Islamic Project Finance

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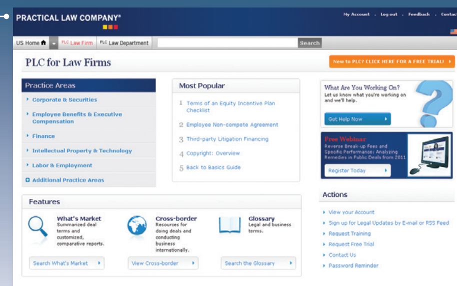
An article explaining the features of Islamic project finance and highlighting the parallels to, and principal differences with, conventional project financing.



While Islamic finance has been enjoying steady growth in importance in recent decades, the recent global economic crisis and the consequential reduction in the availability of non-Islamic bank financing to fund large infrastructure development projects, particularly across the Middle East, have refocused attention on Islamic project finance structures. Whereas in the past, Islamic tranches were introduced to promote the sector (and in many transactions, conventional banks simply split their participation in a project between their conventional and Islamic windows), going forward, Islamic finance will play an increasingly vital role in bridging the gaps left in financing plans for major projects as a result of the combination of several factors:

- The establishment of new Islamic banks (such as Alinma Bank in Saudi Arabia).
- The development of more creative Islamic finance structures which can utilize a project's underlying assets (including intangibles such as rights granted under a concession agreement or a license).
- The emergence of the *Sukuk* (Islamic bonds) market.

This Article will seek to explain the salient features of Islamic project finance structures and will highlight the parallels to, and principal differences with, conventional project financing.

ISLAMIC FINANCE STRUCTURES

Common among all Islamic finance structures is that no interest can be charged. Rather, the financier charges a mark-up or shares in the profits of the venture by doing any of the following:

- Entering into sales and purchase transactions.
- Entering into leasing arrangements.
- Participating in equity investments.

There are several standard products which have been developed to meet the financing needs of projects. Some of these products are based directly on structures described in the *Quran*, while others have been developed with the guidance and approval from eminent *Sharia* scholars, in each case combining acceptable returns with acceptable risks based on *Sharia* principles (see *Box, Islamic Finance Principles*).

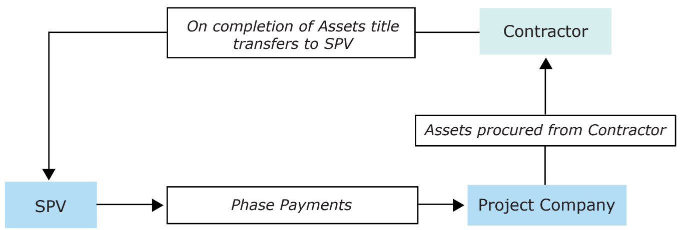
Istisna'a and Ijara

The most common form of Islamic project finance structures for large, longer-term financings (for example, infrastructure, power projects, transport equipment and so on) is the procurement (*Istisna'a*) and forward lease (*Ijara*) combination. The power deals in the United Arab of Emirates, Qatargas II LNG (liquid natural gas) project in Qatar, the Sohar aluminium smelter in Oman, the Rabigh Refining and Petrochemical and Saudi Kayan projects, among others, have all utilized the *Istisna'a–Ijara* structure in recent years.

Istisna'a

These transactions are based on a procurement agreement (or *Istisna'a*) between a special purpose vehicle (SPV) (owned by the Islamic financiers), as the purchaser, and the project company (the borrower), as the procurer. The procurement agreement operates for the construction phase of the project. Under the procurement agreement, the project company agrees to procure assets on behalf of the SPV by a certain date. On delivery of the assets, title to and possession of the assets passes to the SPV.

An important element of this structure is the use of the SPV to act (on behalf of the Islamic financiers) as the purchaser under the procurement agreement. The SPV structure has perceived benefits for both the Islamic financiers and the project company. In the case of the financiers, they are protected from the risks associated with the ownership of the assets, for example, environmental liability. In the case of the project company, because the assets are not held by the Islamic financiers directly, the project company and the assets are isolated from the risk of insolvency of an Islamic financier.



As consideration for the project company procuring the assets, the Islamic financiers agree to pay the project company an amount no greater than the total project cost of these assets. This is the equivalent of the principal amount of the project loans in a conventional project financing. The total project cost is paid to the project company via phase (or milestone) payments which are equivalent to drawdowns under conventional loan facilities. Accordingly, under the procurement agreement, phase payments are made with the same conditions to drawdown as under the conventional loan facilities.

During the construction period of the project, the project company (through the SPV) is entitled to reduce the total project cost payable by the Islamic financiers by altering the specifications of the assets (equivalent to a cancellation under conventional facilities).

Because the procurement agreement provides for a maximum amount the Islamic financiers must pay the project company for its procurement obligations, if the cost of constructing the assets is greater than that amount (whether as a result of a change order or a change in law), the project company must pay the excess. The Islamic financiers have no obligation under the procurement agreement with respect to the excess.

In addition to its liability for any cost overruns, the project company is required to pay liquidated damages to the SPV (which the SPV uses to repay the Islamic financiers) if the:

- Assets are delivered behind schedule.
- Assets are non-conforming.
- Procurement agreement or *Istisna'a* is terminated before the project is completed.

Because the Islamic financiers are repaid from lease payments and lease payments can only be made once the assets are constructed and operational, the liquidated damages provision enables the Islamic financiers to receive monies equivalent to:

- In the case of a delay, the lease payments they would have received had the lease transaction commenced as scheduled.
- In the case of non-conforming assets or termination of the procurement agreement, to all amounts paid by the SPV to the project company to procure the assets.

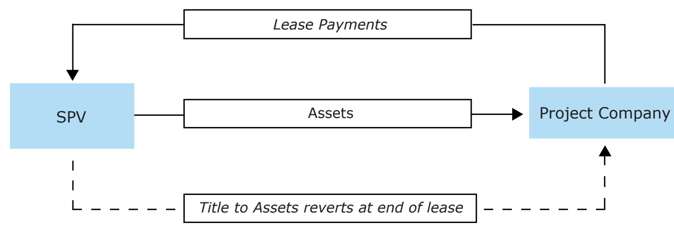
Ijara

The project company, as lessee, and the SPV, as lessor, will also enter into a forward lease agreement to lease the assets on delivery. The forward lease agreement operates during the operational phase of the project (the period following delivery of the assets to the SPV according to the procurement agreement until a date equivalent to the final maturity date under the conventional facilities).

Under the forward lease agreement, the project company will lease the assets from the SPV in return for lease payments. The lease payments are calculated by aggregating a lease:

- Fixed element (equivalent to principal on the conventional facilities).
- Variable element, generally on the basis of a reference such as six-month LIBOR, plus a fixed fee (equivalent to the applicable margin under the conventional facilities).
- Service amount (broadly equivalent to the amount paid to the project company (in its capacity as service agent under the service agency agreement (*see below*)) by the SPV.

Lease payments can be structured to be made at the same times as equivalent payments under conventional facilities.



Under this Islamic financing structure, voluntary and mandatory prepayments are addressed via early lease payment mechanics. Under *Sharia* principles, unlike in conventional operating leases, the SPV (in its capacity as lessor) is responsible for all major maintenance (typically repair, replacement and maintenance of a capital nature without which the assets could not reasonably be used by the project company). The project company is responsible for all ordinary maintenance (typically repair, replacement and maintenance other than major maintenance). In addition, the SPV will be responsible for insurance of the assets. To limit the SPV's liability and ensure that third parties do not have any claims on the SPV or its assets, the project company and the SPV enter into a service agency agreement under which the project company is appointed as agent of the SPV for the purpose of carrying out the major maintenance and procuring the insurance. Should the project company fail to effect any repairs or replacements, or obtain the insurance, the SPV may do so and will be indemnified by the project company for all amounts paid or costs incurred by the SPV.

In some transactions, it may also be a requirement of the financiers that the insurance is also placed with *Sharia*-compliant insurers on a *takaful* (cooperative) basis. If the project company is negligent in the use of, maintenance of, or in procuring insurance or performing its obligations, it assumes principal liability for and will be required to indemnify the Islamic financiers for any related losses.

The SPV and the project company are typically also parties to a purchase undertaking that requires the project company to purchase the assets under certain circumstances. The circumstances that trigger this right are deal specific but a provision in the purchase undertaking under which the project company agrees to purchase the assets on the occurrence of an event of default is, however, quite standard. There are also differences in the way that an *ijara* operates from country to country as to the price the project company must pay for the assets. Depending on the view of the applicable *Sharia* committees, in some countries the assets will be purchased by the project company at the end of the lease period for a predetermined price. In other countries, the assets will be gifted to the project company.

Sale of Intangible Rights and Ijara

In a recent project financing, the parties agreed and the relevant governmental authority consented that the subject matter of the *ijara* would not be the tangible assets to be constructed for the project but the intangible rights granted to the project company under a concession agreement. The "bundle" of rights under the concession agreement were sold to a SPV (on behalf of the Islamic financiers) and leased back to the project company in return for lease rental payments.

A straight sale-and-leaseback structure is often not permitted under *Sharia* principles as it is not considered to be a genuine commercial transaction. To render the proposed structure *Sharia*-compliant, it is required that a third party be interposed between the project company and the SPV.

Murabaha

Another fairly common form of Islamic finance structure (although more commonly used in acquisition financings) is the use of forward payment obligations under *murabaha* contracts. This structure involves a contract between the Islamic financier and the client for the sale of goods at a price that includes an agreed profit margin, either a percentage of the purchase price or a lump sum. The Islamic financier will purchase the goods as requested by its client and will sell them to the client with an agreed mark-up. The profit mark-up must be agreed to before the deal closes and cannot be changed. A more versatile variation of the *murabaha* contract is the *tawarruq* structure. Under a *tawarruq*, following its acquisition of the goods from the Islamic financiers, the client will appoint an agent (usually the same Islamic financier) to sell the goods to a third party and thereby receive the cash.

Musharaka

The *musharaka* involves a partnership between two parties who both provide capital towards the financing of a new or pre-existing projects. Both parties share the profits on a pre-agreed ratio, with losses being shared on the basis of equity participation. As both parties take on project risk, it is quite rare for Islamic financiers to participate in *musharaka* transactions.

Sukuk

The *Sukuk* (Islamic bond) has emerged as one of the most promising developments in the Islamic finance arena. Essentially, the *Sukuk* involves the issuance of certificates in the collective legal or beneficial ownership of the asset, with the certificate holders receiving an income derived from the asset. A *Sukuk* can be placed on top of any Islamic structure but traditionally has been combined with the *ijara* structures. Issues still however remain regarding the tenor and pricing of a *Sukuk* issuance vis-a-vis the conventional lending or bond market.

INTERFACE WITH CONVENTIONAL FACILITIES

Intercreditor Issues

As the Islamic financiers are the (indirect) owners of the assets, this structurally puts an Islamic financier in a better position than a conventional lender, who is usually only a beneficiary of security granted to a collateral agent. However, these concerns can be addressed in an intercreditor agreement which sets out the decision-making process in connection with the enforcement of security and the mechanics for the sharing of enforcement proceeds.

Tax Implications

The Islamic structures set out above can potentially trigger multiple tax duties (for example, stamp duties) on the sale and transfer of assets. While some jurisdictions have introduced specific legislation to avoid these tax impositions, each transaction should be carefully reviewed by tax advisors. It may be possible to manage these issues through the use of vehicles in tax neutral jurisdictions.

Differences within Sharia

Sharia principles are often expressed in general terms, allowing for considerable discretion on how to apply these principles. Because there are different schools of Islamic jurisprudence, they may construe certain precepts differently. Within each school there are also majority and minority views on various issues, either of which may be applied in any particular case. Therefore, a document or structure may be accepted by one *Sharia* committee of a bank but rejected by a different *Sharia* committee. However, a positive aspect is that Islamic finance contracts can be subject to English or New York law (or any other law).

USE OF ISLAMIC FINANCE STRUCTURES LIKELY TO GROW

In the past, the additional complexity, time and cost of introducing an Islamic tranche into a project has dissuaded many sponsors from actively considering these Islamic finance structures. However, as these structures continue to develop it has been seen that the majority of the difficulties brought into a transaction by the *Sharia*-compliant elements are surmountable, and with the need to access alternative funding sources, it is likely that many of the larger project financings, particularly in the Middle East, will need to turn their attention to this rapidly developing market.

ISLAMIC FINANCE PRINCIPLES

Set out below are the key principles of Islamic finance:

- Returns to financiers should generally be linked with the profits of an enterprise and derived from the commercial risk taken by the financier; *Sharia* views money as a means of exchange with no intrinsic value.

- *Sharia* principles encourage financiers to become partners in the project to share the profits and risk in the business instead of being pure creditors; profits should not be assured and therefore fixed returns on investment should not be guaranteed.
- Transactions should be free from speculation or gambling (*maisir*); the prohibitions of *Sharia* do not usually extend to general commercial speculation as seen in most transactions, but aim to prevent speculation which may be considered gambling.
- The existence of uncertainty (*gharar*) in a contract is prohibited; transactions where the price, time of delivery or the subject matter are not determined in advance may not be compliant with *Sharia* principles.
- Investments relating to alcohol, drugs, gambling or other activities prohibited by *Sharia* are not permitted.