



Islamic Infrastructure Project Financing in Pakistan

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Disclaimer

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1) INTRODUCTION

State Bank of Pakistan, like a central bank in any developing country performs both the traditional and developmental functions to achieve macro-economic goals. The traditional functions, which are generally performed by central banks almost all over the world, may be classified into two groups: (a) the primary functions including issue of notes, regulation and supervision of the financial system, bankers' bank, lender of the last resort, banker to Government, and conduct of monetary policy, and (b) the secondary functions including the agency functions like management of public debt, management of foreign exchange, etc., and other functions like advising the government on policy matters and maintaining close relationships with international financial institutions. The non-traditional or promotional functions, performed by the State Bank include development of financial framework, institutionalization of savings and investment, provision of training facilities to bankers, and provision of credit to priority sectors.

The scope of Bank's operations has been widened considerably by including the economic growth objective in its statute under the State Bank of Pakistan Act 1956. The Bank's participation in the development process has been in the form of rehabilitation of banking system in Pakistan, development of new financial institutions and instruments in order to promote financial intermediation and inclusion in the country.

The State Bank also has been playing an active part in the process of Islamization of the banking system. SBP has been playing a dual role of regulator as well as a facilitator for the Islamic banking industry. The Central bank has issued essentials of major Islamic finance products and instruments along with their model agreements for Islamic Banking Institutions (IBIs). Over the years, SBP has introduced and implemented key regulatory reforms and prudential measures to ensure that the industry has necessary risk management systems and infrastructure to measure and manage the peculiar risks of Islamic finance industry. Further in order to align its regulatory framework with the international regulatory standards and best practices, it regularly reviews and evaluates the standards issued by global standard setting bodies like IFSB, AAOIFI, IIFM for their possible implementation keeping in view local legal, regulatory and economic environment.

This paper is an effort to study and analyze Islamic project finance trends in Pakistan highlighting common modes of financing used and challenges prevalent in Islamic project finance.

For the purpose of this study, information/data pertaining to Islamic infrastructure project financing in the country has been gathered from 2008 to 2012 from banks/DFIs, which has been used for analyzing and assessing the financing profiles, trends and growth.

The following sections will focus on infrastructure project finance, Islamic infrastructure project finance, Islamic financial products and instruments, financing trends, challenges etc, and the role they play in financing large-scale infrastructure projects.

2) AN OVERVIEW OF INFRASTRUCTURE PROJECT FINANCING

As per International Project Finance Association (IFPA), Infrastructure Project Financing is defined as “the financing of long-term infrastructure, industrial projects and public services based upon a non-recourse or limited recourse financial structure where project debt and equity used to finance the project are paid back from the cash-flow generated by the project.”

Project finance is the long-term financing of infrastructure and industrial projects based upon the projected cash flows of the project rather than the balance sheets of its sponsors. Usually, a project financing structure involves a number of equity investors, known as 'sponsors', as well as a 'syndicate' of banks or other institutions that provide financing. They are most commonly non-recourse finances, which are secured by the project assets and paid entirely from project cash flows, rather than from the general assets or creditworthiness of the project sponsors.¹

The financing is typically secured by all of the project assets, including the revenue-producing contracts. Project financiers are given a lien on all of these assets and are able to assume control of a project if the project company has difficulties in complying with the financing terms.

Generally, a special purpose entity is created for each project, thereby shielding other assets owned by a project sponsor from the detrimental effects of a project failure. As a special purpose entity, the project company has no assets other than the project. Capital contribution commitments by the owners of the project company are sometimes necessary to ensure project's financial soundness or to assure the financiers' or the sponsors' commitment.

In recent years, project finance schemes have become increasingly common in the Middle East, some incorporating Islamic finance.

3) ISLAMIC PROJECT FINANCE - CHALLENGES

A significant challenge (facing IIPF) has been the difficulty that many Islamic financiers have had until recently competing with conventional lenders in terms of price and tenor. Before the onset of the financial crisis in 2008, the pricing of project financings hit all-time lows and at these levels, project finance was not a particularly attractive proposition for many Islamic financial institutions. Pricing coupled with the length of tenors conventional lenders were able to commit to (upto 15 years in the oil and gas sector and over 20 years in connection with power transactions) made it difficult for Islamic financiers to compete. Islamic financial institutions tend to focus more on retail banking and rely more

¹www.en.wikipedia.org/wiki/Project_finance

on deposits as a source of liquidity rather than the longer-term bond market tapped by conventional banks.

A second obstacle for some Islamic financiers has been the risks associated with project finance. A lot of time and effort have gone into the development of Islamic finance transactions such as the Istisnaa-Ijara model in order to try to mitigate risks to Islamic financiers. However, the remaining risks still make participation in these transactions prohibitive for many Islamic financiers. As the legal owner of the project assets, Islamic financiers have exposure to third-party liabilities including environmental risk etc. Other obligations on the Islamic financiers as owners of project assets include responsibilities relating to Takaful and operation and maintenance of the assets. Under a typical Istisnaa-Ijara mode, these obligations are normally performed by the client on behalf of the Islamic financiers under a service agency agreement, and the client in its capacity as the service agent is liable for any loss or damage suffered by the Islamic financiers as a result of any failure to perform these obligations. However, notwithstanding the considerable effort that has gone into developing these products, the Islamic financiers still bear significant responsibility and risk as owners of the assets such as risk of destruction of asset etc.

The financiers often remain responsible for any capital improvements that are required and, although procurement of Takaful is normally delegated to the client, the bottom line is that the Islamic financiers, as owners of the assets, bear the risk of availability of Takaful claims with respect to the project Takaful policies. The client cannot indemnify to cover the shortfall received from Takaful company if destruction to the asset is not caused by his negligence or if there is no negligence of the client in discharging his duties as a Service Agent. Add to these risks, the standard risks that are always the concern of any project financiers such as counterparty, technology and market risk and you end up with a risk profile that is too onerous for many Islamic financiers to take or results in the pricing of Islamic finance at levels that make it uncompetitive with conventional bank pricing. However, Islamic banks develop their products in a way that maximum risks are mitigated.

Despite the above challenges, the Islamic Banking Industry has come up with viable Shariah compliant project financing solutions that are offered in the market. The next section highlights the key Islamic Project Financing products.

4) AN OVERVIEW OF ISLAMIC PROJECT FINANCING PRODUCTS

Over the past few years, especially in Middle East and some Asian countries, there has been an increase in financing of infrastructure projects in accordance with the Islamic Shariah.

The Islamic Project Financing can be obtained either directly from the financier or issuing Islamic securities (Sukuk). A brief of different financing products are given as under:-

Islamic Project Financing Types	
Categories	Way of Financing
Asset based	Ijara (on existing/future assets i.e. forward lease), Ijara in tranches, Diminishing Musharakah
Debt Based	Istisnaa (manufacturing/commissioning), Murabaha (cost plus profit)
Equity Based	Mudaraba, Musharakah
Agency Based	Wakala
Combination	Istisnaa cum Ijara, Wakala cum Ijara etc.

The challenge is to offer project finance that is not only consistent with Shariah principles but is also attractive to financiers.

Here is brief discussion of how an Islamic project finance transaction is developed. The most frequently used modes in the Islamic project finance sector are the *Istisnaa-Ijara* and the *Wakala-Ijara* modes.

Istisnaa cum Ijara

An Istisnaa-Ijara mode incorporates an Istisnaa contract that applies to the construction phase of a project, and an Ijara contract for the operations phase. The client undertakes an Istisnaa contract to procure the relevant plant and equipment from the manufacturer. The client simultaneously enters into a construction contract with the construction contractor.

The Islamic financiers make phased payments to the client during the construction phase of a project whereby capital is raised from financiers in blocks or separate disbursements based on construction milestones reached and on a predetermined schedule.

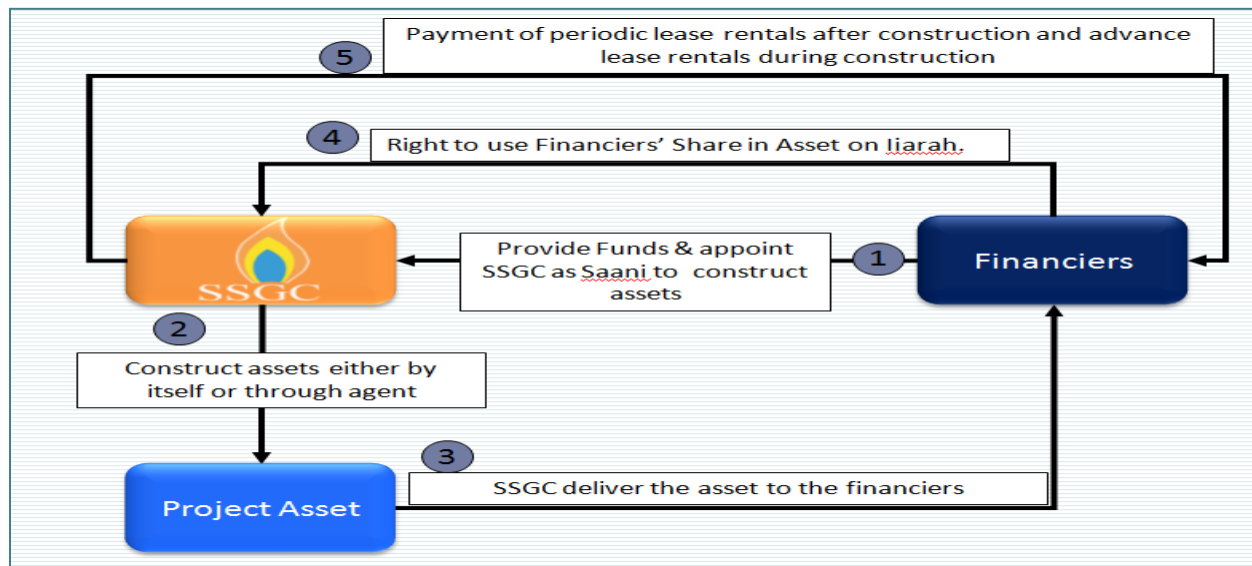
The Ijara contract typically comes into effect upon completion of construction project. The lessor under an Ijara must maintain legal and beneficial ownership of the asset and bear responsibility for risks associated with asset ownership, meaning there must be a link between an Islamic financier's ability to earn profits and the assumption of risk. The Ijara contract also typically includes a promise from the Islamic financiers as lessors to transfer the ownership of the leased asset to the client, as lessee, either at the end of the lease period or in stages during the term of the Ijara as per the guidelines of Shariah. Ownership of the assets is transferred to the Islamic financiers upon project completion pursuant to the Istisnaa contract. Thereafter the Islamic financiers lease the assets to the client in consideration for rental payments that are sized to cover the capital cost of the equipment/project plus a profit margin.

Obligations that would typically fall on the Islamic financiers – such as care and maintenance of the assets and responsibility for Takaful – are normally performed by the client on the Islamic financier's behalf which are reimbursed to the client.

Below is an example of Istisnaa Cum Ijara.

Example of Istisnaa Cum Ijara	
Company	SSGC
Purpose	To finance construction of 18” Dia X 53 pipeline from Dhader to Abb-e-Gham
Facility Amount	PKR 1,000 million.
Tenor	3 years.
Grace	15 months.

The process flow of the project is as under:-



Wakala Cum Ijara

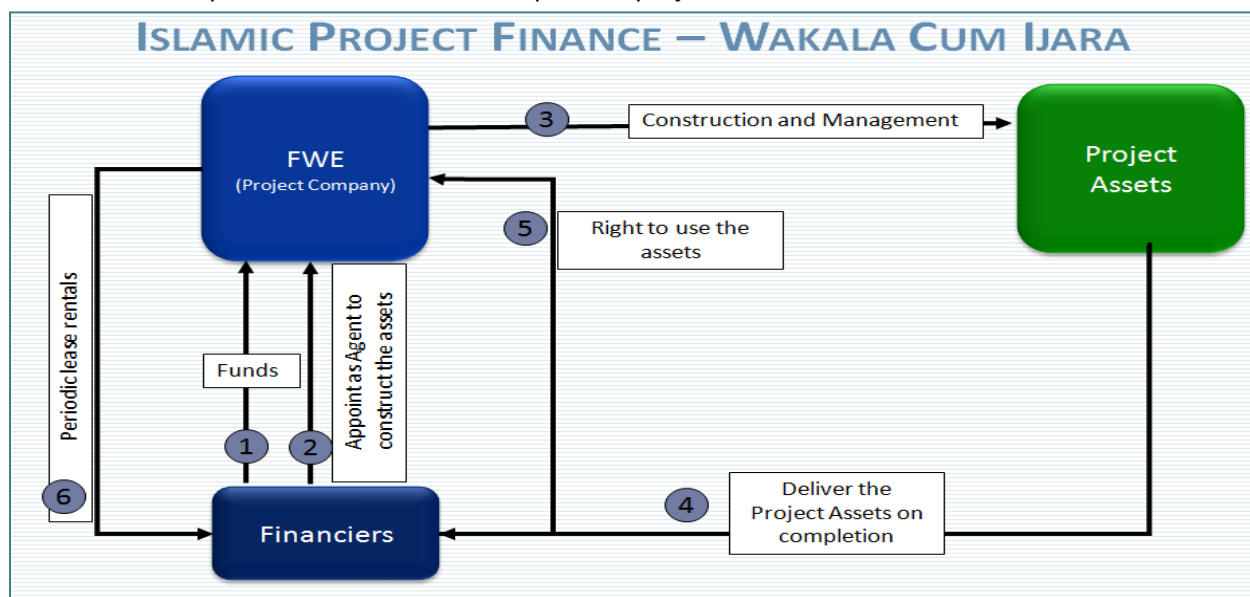
The *Wakala – Ijara* mode is an alternative but similar method commonly used in Islamic project finance. Under this mode, the client is employed as the Islamic financier’s agent or “Wakil” in accordance with the terms of an agency agreement known as a Wakala agreement.

The client procures the design, engineering, construction, testing, commissioning and delivery of the assets identified in the Wakala agreement as the agent for the Islamic financier and Islamic financier bears the risk of all the above mentioned activities.

Example of a Wakala cum Ijara Project	
Company	FWE
Purpose	To set up Wind Power Generation Complex.
Project Cost	USD 134 million
Facility Amount	PKR 10,000 million.
Tenor	12 years.
Grace	2 years.
Project	Construction of 50 MW Wind Power Project, situated at Kutti Kun, District Thatta,

Sindh.

The below is the process flow of the above specified project.

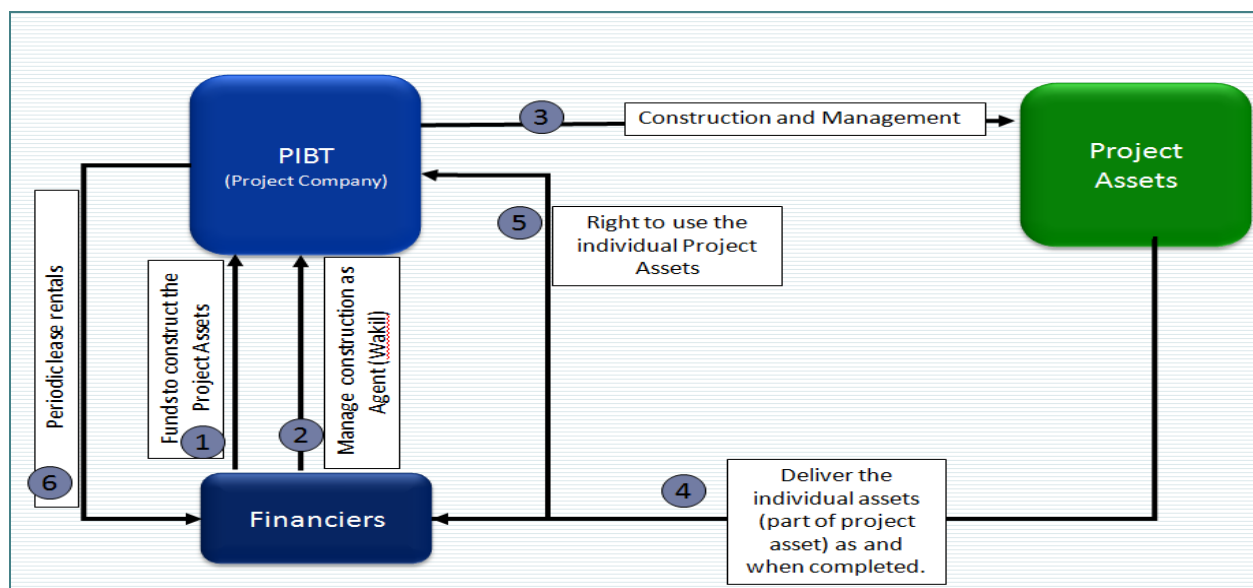


Tranches Ijara

This mode of financing assists the Islamic financiers to recognize the Advance Lease Rental as soon as any individual asset, part of the project asset, is completed and in usable condition.

Example of Tranches Ijara	
Company	PIBT
Purpose	To finance Company’s capex plan
Project Cost	USD 184 million
Local Facility	PKR 4,100 million
Tenor	12 years
Grace	3 years
Project	To set up a dedicated Cement, Coal and Clinker Terminal with a handling capacity of 11 million tons per annum.

The process flow of the above specified project is as under:-



It is depicted in the process flow chart that the PIBT (as Agent) will construct a dirty cargo handling terminal, while the Financiers will inject funds as and when required by PIBT.

PIBT as agent will construct the Project Asset and will also enter into supply, construction and other contracts.

PIBT will be deemed to commence usage of assets as soon as each asset/section turns into the usable condition and will take such asset/section on lease thereby making rental payments to its financiers' for using each individual assets.

Financiers undertake to transfer the Project Assets at the end of the Tenor, while PIBT will undertake purchase of the Project Assets in the event of default.

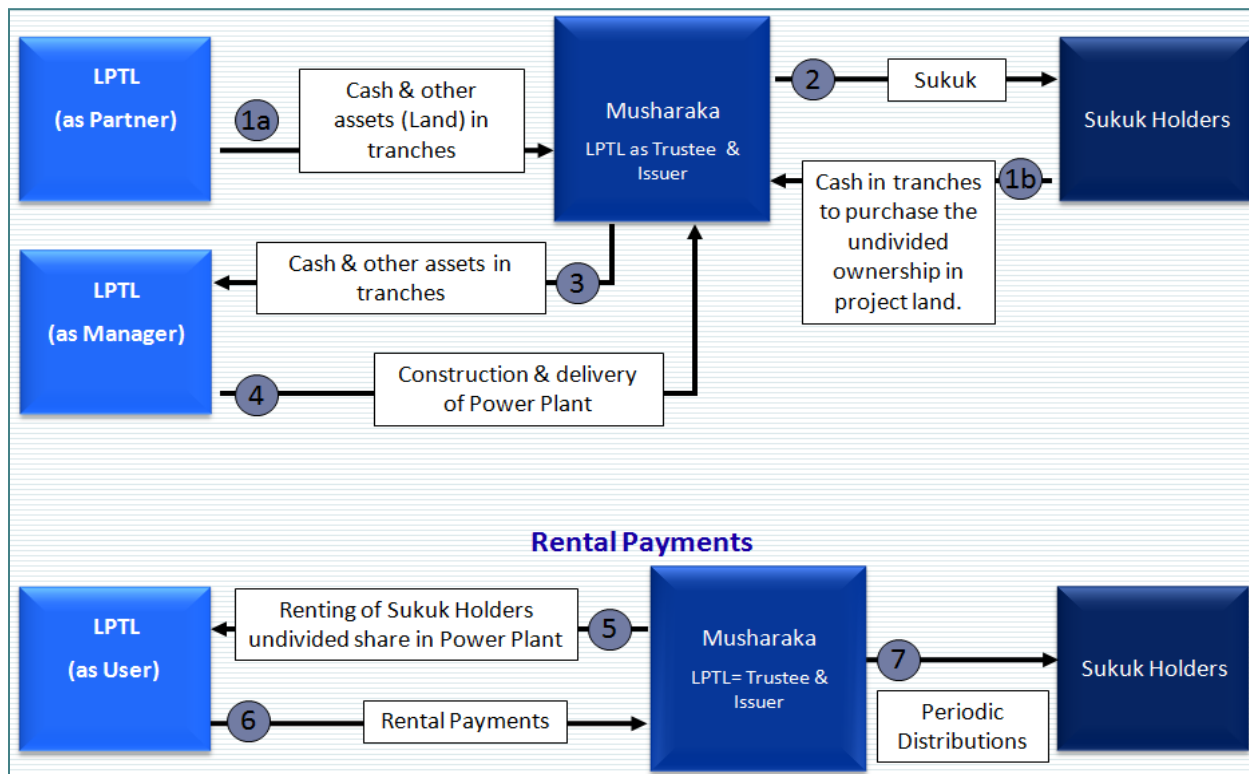
Sukuk

Sukuk are among the best ways of financing large enterprises and infrastructure projects that are beyond the ability of a single party to finance, an ideal mean for investors to deploy large or small capital and an excellent way of managing liquidity for banks and Islamic financial institutions². Sukuk can be structured for various Islamic modes of finance. An example of Musharaka Sukuk is given as under:

Example of Sukuk Financing	
Company	LPTL
Purpose	To setup a new project under the name of LPTL
Project Cost	USD 241 million
Issue Size	PKR 15,000 million
Tenor	12 years
Grace	2 years
Project	To setup a 200 MW power plant on the BOO (Build Operate Own) concept, based on Residual Furnace Oil (RFO)

² <http://www.sukuk.com.pk>

Process flow of the above specified project is as under:-



LPTL and Sukuk Holders enter into a Musharakah to construct and then own undivided share in the Power Plant. Here, Sukuk will be issued by LPTL, as Issuer, to the Sukuk Holders against the cash contribution towards Musharakah.

The Sukuk Holders will purchase the undivided ownership in the land, while the Project Company will contribute its share in kind (the remaining portion of undivided ownership in land). This will enable the financiers to charge rental as income from the very day Musharakah is created.

LPTL (as managing co-owner) will get the Power Plant constructed as per specification at an agreed cost. Sukuk Holders' undivided share in Musharakah Assets (Power Plant) will be rented to LPTL on completion of the construction in consideration of Periodic Rentals which include Base Rental (Principal) and Variable Rental (Profit).

LPTL undertakes to purchase the Sukuk Holders' Musharakah share on maturity or in the event of default.

5) ISLAMIC PROJECT FINANCING IN PAKISTAN

Islamic Banking Industry has grown manifold since start of its operations in 2002-03 and has achieved around 10 percent share in total banking industry. As of December 2012, 1,097 branches of Islamic Banking Industry have been established in Pakistan.

The data on Islamic Infrastructure Project financing (IIPF) for the period 2008-2012 has been gathered from banks and DFIs, on the basis of which analysis and assessment of the financing profile, trends and growth has been made. As per the collected data, 2 commercial banks with Islamic banking branches, 1

Islamic bank and 3 DFIs have been contributing in IIPF. An analysis on different parameters is given below:

a) IIPF - Sector Wise Financing

Infrastructure Project Finance (IPF) Guidelines of SBP define infrastructure project as any of the 14 sectors specified in the section 14 of the Guidelines.

Table A lists the sectors where IIPF financing was made by the financial sector. It is clear from the table that Power Generation was the key sector where banks invested. It is also evident that the outstanding financing against power generation sector was hovering around Rs. 4.7 billion over the period under review. Of the total outstanding finance, more than 95 percent was the share of power generation sector, as of Dec-10 and the same further enhanced to almost 100 percent as of Dec-11. Banks and DFIs took interest in power generation sector due to the incentives and guarantees provided by the Government of Pakistan through Power Policy.

Sectors	Dec-12	Dec-11	Dec-10	Dec-09	Dec-08
Power Generation	4,350	4,668	4,630	2,688	1,361
Oil & Gas Exploration and Distr.		3	200	500	500
Shipping/Container Terminals			10	10	10
Total	4,350	4,671	4,840	3,198	1,871

Moreover, at the end of Dec-12 the total amount outstanding against Islamic Infrastructure Projects saw a growth of 132 percent when compared with Dec-08.

b) IIPF - Cumulative No. of Projects

Table B portrays the cumulative number of projects undertaken by the financial institutions under Islamic Infrastructure Project Financing. As discussed earlier, power generation was the only leading sector where banks and DFIs invested under Islamic mode, while only one project was started in 2008 in Oil & Gas Exploration/Distribution sector.

Sectors	Dec-12	Dec-11	Dec-10	Dec-09	Dec-08
Power Generation	8	8	8	7	3
Oil & Gas Exploration and Distr.	-	1	1	1	1
Shipping/Container Terminals	-	-	1	1	1
Total	8	9	10	9	5

Note: Total number of projects less the matured ones.

The table shows that the total number of projects undertaken by the industry could not cross the figure of 10 over the period under review. However, it is encouraging that at the number of projects have increased from 05 to 08, a growth of 60 percent, during the period Dec-08 to Dec-12.

c) IIPF - Total Amount Sanctioned

Table C shows the amount sanctioned by the financial industry under Islamic Infrastructure Project Financing in the country. It is evident from the table that the total amount sanctioned by the financial institutions hovered around Rs. 6.5 billion during the period under review.

Table C: Sectoral Trends - Sanctioned Amount (Rs. Millions)					
Sectors	Dec-12	Dec-11	Dec-10	Dec-09	Dec-08
Power Generation	4,881	5,045	6,006	5,437	2,933
Oil & Gas Exploration and Distr.	-	500	500	500	500
Shipping/Container Terminals	-	-	10	10	10
Total	4,881	5,545	6,516	5,947	3,443

Note: Total sanctioned amount less the matured ones.

During the period Dec-08 to Dec-12, a growth of about 42 percent was witnessed in the total amount sanctioned. Again, the major beneficiary remained the power generation sector which saw a growth of more than 66 percent during the five years period under review, while the share of other sectors was negligible.

d) IIPF - Cumulative Amount Disbursed

Table D shows the total cumulative disbursements made by the financial sector at the end of the mentioned periods. It is encouraging that the overall growth in cumulative disbursements for the period Dec'2008-12 is about 156 percent.

Here again, the major beneficiary was power generation sector with a growth of more than 250 percent whereas other sectors did not see any improvement as only two projects were undertaken by the industry and that too matured in 2010 and 2011.

Table D: Sectoral Trends - Cumulative Disbursements (Rs. Millions)					
Sectors	Dec-12	Dec-11	Dec-10	Dec-09	Dec-08
Power Generation	4,798	4,886	4,824	2,927	1,361
Oil & Gas Exploration and Distr.	-	500	500	500	500
Shipping/Container Terminals	-	-	10	10	10
Total	4,798	5,386	5,334	3,437	1,871

Note: Cumulative amount against the projects less the matured ones at the end of December

e) IIPF Vs IPF - Outstanding Amount

Table E shows a comparison of total amount outstanding against Islamic and overall i.e. IIPF Vs IPF. Over the five years, the share of IIPF in total Infrastructure project financing (IPF) has been hovering around 2 percent, while the growth recorded in IIPF was about 133 percent over the period Dec'2008-12.

Table E: Sectoral Trends - Outstanding Finance (Rs. Billion)					
	Dec-12	Dec-11	Dec-10	Dec-09	Dec-08
Total Outstanding-IIPF	4.3	4.7	4.8	3.2	1.9
Total Outstanding-IPF (overall)	289.3	265.5	298.5	275.9	234.4

f) IIPF - Non Performing Assets

The non-performing assets against IIPF did not occurred at all. This might be due to the fact that Islamic Banking Institutions made very prudent financing decisions.

g) IIPF - Banking Sector-wise Share

At the end of Dec-12, 14 commercial banks with Islamic banking branches and 5 Islamic Banks were offering Islamic financing products. However, as far as IIPF is concerned only two commercial banks with Islamic banking branches, one Islamic bank and 3 DFIs made investments in Infrastructure sectors.

Table F: Banking Sector wise Trends - Outstanding Finance (Rs. Million)					
Category	Dec-12	Dec-11	Dec-10	Dec-09	Dec-08
Islamic Banking Institutions	2,979.6	3,182.6	3,177.1	1,744.8	1,011.0
DFIs	753.2	795.8	967.7	818.0	510.0
Total	4,350	4,671	4,840	3,198	1,871

A review of the five years data (2008-2012), as regards banking categories, suggests that public sector banks, foreign banks and specialized banks did not contribute at all in IIPF and their financing remained Nil for the period under review. However, Private Banks, Islamic Banks and DFIs were the only categories of banks which undertook IIPF in three categories of the Infrastructure sectors i.e. Power Generation, Oil & Gas Exploration/Distribution and Shipping/Terminals.

Table F clearly states that the major portion of Islamic financing is attributable to Islamic Banking Institutions followed by DFIs. Both the categories witnessed a growth of 195 percent and 76 percent each respectively.

Table G: Banking sector wise Trends – Cumulative Disbursements (Rs. Million)					
Category	Dec-12	Dec-11	Dec-10	Dec-09	Dec-08
Islamic Banking Institutions	3,274	3,362	3,372	1,985	1,011.0
DFIs	820	1,320	1,268	818	510.0
Total	4,798	5,386	5,334	3,437	1,871

Table G portrays the cumulative disbursements made by the banks at the end of the specified periods. A growth of 156 percent was recorded for the period 2008-12 while the growth of Islamic Banks was more than 224 percent and private banks 101 percent.

Table H is a split of the banking category wise number of projects at the end of the mentioned periods. It is encouraging to note that the banks saw an increase in their total number of projects. The growth recorded over the five years' period was 60 percent.

Table H: Banking sector wise Trends – Total Number of Projects (as of)					
Category	Dec-12	Dec-11	Dec-10	Dec-09	Dec-08
Islamic Banks	3	3	3	2	1
DFIs	2	3	4	4	3
Commercial banks with Islamic banking branches	3	3	3	3	1
Total	8	9	10	9	5

Note: Total number of the projects less the matured ones.

6) WAY FORWARD

Infrastructure projects usually require large scale investment and investment for longer tenors. The projects can be financed through public or private funds or their combination (Public Private Partnerships). Public sources of financing large infrastructure projects may include budgetary allocation from government, specialized public entities/development banks, sovereign wealth funds, and sovereign guarantees, etc. while private sources may include syndicated financing by banks/financial institutions, infrastructure funds, private equity funds, and other capital market instruments (Sukuk).

There is an immense potential for banks & DFIs venturing in Islamic Project Financing against different infrastructure sectors. Most imminent among them are Power Generation & Power Transmission sectors. Further, there is a huge potential for investment in sectors like water supply, dams, irrigation, water treatment systems, sanitation and sewerage systems, and solid waste management systems etc. Besides, Social Infrastructure (Health & Education) also requires attention of the private sector.

Thus, infrastructure projects may be financed through pure Islamic sources as well as through co-financing models. There is a huge potential for long term infrastructure project financing as Muslims and governments in the Islamic world are also looking for Shariah-compliant investment possibilities outside of their home countries; therefore, providing investment opportunities in Pakistan would be critical for its sustainable economic development in the long run.

The global projects and trends show that despite decades of misunderstanding and uncertainty, Islamic financial practices are becoming better known and accepted throughout the world. As the general level of knowledge about Islamic finance and banking increases, its use in project finance will surely increase. This is also evident from the fact that our banking industry has been able to enhance its share in total outstanding financing as well as in IIPF over the past five years; however, there is still a huge potential when we take into account the potential (USD 60-65 billion) of infrastructure project financing in the country.

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GLOSSARY

BCO	Banking Companies Ordinance
BPD	Banking Policy Department
CTFS	Commission for Transformation of Financial System
DFIs	Development Finance Institutions
FSC	Federal Shariat Court
IFN	Islamic Finance News
IH&SMED	Infrastructure, Housing & SME Finance Department
IIPF	Islamic Infrastructure Project Financing
IPF	Infrastructure Project Financing
OECD	Organization for Economic Cooperation & Development
PFI	Private Finance Initiative
PLS	Profit and Loss Sharing
PPP	Public-Private Partnerships
SAB	Shariat Appellate Bench
SBP	State Bank of Pakistan
SPCs	Special Purpose Corporations