UCITS funds must have sufficient liquidity to support the possibility of redemption; and NAV publication at least twice a month.
- UCITS funds must disclose on an annual and semi-annual basis; and,
- UCITS funds have a basic disclosure obligation in the form of the key investor information document (“KIID”), and a detailed offering memorandum with standardized warnings.

Table 19 demonstrates the qualitative factors. Developed or established financial centers like Luxembourg, Singapore, Dublin and London score well. With a dual UCITS and private fund infrastructure which is widely used, Luxembourg tops the list. All of these centers have long track records with investors and managers, as well as solid regulatory and administrative frameworks.

Smaller, specialized offshore centers like Mauritius, the Cayman Islands, Jersey (Channel Islands) and Malta score less well. Often, the pure offshore centers deliver very high quality, targeted benefits to specific investor universes. Yet they often lack the framework to accommodate smaller investors. Their regulatory and administrative capacities are often questioned by some onshore regulators. And, sometimes, their tax treaty arrangements are limited in scope and serve only a few investee markets.

Member country financial centers like Bahrain, Malaysia and DIFC perform well on qualitative factors. Others like the QFC have not yet broadened their reach to build the same degree of

investor recognition as their peers in Bahrain, Malaysia and Dubai. Since no MC is inside the UCITS framework, the qualitative factors evaluated their relationships with UCITS countries and cross selling/listing arrangements with the UCITS countries.

In **Table 20**, the cost of doing business and efficiency factors are considered. The evaluation criteria were established in Section 4.3.1 and applied to each of the jurisdictions discussed. The evaluations are divided into two sections which address Section A: Breadth of Investor Reach and Section B: Business Factors. Since a critical factor is investor reach and bringing new investors under the IDB umbrella, the scores in Section A are given 100% weighting. In certain cases, the outward business factors may appear undesirable, but investor factors make dealing with that jurisdiction very attractive.¹⁰¹ Therefore, the Section B factors are assessed a 50% weight.

The scoring ranges from a negative one to a positive two in whole numbers. A negative factor means that a concept or legal requirement is missing; zero means that it is not a business factor or can be added easily; one means that it is present, but is not optimal; and two means that the factor is amongst the most attractive in the market. These subjective allocations are based on the country tables delivered in this chapter.

The factors represent two distinctive features. First, what makes a financial center attractive to investors, and facilitates the widest universe of investors? Second, does a financial center easily facilitate Islamic financial and investment concepts?

Generally, the well-known global offshore centers offer the lowest costs and most attractive service packages. Yet, some of these same centers impose costly or restrictive director requirements. Other centers suffer from singular taxes that apply either to certain asset classes or must be claimed through an administrative process that incurs costs and takes time. MC centers include countries like Malaysia and Bahrain with reasonable costs of doing business as well as countries like the United Arab Emirates and Qatar with much higher costs of doing business. As can be expected, centers associated with major capitals like London and Dublin, score poorly on cost factors.

¹⁰¹ For instance, CIMB Principal Asset Management selected to base their European fund operations in Dublin because of their capacity to leverage off of the existing infrastructure that Principal has already implemented in Ireland. Their cost of establishment is lower than if they selected a jurisdiction in which neither CIMB nor Principal had an European presence. Remarks by Datuk Noripah Kamso at the Global Islamic Finance Forum, Bank Negara Malaysia, September 19, 2012.

Factor	Luxembourg	Singapore	Malaysia	Dublin	Bahrain	London	DIFC	Mauritius	Bermuda	Cayman Islands	Jersey	Malta	QFC
Final Score	23.5	20	20	18	21	17.5	16	12.5	14	13.5	11.5	8	-3.5
A. Breadth of Investor Reach													
Master-Umbrella-Fund (MUF)	2	2	2	2	1	2	1	2	2	2	2	2	-1
Global investor Recognition	2	2	1	2	1	2	1	1	2	2	2	1	-1
Islamic Investor Recognition	1	1	1	1.5	2	2	2	0	0	2	2	-1	1
UCITS	2	1	1	2	1	2	0	0	-1	-1	-1	2	-1
Number of Funds	2	2	2	2	2	3	-1	0	2	1	1	-1	-1
Tax Treaties	2	2	1	2	1	2	0	1	1	2	1	2	1
Listing	2	2	2	2	2	2	2	1	1	1	1	1	-1
Cross Reg: Managers & Funds	1	2	1	1	2	-1	2	2	1	1	1	1	0
Unrestricted Placement	2	2	2	2	2	2	2	2	0	-1	-1	2	-1
ETF and/or REITs	2	2	2	1	1	2	1	0	1	0	0	-1	-1
AAOIFI/IFSB/Recognition	2	1	2	0	2	1	2	1	0	0	0	0	2
Part A Total Score	20	19	17	17.5	17	19	12	10	9	9	8	8	-3

Table 19: Breadth of Investors Evaluation for Different Domiciles

Factor	Luxem- bourg	Singapore	Malaysia	Dublin	Bahrain	London	DIFC	Mauritius	Bermuda	Cayman Islands	Jersey	Malta	QFC
B. Business Factors													
Low or no tax	2	1	2	2	2	-1	2	1	2	2	2	0	2
Establishment Costs	2	1	2	0	2	-1	2	1	2	2	2	2	-1
Director Residency Requirement	2	-1	2	-1	1	-1	2	2	2	1	-1	-1	-1
Require Local Fund Admin services	-1	-1	-1	-1	1	-1	1	-1	2	2	2	-1	-1
Time to Market	2	2	1	1	2	1	1	2	2	2	2	0	0
Part B Total Score	3.5	1	3	0.5	4	-1.5	4	2.5	5	4.5	3.5	0	-0.5

Table 20: Business Factors Evaluation for Different Domicile

When the qualitative and cost of business factors are balanced, the top five jurisdictions are:

Luxembourg	23.5
Bahrain	21
Malaysia	20
Singapore	20
Dublin	18

Yet, as the Master-Umbrella-Fund (MUF) concept is developed, IDB should consider the strongest centers as the hub location, and take advantage of the various other centers for feeder or outbound investment purposes according to the strength of the centers.

The overall evaluation points to a number of feeder jurisdictions, as well as jurisdictions which facilitate tax efficient outbound investment. These include Bahrain, which has treaties with Malaysia, the various central Asian states, and Turkey; Malta, which is suitable for investment into North African countries like Libya, Morocco, Algeria, and Tunisia; and, Mauritius, which has favorable treaties for investment into Africa and India.

Although this study proposes an umbrella fund with a master feeder structure, the IFC does not use the MUF approach. The IFC uses a different jurisdiction for different funds. For example, the IFC uses Mauritius if an investment is aimed at India. For other funds, The IFC uses domiciles like Caymans or Luxembourg as the IFC determines is suitable for the investment direction. A strategic difference for IDB is the development of capacity as well linkages between member states. The benefit to IDB of designing a flexible fund architecture is that it makes facilitation of the linkages between MCs and from MCs to the global investor markets. The difference between IDB and the IFC is that IDB has a broader mandate for its MCs, whereas the IFC is focused on financing (directional flow). Chapter 5 will elaborate further how IDB and its MCs may benefit from the MUF structure.

Chapter 5 - Proposed Fund Concept

5.1 Proposed Structure

In its 'Fund of Funds' concept note, IDB was planning to establish a platform to pool capital from different investors (including Sovereign Wealth Funds – SWFs) and seed capital into the first closing of multiple sector funds. IDB also highlighted that investors may be given an option either to invest in the overall platform or selective sector funds. Refer to **Figure 38** for the illustration of the IDB Fund of Funds concept.

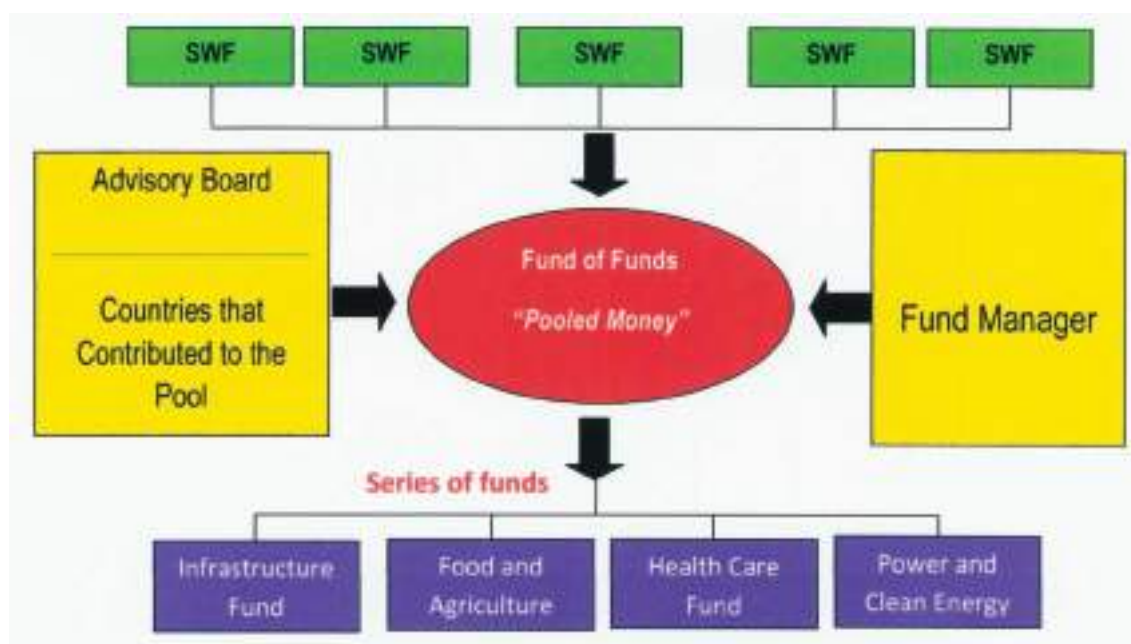


Figure 38: IDB 2011 “Fund of Funds” concept note

Based on the previous jurisdiction analysis, almost all offshore centers and many onshore centers permit master feeder funds. This concept may be used to enhance IDB’s Fund of Funds concept. The master fund will be hosted in a jurisdiction like the Cayman Islands or Luxembourg. The role of the master fund is to collect from multiple feeder funds in other jurisdictions or via other permitted investment vehicles.¹⁰² The simple purpose of the master feeder structure is to upstream funds to a common purpose. Refer to **Figure 39** for illustration of the master-feeder-umbrella structure. Once aggregated, the funds are applied into different sectors. The platform may pool commercially-oriented funds as well as benevolent funds. Investors will specifically identify the amount they would like to allocate to the benevolent funds. Investors will have the ability to switch within the funds (within commercial sectors, and within the benevolent funds focus) and switch between the commercial and benevolent funds. The next sections will discuss further the mechanisms of the commercial and benevolent funds.

¹⁰² The concept has developed a bad name due to its abuse by Bernard Madoff for his Ponzi scheme.

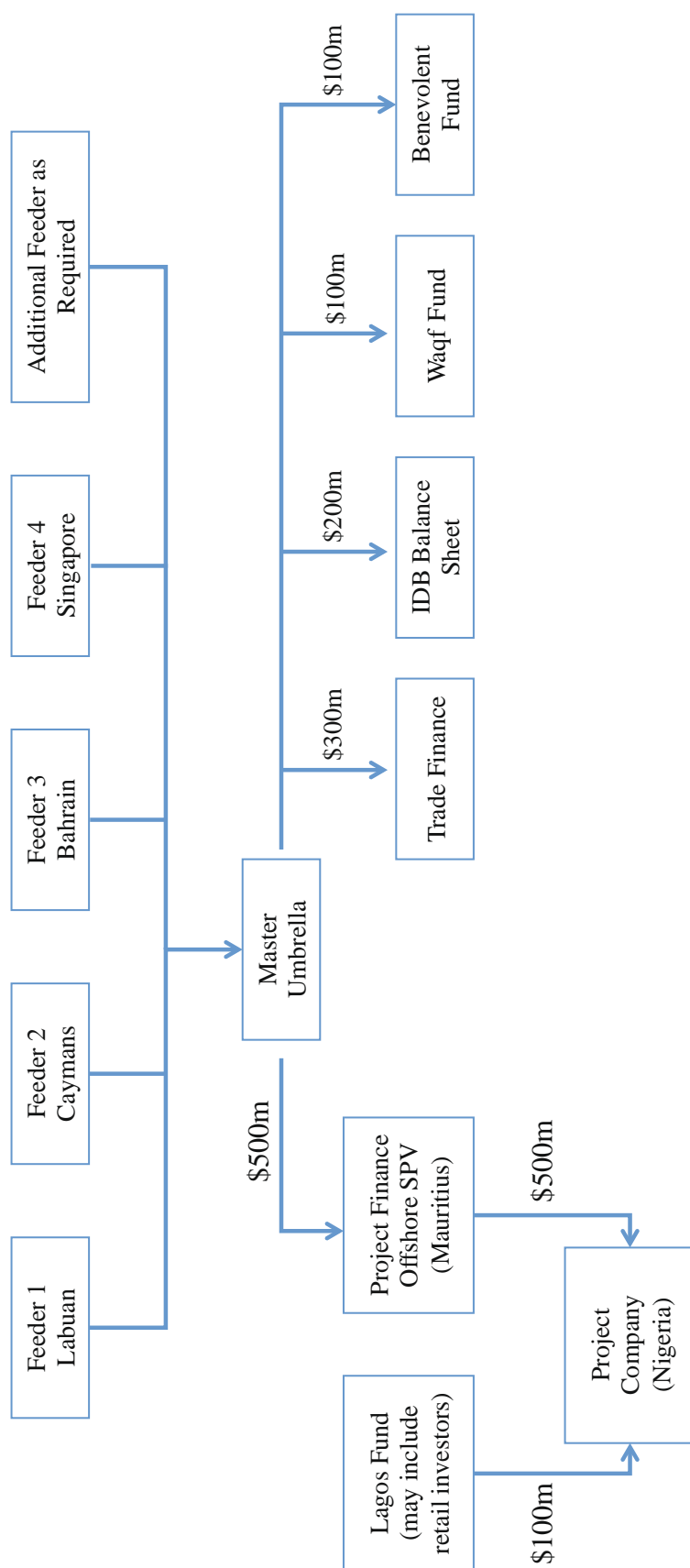


Figure 39: Master Feeder Umbrella Structure to Pool Funds

5.1.1 *Commercially Oriented Funds*

IDB focuses on three main strategic areas; human development (which includes education, health & gender equality), agriculture and infrastructure development. Most of the human development¹⁰³ and agriculture¹⁰⁴ strategic focus activities are not necessarily commercially-oriented operations. The IDB Group's cumulative operation (1976 – 2011) amounted to \$78 billion of which 51% was focused on project financing and 47% was trade operations. Within project finance, the top five sectors are:

- i. Energy 24.6%
- ii. Transportation 23.2%
- iii. Water, Sanitation & Urban Services 12.8%
- iv. Agriculture 11.1%
- v. Industry & Mining 8.5%

Therefore, the proposed structure has focused on infrastructure and trade finance as the illustrative sectors for the proposed fund. The downward fund flow into specific countries is done via an SPV in a jurisdiction with the best tax treaties. For example, since Mauritius has superior tax treaties with African countries, for investment in Nigeria, the downstream from the master is best done via a Mauritius SPV. Given IDB's focus on building local capital markets, the downstream fund may co-invest with a local market fund (which may include onshore retail investors) for a project financing in the target business activity. This allows broader resource mobilization for different projects. Section 5.3 elaborates further on how IDB may adopt IFC's approach in using local GPs and a systematic governance and risk management toolkit to develop local market. This helps not only in capacity building for local managers, but also enhances local governance and trust to mobilize local resources.

Besides funding a specific project, the fund may also invest into arrangements that IDB has developed with other MDFIs. For example, in April 2011, IDB and the World Bank Group launched the Arab Financing Facility for Infrastructure (AFFI) that targets to fund infrastructure development in non-GCC MENA countries. The proposed fund may invest through the Arab Infrastructure Investment Vehicle (AIIV) that has been set up for the AFFI project.

The fund approach allows IDB to make a number of specific investment decisions. These include the basis under which IDB will provide funds, and what that means in terms of cost. Funds like the benevolent sub-fund would have the capacity to make non-interest bearing loans or to provide highly concessionary pricing on trade or other transactions supporting MCs and their projects. Even within country or asset specific funds, an allocation may be made to provide finance at below market costs. The fund approach, however, will require that investors are aligned to fund strategies which may include below market returns being

¹⁰³ Education includes basic education, science, math, technology, vocational & technical education, and non-formal literary program. Since inception, IDB has funded \$2.5b for 455 operations. Health includes prevention, access to healthcare and alternative financing program. IDB has spent \$1.6 billion for 277 operations. Gender equality programs focuses on women access to finance and education. Refer to page 8 and 9 of (Islamic Development Bank, 2012)

¹⁰⁴ Agriculture includes food security, water & irrigation and microfinance activities with the aim to alleviate poverty, rural development, increase market linkages and infrastructure development. Refer to page 10 of (Islamic Development Bank, 2012)

contracted when delivering investments to MCs and their projects.

The proposal also suggests that a certain minimum investment amount is collected at the closing date. Any amount that is not invested in the sector funds (as there may not be approved projects yet) is placed with IDB via *Mudarabah* to invest in IDB's existing operation. The placement with IDB may be callable when a project is approved and funding is needed for the different funds.

IDB, in its concept paper highlighted that investors may be given an option either to invest in the overall platform or selective sector funds. To enhance this further, the proposal recommends building in a switching mechanism between sectors as well. This may be done by leveraging on the umbrella fund concept where there are different classes of investors. In the above example, the trade finance fund may have lower risk, shorter term¹⁰⁵ and lower return. Let's call this Class A investors. Any amount placed with IDB may also fall under Class A. The infrastructure fund may have higher risk, longer term, thus higher return. Let's call this Class B investors.

From a *Shariah* perspective, since Class A invests in trade finance, which may mostly be based on *Murabaha*, this class represents a debt certificate (*dayn*). The participation into IDB operations may also wholly invest in *Murabaha* and *Istisna`a* financing.¹⁰⁶ Investment into the infrastructure fund may be viewed as an investment into a non-monetary asset (*`ain*). These two certificates may be exchanged freely from the *Shariah* perspective. This will enable investors that are in the lower return class to switch to the higher risk, higher return class. For practical purposes, the fund may charge a switching cost and outline any conditions that must be fulfilled¹⁰⁷ to manage the switching process. Refer to Figure 40 for illustration.

¹⁰⁵ Common trade finance facilities are less than one year. IDB may, for capacity building, even have a 2-3 year facility. Compared to the infrastructure fund, 2-3 years is still a relatively short term.

¹⁰⁶ From a *Shariah* perspective, since the switching is to enable those who have debt certificates to exchange it for non-debt certificate, Class A may be fully invested in *Murabaha* and *Istisna`a*. It may also invest into non-debt instruments like *Ijarah* etc.

¹⁰⁷ Matching investor demand from other class, liquidity and minimum size of a particular class to be maintained etc.

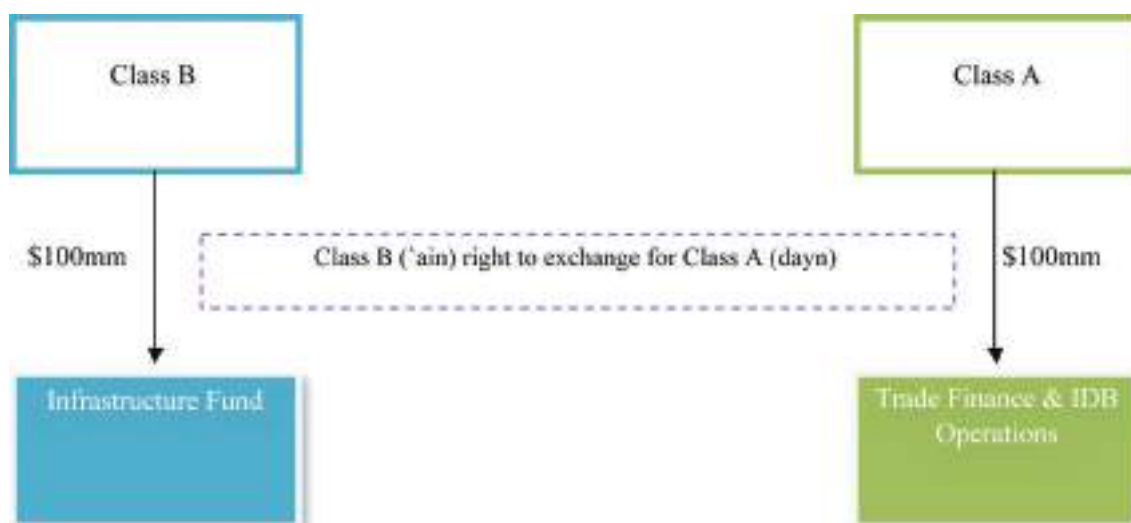


Figure 40: Switching between Classes in Commercially Oriented Funds

5.1.2 Socially-Oriented Funds

Since IDB has a number of strategic focus areas that may not appeal directly to commercial private investors, the master fund may include a sub-investment in socially-oriented funds. Similar to a commercially oriented fund, the socially oriented fund may also have two classes; benevolent fund and *waqf* fund. For the *waqf* fund, investors endow capital for good and are not looking for repayment of capital or any return. These may include purification funds from Islamic financial institutions and other charitable donations by either corporate, financial institutions or other donors. The *waqf* fund invests these contributions (either in the infrastructure fund, trade finance fund or even the benevolent fund) and uses the profit generated to invest in not necessarily commercial activity like human development, poverty alleviation, food security etc.

The capital of the *waqf* is preserved while the return from the investment is used to fund non-commercial activities. IDB has already applied the *Waqf* Fund in its operations. The proposal recommends that the *Waqf* Fund is brought under the same platform and is used to invest in other umbrella funds. This ensures that the investment in the *waqf* not only supports the overall fund structure, but also that the *waqf* fund is applied in the most effective and profitable investment opportunities available.

	Class C: Benevolent Fund	Class D: <i>Waqf</i> Fund
Investor Expectation	Investors provide capital with aim of repayment and earning a below market return in order to help beneficiaries.	Investors endow capital (i.e. not looking for capital being returned)
Fund Operation	The fund uses the capital to finance beneficiaries that need subsidized funding. However, the aim of the fund is to instill financial discipline in the beneficiaries i.e. they have to pay back capital and some return. The financing may be in the form of <i>Murabaha</i> , <i>Ijarah</i> etc to SMEs, MFIs, social housing etc.	The fund invest the capital, then uses the return generated (not capital) to invest in not necessarily commercial activity like human development, poverty alleviation, food security etc. The <i>waqf</i> may invest in the infrastructure fund, trade fund or even the benevolent fund.

Table 21: Benevolent and Waqf Fund in Socially Oriented Umbrella Fund

Since the *waqf* fund is more charity-oriented, and the capital is endowed, the proposal recommends another sub-class; a benevolent fund. The investors in this sub-class are entitled to get back their capital and earn a below market return. The investors may make a contribution in the form of *Qard* or *Wakalah* investment. The fund will use these contributions to directly fund beneficiaries that need subsidized financing. The fund will use commercial contracts like *Murabaha*, *Ijarah* etc to support the SME, MFI and social housing for example, but with a low financing rate. The fund will not, however, use grants in its operations as it aims to instill financial discipline in the beneficiaries i.e. they have to pay back capital and some return, albeit low. **Table 21** summarizes the difference between the sub-classes under the socially oriented umbrella.

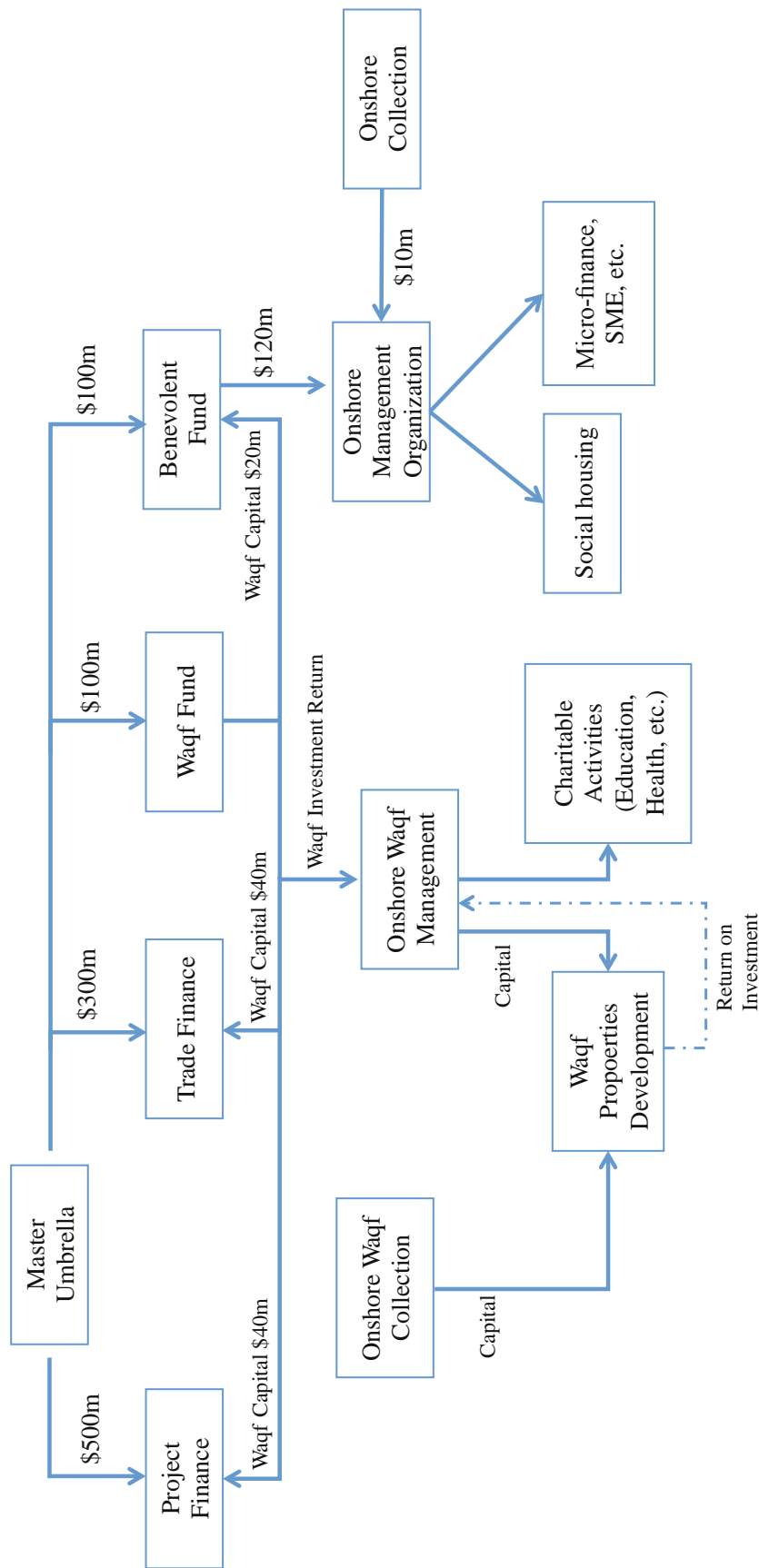


Figure 41: Operation of the Socially Oriented Funds

Figure 41 illustrates the operations of the *Waqf* and the Benevolent Fund. Although the *waqf* fund is focused on charitable activities, it may also be used to modernized and commercially manage *waqf* properties. The Islamic Religious Council of Singapore (MUIS), for example, has even issued *Sukuk* to fund the modernization of its *waqf* properties. This model allows onshore collection for the *waqf* fund. The *waqf* development in Singapore not only focuses on *masajid*, but also residential, service apartments and commercial buildings. The aim of the modernization is to ensure the *waqf* properties generate income which may be used for other charitable activities. Besides the *Sukuk* issuance for *waqf*, Singapore has also set up a Mosque Building and Mendaki Fund (MBMF) wherein Muslim employees in Singapore make small monthly contributions through an automatic Central Provident Fund (CPF) deduction.

The benevolent fund may also build an onshore fund collection to widen the resource mobilization. Unlike the *waqf* fund that does not pay any return, this fund pays a lower than market return on investment. Thus, it may have a different appeal to investors; be it retail or corporate. In both of the socially oriented funds, IDB needs to assist with capacity building, proper management and proper governance of the funds.

Since the fund strategy accommodates investment in projects, businesses, listed companies or listed financial instruments, it should help to support the development of domestic capital markets. This, in turn, should create access to medium and small sized investors. The retail investors in the investee country have an opportunity to profit from their financial participation in the development of their own countries. In the process of building local market investor access, the IDB fund strategy would also support the evolution and growth of domestic asset managers and Islamic financial institutions in their home markets.

5.2 Murabaha Funds & Market Feedback

Money market funds (based on Commodity Murabaha) have been a popular short-term placement in many markets. In Saudi for example, as at September 2012, the total size of mutual fund is SAR90 billion, of which 62% are Murabaha funds. Refer to **Figure 42**. The returns on these funds are low, ranging from 0.3% to about 1.4%. Refer to **Figure 43**.

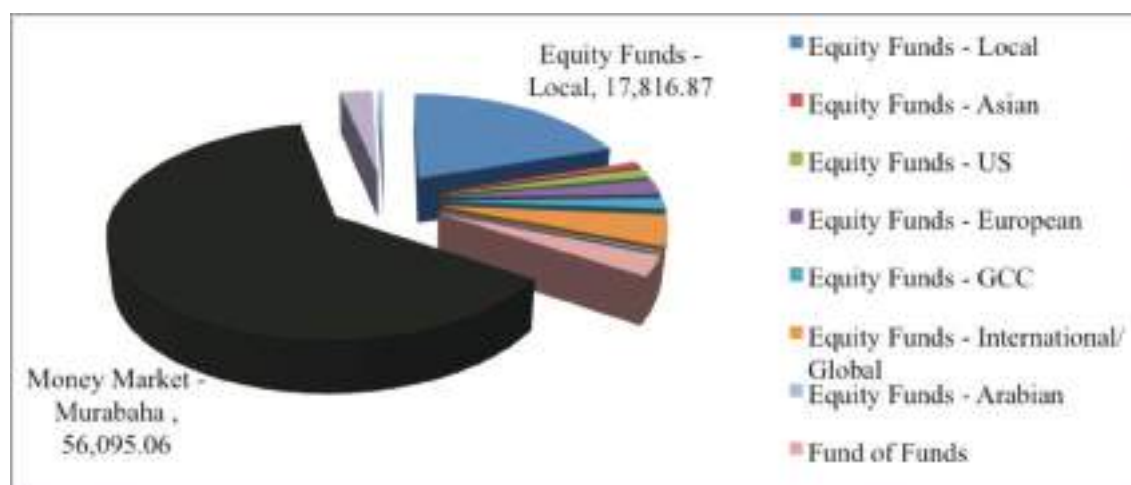


Figure 42: Types of Mutual Fund in Saudi

Source: (Alinma Investment, 2012)

Islamic and conventional, all Saudi Arabian banks and three (3) Saudi Arabian investment banks. The response rates from the international investors were good with thirteen (13) investors giving feedback, which ranged from highly detailed to short, covering a specific aspect of the inquiry.

Saudi Arabian banks and investors were reluctant to reply and only three provided replies. Some of the Saudi Arabian institutions appear to have misunderstood the inquiry and treated it as if it was competitive to their business interests. For instance, they would like to promote *Murabaha* funds and not be displaced by an IDB-led fund.

We have reconstituted the responses into issues for the international investors and Saudi Arabian investors.

5.2.1 International Investors:

1. Regulations: The most common issue brought up was whether or not the underliers in an IDB fund would be tradable. This is because many fund managers are targeting the UCITS markets or their home country regulator is adopting UCITS like regulations. The issue with mutual funds is that most countries, including Malaysia, require the underliers to be liquid. The benefit of a mutual fund is that it allows open-ended investment accumulation. But illiquid assets have to go into closed fund structures and may have liquidity like REITs, Business Trusts, or ETF by issuing shares. Then the only way to grow equity is to have a rights issuance or secondary offering.

The purpose of a mutual fund is to allow daily liquidity and open-endedness. An example of an illiquid fund that obtained liquidity was the Malaysia Fund Inc. (AmBank and Morgan Stanley). This was a business trust that listed itself.

If the underliers are not eligible for mutual funds or UCITS funds, then the option is to seek a close ended fund. This may limit the distribution strategy and restrict the number of jurisdictions in which a fund may solicit investors.

Another concern was anti-terrorism and whether or not institutions would be subject to either guilt by association or directly under FACTA (the US regulation).

2. Selling: Most did not think that the term Islamic is necessarily a barrier to buyers, but many felt it would be better to de-emphasize the work in the fund or the security's documentation. One even felt that 'socially responsible' is a better term.

The predominant reply from the international managers was that performance is the best way to sell such an emerging markets or infrastructure fund. This is further amplified as one manager noted that investors generally assume that Islamic investments are inferior. Generally, selling international emerging markets to retail investors and HNWI was considered to be difficult.

These were important parameters highlighted by the respondents:

- a. If the IRR is less than 10%, it will not be appealing;
- b. There must be a clear exit strategy;
- c. The duration will be considered; and
- d. The covenants will matter.

Product complexity affects whether or not emerging markets products can be sold to retail domestic investors or sophisticated investors (5 respondents). The term of the product would be important as many investors do not seek long-term investments (3 respondents). The capacity to sell such emerging market investments is impacted directly by the reputation of the investment manager (3 respondents).

Target investor should drive the network for distribution. Even though many markets have excess cash and lack good *Shariah*-compliant retail investments, reaching these potential investors is challenging given the fragmentation of distribution systems serving them.

One manager noted that a multi-fund platform would be the best way to reach these investors. Another worried that markets like Qatar do not have a deep experience with mutual funds yet.

One respondent pointed out the costs of selling retail products. For example, retail distribution is often complex and has costs which vary by market:

“Retail mutual funds are very much a “Pay to Play”¹⁰⁸ vehicle and this is expensive. Wire houses have to be paid off by sponsorships, loads and other placement fees to sell your funds and this is not cheap.”

Two managers thought that the product should be sold as a close-ended fund which could later be listed.

“One distribution channel would be to solicit funds locally. For example, create a local *Mudarabah* with the community; locals will be more inclined to believe in a project and invest in it since they will not be subject to the same biases as an international investor may be.”

3. Emerging Markets/Development/Infrastructure Investment: This investment target is attractive to institutional investors due to its low correlation with other asset classes; low volatility; income orientation; and frequent government backing. One investor felt that the support of IDB or stronger IDB member states would make a fund attractive. The extension of this thought is that a domestic investor will be encouraged by the support of the investor’s own government. Yet, the view is that emerging markets investing is a specific area and does not have a broad appeal. For investors who are not seeking emerging markets risk, this is deemed to be a “hard sell”.

“The biggest challenge for investors in a ‘development mutual fund’ will be the valuation of the projects while in development. Completed projects can be assessed in terms of growth and income potential but it is hard to evaluate development projects that are in process, especially infrastructure related projects such as bridges or roads. For these reasons a development mutual fund is probably not very attractive to most investors.”

¹⁰⁸ “Pay to play” refers to market conventions in which brokerages only distribute funds for which they receive some form of compensation. Retail costs are not necessarily the same level as institutional distribution.

Four (4) respondents noted that the perception of risk in emerging and frontier markets means that a fund must pay a premium or higher yield to investors, even if IDB is accepted as a suitable manager.

One investor worried that OIC countries have a stigma attached to them compared to other emerging markets and this would affect the fund.

“In my opinion the [investor] segment that would be interested would be the Arab/Islamic segment within OIC countries. I don’t see that foreign conventional investors would be that interested. Unless you are selling an asset directly in which case some international banks may be interested.”

4. Balanced Fund Alternative: The only comment about whether or not infrastructure or development funds could act as “balanced funds” was negative. In this investor’s view, despite their potential to generate income and capital gains, development funds’ primary characteristic is to take risk in emerging markets. As a result, the investor did not think that emerging market and infrastructure funds should be sold as if they were balanced funds.

5. Sukuk: One investor noted that *sukuk* would be attractive, but inconsistent with emerging markets investing. The manager noted that *sukuk* are defensive and emerging markets investing is risk-oriented. Project-recourse-only *sukuk* would be difficult to sell, but those with government or international agency backing should be marketable. IDB’s risk is acceptable in the institutional investor markets.

Overall, five (5) investors felt that *sukuk* would be more attractive to various investor universes. One reason for this is that *sukuk* may be structured with a recourse to the sponsor or a guarantor, and until now Islamic institutional investors prefer recourse investments. One pointed out that emerging market *sukuk* for infrastructure are largely untested.

6. Asset Manager: One manager felt that Bahrain was no longer a stable market in which to operate as an asset manager. As a result, this would deter institutional investors from a fund. Another felt that IDB would not be a competent asset manager and felt that it was more of a political body than a financial institution.

5.2.2 Saudi Arabian Responses:

1. Regulation: Saudi bankers wondered if a fund involved in illiquid assets would face regulatory restriction. If it were a public fund, the same manager wondered if it would face problems relating to the raising of funds in KSA and their export to high risk markets.

2. Sukuk: All three Saudi respondents wondered if a *sukuk* issuance would be better than a fund offering. “*Sukuk* have high demand in Saudi market.”

3. HNWI: The Saudi Arabian respondents argued that wealthy individuals and family offices will want an above average return and may want unique deals. This implies more costs, and higher returns.

4. Selling: The Saudi Arabian market likes to buy Saudi Arabian assets. If a business concept is not well understood, it must be sold.

“Development fund(s) will be welcomed if they have same liquidity profile (daily liquidity for subscription/redemption) as money market funds, given your point that such fund(s) will be having superior risk/return profile. Generally Saudi investors invest in money market funds to park excess liquidity and such investors are sensitive to a better return, if they think there is no risk to their investment.”

Retail development fund has not been tested as a concept.

5. Yield: Two (2) of the Saudi respondents noted that the yield on IDB funds or *sukuk* must show a premium to *Murabaha* funds to sell in the Kingdom. This means that it must be much higher than the 1.3% which the highest yielding *Murabaha* funds currently offer. Even then, cracking the retail market would be a challenge, but there might be some opportunity with HNWI.

6. Liquidity: *Murabaha* funds allow redemptions twice a week. There was doubt as to whether funds that would be investing in emerging markets could truly have such frequent liquidity.

In summary, the market players still prefer a *Sukuk* issuance to a ‘development fund’ idea. *Murabaha* funds are used in the market as short-term placements, with frequent redemption options. As such, a ‘development fund’ will not be a natural alternative to this group of investors. As for tapping into retail investors, the market players highlighted that the cost of retail distribution is high, this is regardless if IDB is aiming to issue *Sukuk* or funds.

Chapter 6 - Conclusion

The objectives of this study are for IDB to find a balanced approach to the cost of financing and management of IDB's balance sheet and rating. The task is monumental. Even civic minded pension funds like CALPERS have found that investing in the rejuvenation of Californian infrastructure is not as easy as they would like given the historically low interest rates and a flat yield curve.¹⁰⁹ For an MDFI like IDB, MCs require financing to bear a margin akin to a triple "AAA" debt. On one hand, a highly rated MDFI like the World Bank offers a lower cost than a smaller but highly rated MDFI like IDB. On the other hand, the real risk of the MCs combined with the nature of Islamic financial tools means that the cost of financing would be higher than a traditional loan. The cost of financing is usually way below the risk of financed projects.

The two key capital market areas that this study examined are *Sukuk* and funds. These are evaluated in **Chapter 2** and **Chapter 3** respectively. IDB has been an active issuer in the *Sukuk* market, while it has only sparingly used investment funds as an alternative funding strategy.

Since 2003, IDB has been a regular issuer in the global *sukuk* market. This has allowed IDB to obtain external financing with thin margins based on its AAA credit rating. Yet, reliance on the strength of IDB's balance sheet to reduce the risk to investors in its *sukuk* means that IDB will either face a maximum capacity limit for new issuances, have to raise more equity capital, or face the risk of a change in its rating. Therefore, one of our aims for this research was to identify off-balance sheet tools, which could give IDB the means to raise funds for its MCs without stressing the its own balance sheet whilst striving to achieve a low cost of funding to MCs when appropriate.

From the perspective of financial cost, *sukuk* issuances are currently the best tool for IDB to raise capital. In terms of investor diversification, retail *Sukuk* provides an opportunity to reach a much broader group of investors. One intuition that we have is that the broader the investor group, the cheaper the financial cost will be. From the Malaysian experience, the evidence indicates otherwise. IDB has to be prepared to pay a slightly higher cost than the non-retail *Sukuk* offerings, especially if the *Sukuk* is offered in emerging markets. One limitation of continuously pursuing the *Sukuk* strategy is the burden on IDB's balance sheet.

In finding an alternative to the current *Sukuk* strategy, we examined whether using a funds strategy will allow IDB to broaden its investor base and provide different cost alternatives for MCs. We analyzed the behavior of MDFIs and various development funds. The evidence indicates that MDFIs have pursued the private equity fund route to finance infrastructure developments. Macquarie, based on its success in Australia, has experimented with a blended approach – using two different jurisdictions to tap into different investor groups.¹¹⁰

¹⁰⁹ Walmsley, Shayla, CalPERS 'cannot compete' with cheap finance on infrastructure, on October 18, 2012 accessed at: <http://www.ipe.com/realestate/articleprint.php?id=47973>.

¹¹⁰ MIIF, for example, used the Bermuda fund to tap into institutional investors, and complemented this with a listing on Singapore stock exchange to tap into retail investors. Singapore was chosen as the fund was focused on the China & Taiwan market. Macquarie also used similar approach for the Indian market with MSIF being the offshore fund,

Funds, however, need the right infrastructure. In the fourth chapter, the study delivers a SWOT analysis of 13 jurisdictions. The goal was to find which domiciles are best suited to draw investors of different types, and to facilitate IDB's delivery of a master umbrella fund. IDB members like Bahrain and Malaysia performed well in the review. So did some global jurisdictions – especially Luxembourg. Therefore, the opportunity is there for IDB to consider a blended approach to jurisdictions.

We proposed that a master-umbrella fund which accommodates multiple sub-funds (infrastructure, trade finance etc.) including a charitable fund, provides IDB the most flexibility. IDB may also develop local capital markets to tap into retail investors where the projects are taking place. The master fund strategy requires IDB to provide seed money, but does not expand IDB's balance sheet. An advantage of this strategy is that it allows the introduction of natural hedges in the sub-funds, which sell units in local currency to local investors or international investors who have reason to earn in that currency.

Based on our analysis of different investor segments and their expectation in **Chapter 4**, we believe the funds strategy will allow IDB to access investors outside of IDB's traditional space. These may include institutional investors from the global markets (pension, insurance, family offices, HNWIs and SWFs) as there is an increasing interest in infrastructure investment. Although funds have a significant capacity to deliver off balance sheet finance and tap into a broader investor group, this strategy may not easily allow IDB to deliver finance at an attractive cost to its MCs. Indeed, IDB would have to work with focused sub-funds that have either charitable or special return parameters to achieve the lowest cost of funding to MCs. In general, there is a negative relationship between off-balance sheet strategy and cost of funding. If investors do not have recourse to IDB, they will necessarily require higher return. This is the tradeoff that IDB has to keep in mind when pursuing the funds strategy. From Preqin's database, the infrastructure funds have been paying around 10% IRR, with a peak in Years 2000-2005 that reached to 20% return. Most of these funds are investing in developed markets.

Fund investors have been keen on the emerging markets and “infrastructure” has become the code word for funding investment in high growth developing countries, as well as countries that are perceived to have the capacity for high growth. IDB member states are prominent among these markets. The encouraging outcome from our analysis of the infrastructure investment is the fact that a highly diversified group of investors look for fund investments in both infrastructure (developed and emerging markets) and emerging markets. They require, however, a trusted partner to lead them to these markets, and IDB can easily play this role. A sub-issue, which may raise some concern, is that anti-Muslim bias would mean that IDB should choose fund names that stress on emerging markets and ethical investment as opposed to overplaying the word “Islam”. Likewise, such fund structuring may require IDB to avoid using transliterated Arabic words in fund documentation. Instead, IDB could use plain English language descriptions of the investment processes. The objective is to avoid dismissal of IDB investment opportunities prior to the prospective investor's analysis of the true risks and benefits of the offering.

We also conducted a small survey with about 20 respondents to get their input on the following two areas:

1. Will current investors who place their money in *Murabaha* funds that pay about 1.3% be willing to switch to an infrastructure fund, with a similar return profile?
2. What are the investors' views about a 'retail development fund', and or a retail *Sukuk* strategy?

On hypothesis (1) - switching from *Murabaha* funds to development funds, the general view from the respondents was that the 'development fund' is not a natural alternative to *Murabaha* funds. The reason being –*Murabaha* is a short-term placement for these investors while waiting for the right investment opportunity. This is why the return is low. The *Murabaha* fund also has a very frequent redemption built in – some even allow a twice-a-week redemption window. A 'development fund' will not be able to offer this type of liquidity unless a strong fund sponsor provides a liquidity facility. The challenges with liquidity facilities are that do not necessarily dampen an investor's desire for returns, and they may not satisfy the full demand for liquidity during a market event. As a result, the fund may be forced into an involuntary wind-down.

If the liquidity is not there, investors will necessarily require higher return. There was still a lot preference for *Sukuk* in the market, instead of a 'development fund' strategy.

On hypothesis (2) – 'retail *Sukuk*' or 'development funds', one of the most frequently given feedback was the cost of tapping into this investor group. There are two cost components – first the distribution to retail investors, and second the return expectation from the retail investors. Investor sophistication will be the main factor that drives pricing. 'Retail *Sukuk*' or funds do not automatically mean tighter pricing for IDB. In certain markets, IDB may have to pay higher prices to retail investors, especially when they only look at past rates.

Another point to keep in mind when dealing with retail investors is the frequency, thus the quantum of funds that IDB wants to raise from the retail market. From the review we conducted in **Chapter 2**, India took the approach of raising one large tranche, but faced the problem of under-deployment of the proceeds. It was common to have smaller, much frequent issuances in London and Malaysia. This will definitely need investor awareness and education. In the field of development investment, the concept of a 'retail fund' remains untested. Nonetheless, this is a natural fit to provide funding for development projects. If IDB is able to invest in its MCs as well as other infrastructure projects (i.e. proper diversification), the overall return might be appealing to investors. At the domestic market level, initial years may need IDB to pay a slightly higher cost than the traditional *Sukuk* funding option. However, in the long run, once the investors become more familiar with the concept, this may prove to be a cost efficient funding option for IDB.

The fund investors who seek infrastructure and emerging markets investment are a specific group of fund managers. Therefore, we believe that it is more suitable for IDB to pursue these investors via private equity investment style – which it has been doing with its two infrastructure funds. This allows IDB to deal with sophisticated investors during the development period, and once the project is generating cash flow, IDB may seek listing of the fund, thus providing the greenfield investors with the return that commensurate with the risk they took. This will also allow IDB to tap into retail investors once there is a stable cash flow generated from the project.

As liquidity and currency risks are two of the main perceived issues for a 'development fund', IDB may consider a number of structural approaches. On the one hand, the quantum of money invested through IDB's International Islamic Trade Finance Corp. (ITFC) would be allocated to a higher proportion of short-term self-liquidating trade deals. On the other hand, IDB and its co-sponsors may determine that they should make a contingent allocation of capital to fund redemption requests under specific conditions. Moreover, IDB may select to absorb the currency risk and provide specific hedging through its own treasury to cover expected future payments from funds to investors. Tapping into domestic retail investors to raise funding locally may minimize the hedging need for exotic currency of various MCs. In addition, by offering various funds in various jurisdictions (e.g. USD in GCC, Euro in Turkey etc.) the overall fund network will be able to naturally hedge the currency risks and match the SDR currency structure of IDB's balance sheet.

IDB cannot find a panacea for their delivery of low cost financing via only a fund strategy. What it can do is build a highly diversified fund strategy that addresses a wide variety of investment forms and delivers different forms of capital at different return levels. This would create greater capacity for IDB to serve as many MCs as possible in as many suitable ways as can serve the dynamic needs of the MCs.

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Appendix I: Top 10 investors in Unlisted Infrastructure Funds

Source: Preqin Global Infrastructure Report, p.36

1. Global – including Public Pension

Rank	Investor	Currently Committed to Infrastructure (\$bn)	Investor Type	Investor Location
1	OMERS	15.1	Public Pension Fund	Canada
2	CPP Investment Board	9.4	Public Pension Fund	Canada
3	Corporación Andina de Fomento (CAF)	8.4	Government Agency	Venezuela
4	Ontario Teachers' Pension Plan	7.9	Public Pension Fund	Canada
5	APG - All Pensions Group	7.5	Asset Manager	Netherlands
6	TIAA-CREF	6.5	Private Sector Pension Fund	US
7	Khazanah Nasional	6.4	Sovereign Wealth Fund	Malaysia
8	Industrial Development Bank of India	6.1	Investment Bank	India
9	AustralianSuper	5.1	Superannuation Scheme	Australia
10	CDP Capital - Private Equity Group	4.9	Asset Manager	Canada

2. Public Pensions Only

Rank	Investor	Currently Committed to Infrastructure (\$bn)	Investor Location
1	OMERS	15.1	Canada
2	CPP Investment Board	9.4	Canada
3	Ontario Teachers' Pension Plan	7.9	Canada
4	ABP (Managed by APG)	6.1	Netherlands
5	ATP Lifelong Pension	2.6	Denmark
6	Public Sector Pension Investment Board	2.3	Canada
7	FUNCEF	1.9	Brazil
8	PFZW (Managed by PGGM)	1.7	Netherlands
9	Universities Superannuation Scheme	1.5	UK
10	PensionDanmark	1.4	Denmark

3. Global – excluding Public Pension

Rank	Investor	Currently Committed to Infrastructure (\$bn)	Investor Type	Investor Location
1	Corporación Andina de Fomento (CAF)	8.4	Government Agency	Venezuela
2	APG - All Pensions Group	7.5	Asset Manager	Netherlands
3	TIAA-CREF	6.5	Private Sector Pension Fund	US
4	Khazanah Nasional	6.4	Sovereign Wealth Fund	Malaysia
5	Industrial Development Bank of India	6.1	Investment Bank	India
6	AustralianSuper	5.1	Superannuation Scheme	Australia
7	CDP Capital - Private Equity Group	4.9	Asset Manager	Canada
8	PGGM	3.5	Asset Manager	Netherlands
9	QIC	3.4	Asset Manager	Australia
10	International Finance Corporation (IFC)	3.2	Government Agency	US

Appendix II: Top 5 investors in Private Equity Funds

Source: Preqin Global Private Equity Report, p88

1. Endowments

Rank	Investor	Allocation to PE (\$bn)	Country
1	Yale University Endowment	6.8	US
2	Princeton University Investment Company (Princo)	6.3	US
3	Harvard Management Company	6.0	US
4	Stanford Management Company	5.3	US
5	University of Texas Investment Management Company	4.0	US

2. Family Offices and Foundations

Rank	Investor	Allocation to PE (\$bn)	Country
1	Wellcome Trust	6.3	UK
2	Bregal Investments	4.0	UK
3	Howard Hughes Medical Institute Endowment	3.6	US
4	Kernay	2.0	US
5	J. Paul Getty Trust	1.9	US

3. Insurance Companies

Rank	Investor	Allocation to PE (\$bn)	Country
1	Northwestern Mutual Life Insurance Company	8.9	US
2	MetLife Insurance Company	6.6	US
3	CNP Assurances	4.8	France
4	SunAmerica Financial Group	4.5	US
5	Zurich Financial Services	3.3	Switzerland

4. Private Sector Pension funds

Rank	Investor	Allocation to PE (\$bn)	Country
1	TIAA-CREF	10.5	US
2	General Electric Pension Trust	7.0	US
3	AT&T Pension Fund	6.4	US
4	Verizon Pension/Benefits	5.8	US
5	IBM Retirement Fund (USA)	4.3	US

5. North American Public Pension

Rank	Investor	Allocation to PE (\$bn)	Country
1	California Public Employees' Retirement System (CalPERS)	32.0	US
2	CPP Investment Board	24.8	Canada
3	California State Teachers' Retirement System (CalSTRS)	22.4	US
4	Washington State Investment Board	15.6	US
5	New York State Common Retirement Fund	14.5	US

6. European Public Pension

Rank	Investor	Allocation to PE (\$bn)	Country
1	ABP (Managed by APG)	16.0	Netherlands
2	PFZW (Managed by PGGM)	8.6	Netherlands
3	Universities Superannuation Scheme	4.6	UK
4	Keva	1.8	Finland
5	AP-Fonden 6	1.8	Sweden

7. Other investors to watch in 2012

Perm Mutual Life Insurance Company			Insurance Company
Location: US	Total Assets: \$8.6bn	Target PE Allocation: 3.5% of Total Assets	Current PE Allocation: 3.5% of Total Assets
Perm Mutual Life Insurance Company plans to commit to 15 new funds over the course of 2012, committing between \$100mn and \$125mn to the asset class in total. It will look to target buyout, venture and distressed debt funds for forthcoming commitments. The insurance company typically commits between \$5mn and \$10mn per fund, and will be mostly looking to work with fund managers it has not previously invested with.			
Hartford Municipal Employees' Retirement System			Public Pension Fund
Location: US	Total Assets: \$920mn	Target PE Allocation: 7% of Total Assets	Current PE Allocation: 6% of Total Assets
Hartford Municipal Employees' Retirement System (HMERS) is planning to invest in two to three new private equity funds over the course of 2012. It is looking to invest mostly with managers it has not previously worked with, in addition to re-upping with some existing GPs in its portfolio. Its focus in 2012 is likely to be on secondaries funds focused on North America. HMERS's target allocation to private equity stands at 7% of total assets; it plans to continue to build up its portfolio over the next two years, and expects to increase its target allocation to private equity to 15% of total assets. The pension fund typically commits between \$2mn and \$15mn per private equity vehicle.			
NTUC Income Insurance Co-operative			Insurance Company
Location: Singapore	Total Assets: SGD 26.4bn		
NTUC Income Insurance Co-operative has set aside between SGD 190mn to SGD 250mn to invest in five to 10 new private equity funds over the next 12 months. It plans to work with managers it has invested with previously as well as managers it does not have an existing relationship with. The insurance company targets a range of fund types including buyout, mezzanine and growth funds. It invests primarily in North America, Europe and Asia, in particular Greater China. It typically makes commitments of between SGD 13mn and SGD 32mn per private equity vehicle.			
Shell Asset Management Company			Asset Manager
Location: Netherlands	Total Assets: €50bn		Current PE Allocation: 5.8% of Total Assets
Shell Asset Management Company is planning to commit €250mn to between four and six funds during 2012. It is expecting to primarily re-up with existing managers within its portfolio, but is also open to forming a limited number of new GP relationships. Over the coming year it is targeting buyout funds, ranging from mid-cap to mega-cap. It invests globally, although it feels that Asia will be presenting the best investment opportunities over the coming year. The asset manager typically commits approximately €50mn per private equity vehicle.			

'Other investors to watch in 2012' (Contd.)

Industrifondens Pensionsforsikring			Private Sector Pension Fund
Location: Netherlands	Total Assets: DKK 90bn	Target PE Allocation: 7.5% of Total Assets	Current PE Allocation: 6.3% of Total Assets
Industrifondens Pensionsforsikring is planning to commit DKK 1.5bn to private equity funds during 2012 and expects to increase its allocation to the asset class in the longer term. For its forthcoming fund commitments, the Danish pension fund will be looking to mainly invest with fund managers that it has not previously worked with. Industrifondens Pensionsforsikring invests in a variety of funds, including buyout, venture, growth and turnaround funds and invests globally, including emerging markets. The pension fund invests in first time funds and also invests in funds before they have held a first close. Typically Industrifondens Pensionsforsikring commits between DKK 75mn and DKK 100mn per fund.			
PPM Managers			Asset Manager
Location: UK	Total Assets: £1.1bn	Target PE Allocation: 100% of Total Assets	Current PE Allocation: 100% of Total Assets
PPM Managers plans to commit slightly more to the private equity asset class in 2012 than it did in 2011 and plans to increase its level of exposure to the asset class in the longer term. The asset manager expects to commit to between four and five new funds over the next 12 months; it may also include some co-investments, and believes that small to mid-market buyout funds are presenting the best opportunities in the current climate. In terms of geography, it feels that Central and Eastern Europe is currently offering the best opportunities. It typically commits between £20mn and £30mn per fund.			
Talinor Asset Management			Asset Manager
Location: Germany	Total Assets: €85 bn		Current PE Allocation: 1.5% of Total Assets
Talinor Asset Management is currently below its target allocation to private equity and plans to commit to eight to 12 new funds over the next 12 months. It will primarily look to work with existing managers within its portfolio. The asset manager continues to invest on a global scale, with a particular focus on vehicles targeting North America and Europe. In the longer term it is looking to increase its exposure to emerging markets, including Asia. It will be primarily targeting distressed private equity, buyout and secondaries vehicles in 2012 and typically commits between €10mn and €30mn per private equity fund.			
Employees' Retirement System of the State of Hawaii			Public Pension Fund
Location: US	Total Assets: \$11.6bn	Target PE Allocation: 5% of Total Assets	Current PE Allocation: 3.3% of Total Assets
Employees' Retirement System of the State of Hawaii (HERS) increased its policy target allocation to private equity from 2.5% to 5% of total assets at the start of Q3 2011. Following this, it will be increasing its private equity target allocation by one percentage point each year until it reaches an allocation of 7% of total assets, expected to be in 2013. The public pension fund is known to have invested across a variety of fund types including buyout and venture vehicles. It primarily invests in North America, but will also consider vehicles focused on Europe and Asia.			

Blue Sky Group			Asset Manager
Location: Netherlands	Total Assets: €13bn		
Blue Sky Group is looking to re-enter the asset class in the immediate future having ceased investing in the mid-2000s. It currently has no private equity holdings, and therefore will be looking to form new manager relationships in 2012 as it looks to build its exposure to the asset class. It is looking to invest in funds of funds based in Europe and the US, and will also consider opportunities in emerging markets, where it views growth and venture funds as presenting the best opportunities. It will not invest in first-time funds.			
Ohio Public Employees' Retirement System			Public Pension Fund
Location: US	Total Assets: \$69.0bn	Target PE Allocation: 10% of Total Assets	Current PE Allocation: 8% of Total Assets
Ohio Public Employees' Retirement System has set aside \$2bn to commit across 12 to 15 new private equity funds over the next 12 months. The public pension fund is open to forming new relationships with fund managers as well as re-upping with its existing fund managers. It has a preference for buyout, growth, venture, distressed private equity and secondaries funds. It invests globally, including emerging markets, and will consider investing in a fund before it has held its initial close. Typically, the public pension fund commits between \$75m and \$300m per private equity vehicle.			
Thailand Government Pension Fund			Public Pension Fund
Location: Thailand	Total Assets: THB 407bn	Target PE Allocation: 2% of Total Assets	Current PE Allocation: 1% of Total Assets
Thailand Government Pension Fund has 1% of its total assets currently allocated to private equity investments within Thailand, and although it is yet to invest overseas, it has set aside another 1% of total assets for international investments. It has set aside \$125m to invest in new opportunities over the next 12 months, with a focus on gaining international exposure. It feels that mid-market buyout and distressed private equity funds are currently presenting the best opportunities, and feels that emerging markets are particularly attractive in the current climate, specifically China and India. Thailand Government Pension Fund will look to form new relationships with fund managers when making commitments over the next 12 months. It will not invest in first-time funds, but will consider spin-offs.			

Appendix III: Extract of Indian Committee Report on Development Infrastructure Funds

Structure: The Committee believes that DIFs should operate as close-ended schemes with a maturity period of seven years and a possibility of one or two extensions, subject to adequate disclosures in the offer documents and approval of trustees.

1. *Liquidity*: The proposed DIF's should get listed within 24 months of the launch of the scheme and be allowed to buy-back the units, from the market within certain limits to safeguard the interests of investors.
2. *Types of investments permitted*: In terms of Investments, it is suggested that the DIF's may be allowed to invest up to 100% of its funds into unlisted securities including both equity and debt instruments. Exposure to listed companies, however, should be limited to 10% of the NAV at the time of making the investments. Further, the DIF's may be allowed to take control of the asset, if they so desire, and own up to 100% of the paid up capital of a company.
3. *Fees and Expenses*: In light of the unique nature of DIFs like dedicated teams for the management of such schemes, requirement of in-depth research because of companies being unlisted and information not being available, higher level of monitoring of investments, the fee structure of such funds will have to be different from the existing Mutual Fund schemes, in line with global practices. The Committee therefore suggests that maximum overall permissible expense ratio for DIFs including investment management fees be additional 1% over and above that specified in the Mutual Fund Regulations. Additionally, the DIFs should also be allowed to charge a performance fee after providing a certain minimum return to the unitholders, as per global practice.
4. *Valuation Norms and Disclosures*: The DIF's should report the fund NAV at the time of each asset valuation and also at quarterly intervals. About valuations, the Committee believes that current SEBI guidelines to value unlisted equity shares will need to be suitably amended for the proposed asset class. The proposed DIFs should engage an approved consultant to value the assets semi-annually. Such an approved list can be drawn up by the SEBI registered rating agencies. Approved consultants for respective DIFs, however may be replaced every three years as a matter of good corporate governance.
5. *Eligible Sponsors*: The Committee proposes that the DIFs can be launched by all SEBI registered Asset Management Companies (AMCs), but should have a dedicated team for managing the funds and their trustees should be satisfied in this respect.
6. *Investor Profile*: The Committee suggests that all the individual/ companies/ corporates/ institutions and FI's should be eligible for making investment in such mutual funds. The profile of DIFs in terms of tenure, risks and returns are also complimentary to liability side of insurance companies and pension funds. Therefore, Govt./concerned Regulators may also consider modifying the investment guidelines for Insurance/pension funds and provident funds so that they could invest directly in such type of mutual funds, as it will serve the twin purpose of meeting sectors' capital needs as also in managing risk-return requirements of Insurance Companies and Pension Funds.
7. *Disclosure of risk factors and reporting of compliance*: Risk factors relevant for such schemes may be disclosed in the offer documents and advertisements for the launch

of such schemes so that the investors may take well informed investment decisions. In addition to disclosure of the NAV's and annual accounts of the scheme, the DIFs may also report financial review of each investee company and the status of implementation of various projects, on quarterly basis. The valuation methodologies may be approved by the trustees and may also be disclosed to investors. The trustees shall review the performance and compliance of regulations in case of DIFs in their periodical meetings and shall report it to SEBI in their reports submitted to SEBI in accordance with regulations.

8. *Tax Benefits*: Considering the long-term and close-ended nature of the proposed DIFs, the Committee believes that it will be extremely important to provide some tax incentives to retail investors to motivate them to invest in DIFs and therefore help in and benefit from the infrastructure creation in the country. The Committee also believes that without the tax incentives no retail investor would be motivated to invest in a DIF. Tax benefits may be provided by (i) enhancement of limit under Section 80C from Rs.1,00,000 to Rs.2,00,000 with the incremental limit exclusively set apart for investment in designated infrastructure funds and (ii) Capital gains arising on account of transfer of long term capital assets may be exempted from tax if the capital gains amount is invested in DIF units for a period of 7 years. However, such tax benefits should be available only to the original investors.

Recommendation rationales (Section D of the report)

1. *Maturity Period*: start with 7 years (allow project to go into brownfield and generate cash flow), then move to perpetual later. Global practice 7-9 years with extension of 1-2 years
2. *Liquidity - listing & timing*. Listing provides liquidity to investors, however this should be done after 2 years since the fund will be deployed in a staggered basis. Allow buy back for 20% of initial unit capital.
 - The main driver of this recommendation is to cater for retail investors preference to exit the fund and not tied for long run. Listing after 2 years prevent negative trading during investment & green field period. Australia, Singapore, Korea & Europe have listed infrastructure funds. Australia has 30-35% retail participation. Korea's initial retail participation was quite low.
 - The purpose of buy back arrangement is to use excess fund not deployed to buy back unit and reduce discount trading.
3. *Draw Downs* - single draw down, invest in money market during interim period. This will make it easier to manage operational issues in dealing with retail investors. Some global funds buy infrastructure assets, then seed these into the fund.
4. *Types of Investments Permitted (i.e. Asset classes)* - allow 100% investment in unlisted securities, both debt & equity. Listed company investment should be limited to 10% of NAV. 20% (NAV) single issuer limit. 50% (NAV) in unrated paper (existing 25% for mutual funds). No restriction in sectors
5. *Exit* - strategic sale (i.e. To any interested investor), sale to financial investor (FI, bank or fund), IPO, buy back (sponsor), expiry of concession is a natural end (make sure get IRR)
6. *Fees and Expenses*:
 - a. Overall expenses ratio: 1% higher than existing mutual fund (because there is higher expenses)

- b. Management fee: up to 1%
 - c. Performance fee/Carried Interest: 20% above the hurdle rate (minimum hurdle rate = 10%)
7. Investor Profile
- a. All individuals/co/FI - may need to adjust investment guideline for insurance & pensions because these are natural investors in these type of funds
 - b. Encourage (positive recommendation) of pension & insurance to invest in DIF. Even 1% from pension allocation will make significant difference & give comfort to foreign pensions to invest.
8. *Tax Benefits* - is crucial to entice retail investors.
- a. Upfront tax incentive - since lock in and no liquidity
 - b. Capital gain exemption if satisfy minimum holding period (India - 7 years)
 - c. Income distribution exemption if satisfy minimum holding period (India - 3-5 years)
 - d. Incentives only applicable to original investors in fund, not those who bought after listing

Appendix IV: Selected Infrastructure debt fund (IDF) Regulation by SEBI August 30, 2011

49L - For the purposes of this Chapter, unless the context otherwise requires-

(1) "Infrastructure debt fund scheme" means a mutual fund scheme that invests primarily (minimum 90% of scheme assets) in the debt securities or securitized debt instrument of infrastructure companies or infrastructure capital companies or infrastructure projects or special purpose vehicles which are created for the purpose of facilitating or promoting investment in infrastructure, and other permissible assets in accordance with these regulations or bank loans in respect of completed and revenue generating projects of infrastructure companies or projects or special purpose vehicles.

(2) "Infrastructure" includes the sectors as specified by guidelines issued by the Board or as notified by Ministry of Finance, from time to time.

(3) 'Strategic Investor' means;

(i) an Infrastructure Finance Company registered with Reserve bank of India as Non-Banking Financial Company;

(ii) a Scheduled Commercial Bank; (iii) International Multilateral Financial Institution.

49O - Conditions for the IDF

(1) An infrastructure debt fund scheme shall be launched either as close-ended scheme maturing after more than five years or interval scheme with lock-in of five years and interval period not longer than one month as may be specified in the scheme information document.

- (2) Units of infrastructure debt fund schemes shall be listed on a recognized stock exchange, provided that such units shall be listed only after being fully paid up.
- (3) Mutual Funds may disclose indicative portfolio of infrastructure debt fund scheme to its potential investors disclosing the type of assets the mutual fund will be investing.
- (4) An infrastructure debt fund scheme shall have minimum five investors and no single investor shall hold more than fifty percent of net assets of the scheme.
- (5) No infrastructure debt fund scheme shall accept any investment from any investor which is less than Rupees one crore (Rs. 10m)
- (6) The minimum size of the unit shall be Rupees ten lakhs.
- (7) Each scheme launched as infrastructure debt fund scheme shall have firm commitment from the strategic investors for contribution of an amount of at least Rupees twenty five crores before the allotment of units of the scheme are marketed to other potential investors.
- (8) Mutual Funds launching infrastructure debt fund scheme may issue partly paid units to the investors, subject to following conditions:
 - (a) The asset management company shall call for the unpaid portions depending upon the deployment opportunities;
 - (b) The offer document of the scheme shall disclose the interest or penalty which may be deducted in case of nonpayment of call money by the investors within stipulated time; and
 - (c) The amount of interest or penalty shall be retained in the scheme.

49P - Permissible investments

- (1) Every infrastructure debt fund scheme shall invest at least ninety percent of the net assets of the scheme in the debt securities or securitized debt instruments of infrastructure companies or projects or special purpose vehicles which are created for the purpose of facilitating or promoting investment in infrastructure or bank loans in respect of completed and revenue generating projects of infrastructure companies or special purpose vehicle.
- (2) Subject to sub-regulation (1), every infrastructure debt fund scheme may invest the balance amount in equity shares, convertibles including mezzanine financing instruments of companies engaged in infrastructure, infrastructure development projects, whether listed on a recognized stock exchange in India or not; or money market instruments and bank deposits.
- (3) The investment restrictions shall be applicable on the life-cycle of the infrastructure debt fund scheme and shall be reckoned with reference to the total amount raised by the infrastructure debt fund scheme.
- (4) No mutual fund shall, under all its infrastructure debt fund schemes, invest more than thirty per cent of its net assets in the debt securities or assets of any single infrastructure

company or project or special purpose vehicles which are created for the purpose of facilitating or promoting investment in infrastructure or bank loans in respect of completed and revenue generating projects of any single infrastructure company or project or special purpose vehicle.

(5) An infrastructure debt scheme shall not invest more than 30% of the net assets of the scheme in debt instruments or assets of any single infrastructure company or project or special purpose vehicles which are created for the purpose of facilitating or promoting investment in infrastructure or bank loans in respect of completed and revenue generating projects of any single infrastructure company or project or special purpose vehicle, which are rated below investment grade or unrated:

Provided that such investment limit may be extended upto 50% of the net assets of the scheme with the prior approval of the board of trustees and the board of asset management company.

Appendix V: SEBI ALTERNATIVE INVESTMENT FUNDS) REGULATIONS, 2012 (May) – Selected Clauses

1. Category I Alternative Investment Fund- Venture Capital Fund
2. Category I Alternative Investment Fund- Social Venture Fund
3. Category I Alternative Investment Fund- SME Fund
4. Category I Alternative Investment Fund- Infrastructure Fund
5. Category I Alternative Investment Fund- Other
6. Category II Alternative Investment Fund
7. Category III Alternative Investment Fund

Investment in Alternative Investment Fund.

10. Investment in all categories of Alternative Investment Funds shall be subject to the following conditions:-

- (a) the Alternative Investment Fund may raise funds from any investor whether Indian, foreign or non-resident Indians by way of issue of units;
- (b) each scheme of the Alternative Investment Fund shall have corpus (total committed investment) of at least twenty crore rupees; (Rs 200m)
- (c) the Alternative Investment Fund shall not accept from an investor, an investment of value less than one crore rupees: (min inv = Rs 10m)

Provided that in case of investors who are employees or directors of the Alternative Investment Fund or employees or directors of the Manager, the minimum value of investment shall be twenty five lakh rupees.

.....

(f) no scheme of the Alternative Investment Fund shall have more than one thousand investors;

(g) the fund shall not solicit or collect funds except by way of private placement.

Tenure.

(1) Category I Alternative Investment Fund and Category II Alternative Investment Fund shall be close ended and the tenure of fund or scheme shall be determined at the time of application subject to sub-regulation (2) of this regulation.

(2) Category I and II Alternative Investment Fund or schemes launched by such funds shall have a minimum tenure of three years.

(3) Category III Alternative Investment Fund may be open ended or close ended.

(4) Extension of the tenure of the close ended Alternative Investment Fund may be permitted up to two years subject to approval of two-thirds of the unit holders by value of their investment in the Alternative Investment Fund.

(5) In the absence of consent of unit holders, the Alternative Investment Fund shall fully liquidate within one year following expiration of the fund tenure or extended tenure

Listing.

(1) Units of close-ended Alternative Investment Fund may be listed on stock exchange subject to a minimum tradable lot of one crore rupees.

(2) Listing of Alternative Investment Fund units shall be permitted only after final close of the fund or scheme.

Conditions for Category I Alternative Investment Funds.

(5) The following conditions shall apply to Infrastructure Funds in addition to conditions laid down in sub-regulation (1):-

(a) at least seventy five percent of the corpus shall be invested in unlisted securities or units or partnership interest of venture capital undertaking or investee companies or special purpose vehicles, which are engaged in or formed for the purpose of operating, developing or holding infrastructure projects;

(b) notwithstanding clause (a) of sub-regulation (5), such funds may also invest in listed securitized debt instruments or listed debt securities of investee companies or special purpose vehicles, which are engaged in or formed for the purpose of operating, developing or holding infrastructure projects.

Appendix VI: Dana Infra Retail Sukuk Distribution Channels

3.1 How to Apply for the DanaInfra Retail Sukuk

Check for DanaInfra Retail Sukuk information		
Check the media and DanaInfra's website (www.danainfra.com.my) for information on DanaInfra Retail Sukuk		
Read the Knowledge Pack		
Before applying for DanaInfra Retail Sukuk, please read the Knowledge Pack carefully		
Apply using application forms <p>The forms are available at the Issuing House, selected branches of the Participating Financial Institutions and downloadable from DanaInfra's website.</p> <p>The key steps to apply for DanaInfra Retail Sukuk via application form are outlined as follows:</p> <ul style="list-style-type: none"> You must have a CDS account Complete the application form with the required information below: <ul style="list-style-type: none"> Personal particulars / company details CDS account number Details of payment Number of units applied Each completed form must be accompanied with remittance for DanaInfra Retail Sukuk amount in full either by: <ul style="list-style-type: none"> Banker's draft or cashier's order purchased within Malaysia only and drawn from a bank in Kuala Lumpur; or Money order or postal order (for applicants in Sabah and Sarawak only); or ATM statement of the Participating Financial Institution Enclose the legible photocopy of your Identification Card / copy of Certificate of Incorporation Submit the above documents by post / courier / hand to the Issuing House at the following address: <p style="text-align: center;">Malaysian Issuing House Sdn Bhd Level 6, Symphony House, Pusat Dagangan Dana 1, Jalan PJU 1A/46, 47301 Petaling Jaya</p> 	Apply via ATMs <p>The key steps to apply for DanaInfra Retail Sukuk via ATMs (Electronic Application) are outlined as follows:</p> <ul style="list-style-type: none"> You must have a CDS account, current / savings account and an ATM card issued by a Participating Financial Institution Follow all instructions as required at the ATM to apply for DanaInfra Retail Sukuk. You must have the following details: <ul style="list-style-type: none"> CDS account number Number of units applied Amount payable for the units applied and to be deducted from current / savings account Confirm the Mandatory Statements (refer to the Frequently Asked Questions Section for details) Keep the ATM transaction slip for your record <p>(Please note that if there are any references to "shares" in the ATM screen, it shall be deemed to mean "units" for the purpose of your application)</p>	Apply via Internet Banking <p>The key steps to apply for DanaInfra Retail Sukuk via Internet (Internet Application) are outlined as follows:</p> <ul style="list-style-type: none"> You must have a CDS account and an account with Internet Banking access to the following Participating Financial Institutions: <ul style="list-style-type: none"> www.cimbclicks.com.my www.eipocimb.com www.mandabank2u.com.my www.rhb.com.my Follow all instructions as required within the respective Internet Banking portal to apply for DanaInfra Retail Sukuk. You must have the following details: <ul style="list-style-type: none"> CDS account number Number of units applied Amount payable for the units applied and to be deducted from current / savings account Confirm the Mandatory Statements (refer to the Frequently Asked Questions Section for details) Print the Confirmation Screen for reference and retention <p>(Please note that if there are any references to "shares" in the internet screen, it shall be deemed to mean "units" for the purpose of your application)</p>

Note: Kindly refer to DanaInfra's website at www.danainfra.com.my for further details on DanaInfra Retail Sukuk application

Source: (Dana Infra, 2013)



The Financial Product Development Center (FPDC) was established in Muharram 1432H (December 2010G). Its main purpose is to enhance the leadership of the Islamic Development Bank Group in the development and promotion of innovative Islamic financial products within the framework of the Maqasid al-Shariah. This is accomplished while further strengthening the financial soundness and relevance of the IDB Group.

The Center is the focal point for the development of new and innovative financial instruments at IDB Group, and for this purpose it also collaborates with various institutions in the Islamic financial industry.

Strategic Objectives

The Center has three major strategic objectives:

- ❖ Developing Business Process for new product development.
- ❖ Building capacity of product developers.
- ❖ Designing new financial products.

These three objectives are summarized by the “3Ps” that the Center works along: Process, People, and Products.

For any queries, please contact:

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