BANKING ON OIL & GAS

Leveraging Islamic instruments can help GCC banks match regional liquidity with the mounting need for oil & gas infrastructure investments, believe Middle East Strategy Advisors' Mazen Khoury and Glen Osmond.

International lenders have historically dominated the funding of GCC oil and gas infrastructure investments, leaving only a small role for local banks. Opportunities exist to break into this market, but regional bankers need to articulate a differentiated product offering which can be further facilitated by the use of Islamic finance. Realistically, Islamic instruments will need to have lower transaction costs (made up mostly of lawyer and due diligence fees) in order to credibly compete on the regional long-term funding arena.

Ageing assets and high demand for oil are driving the need for considerable investments into new productive oil and gas capacity. Even though higher oil prices are generating windfall profits, national oil companies are transferring funds to governments who need to wipe off accumulated budget deficits and most international oil companies are under pressure to return profits to shareholders. Given the magnitude of the investments required, there are increasing calls for project finance and long-term structured funding solutions. Long-term structured funding sources are typically large European and Japanese financial institutions. Their key advantages include:

(1) Demonstrated project structuring skills and capabilities, allowing for lower average transaction costs.

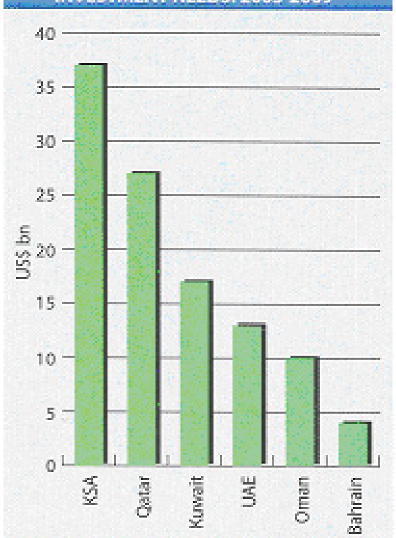
(2) Political clout to warrant alliances with oil and gas majors and western equipment suppliers, when negotiating new projects with GCC sponsor governments.

(3) Sufficient scale supporting underwriting capabilities.

Accordingly, GCC banks are sidelined as 'fringe' players and are effectively shut out from margins accruing to the more established global project finance players. Local banks are being left to scramble for leftovers from larger transactions, short-term finance deals and bridge loans. Ironically, leaders in long-term Islamic finance – often touted as a key differentiator of the regional finance industry – are large European players such as BNP Paribas.

There are recent signs that times are changing. In July 2005, Dolphin Energy announced that 25 banks will provide conventional and Islamic project finance totalling $3.45 billion. Of this financing, $1 billion is an Islamic Istithna'a instrument which was led by five banks including two regional institutions.

OIL & GAS INFRASTRUCTURE INVESTMENT NEEDS: 2005-2009*



*Estimate; Source: Standard Chartered Bank

Dolphin proactively approached Arab bankers with lead banks making a special point to invite Islamic investors from across the Middle East and Asia to join the financing. This allowed local banks to benefit from supportive funding terms, whilst helping build a track record for key local bankers with the advent of innovative Islamic instruments.

There are considerable challenges ahead for GCC local banks, which while being backed by substantial market liquidity, still must actively seek capital-intensive investment or loan propositions. In order to place deals, regional bankers are presently driven to decrease the rigour with which they will assess project risks and reward profiles under normal circumstances.

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According to interviews by MESA (Middle East Strategy Advisors) with regional oil company CFOs and Islamic financial institutions, the key to GCC bankers placing Islamic finance instruments and effectively funding the region's investment in oil and gas productive assets is that they need to build size, establish differentiated products, and articulate a simple well-defined value proposition.

To secure a more sizeable share of the oil and gas funding market, regional banks should focus on both improving Islamic offerings, as well as targeting conventional lending. In both regards key success factors include:

Sharia'ah compliance boards. Clarify the currently prevailing legal and regulatory uncertainties: the creation of Sharia'ah compliance boards by key players, and the proactive involvement of theologians in affirming compliance standards, should be sought.

GCC oil and gas project finance deals*			
Arranger	No. of deals	Amount ($bn)	Share (%)
1. Barclays (UK)	5	2.0	9.6
2. Mizuho (Japan)	11	1.8	8.5
3. Royal Bank of Scotland (UK)	9	1.5	7.2
4. BNP Paribas (France)	12	1.4	6.6
5. Westpac (Australia)	7	1.2	5.5

*For the period May 2004 – April 2005

Innovative structured products. Devise innovative structured products that are not offered by large international players: including increased use of securitisation techniques, and arranging more complex sukuks, or 'Islamic bonds'.

Islamic tools as subsets of conventional products. Pursue further ways to introduce Islamic finance products as self-contained tranches within larger conventional project finance: as is the case with Dolphin Energy.

Sector specialisation. Target sector specialities which will allow replication and achieve cost-effective instruments: such as in the LNG market; funding downstream refining facilities; and funding exploration and production of oil fields in areas such as Yemen, Libya or Oman.

Alliances with project promoters. Seek long-term alliances with western project promoters and suppliers: this will help influence funding decisions at the beginning of the finance structuring plan.

Partner with smaller oil companies. Partner with smaller oil and gas players seeking entry into the regional oil and gas arena by providing customised funding solutions.

Lobby ECAs. Effectively lobby Western European and US Export Credit Agencies (ECAs), to cover Islamic-compliant project finance terms, rendering the entire market more attractive to participants.

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Leverage shareholders. Leverage relationships with shareholders, often regional high net worth individuals who demand Islamic solutions are often also key political sponsors of medium scale oil and gas projects.

Regional banks are clearly on the scene and advancing along many of these fronts; however, meaningful progress is likely to continue and come from champions willing to aggressively drive the emergence of local banking expertise and define the value of Islamic finance for the oil & gas structured finance. ■