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Ins And Outs Of Islamic Project Finance

Law360, New York (August 30, 2012, 12:49 PM ET) -- Islamic finance consists of various financing structures which are compliant with Shari'ah law, the legal and moral system which guides observant Muslims. Islamic financing of international projects began in the early 1990s. Since then, it has rapidly evolved and become a key source of funding in many project financings, particularly in the Middle East.

As a result of the global financial crisis, the use of Islamic finance as a source of funding for projects has become even more widespread, as international banks have lost appetite for Middle East projects, creating a liquidity issue in the market, and from increasing local demands on Middle East-based banks to provide financing in accordance with Shari'ah compliant structures. Increasingly, it is also being used as a source of funding in new markets into which Middle East capital is flowing, including places as diverse as Uzbekistan, the U.K. and Hong Kong.

Many projects in the Middle East are now either entirely financed with Shari'ah compliant funding, or have a Shari'ah compliant tranche, in which an Islamic tranche forms part of a wider multisourced financing. Although the latter is more common, the market increasingly is seeing wholly Islamic financed projects, the first of which was the Al Waha petrochemical project in 2006.

Having an Islamic tranche in a multisourced financing can be challenging for both the banks (normally comprised of commercial banks, export credit agencies and development finance institutions) and the sponsors, as the parties need to apply traditional, market-recognized project financing principles to a Shari'ah compliant framework.

All Shari'ah compliant project financings need to be structured with the following prohibitions in mind:

Interest (Riba): No interest can be earned. Any return on funds provided by banks has to be earned by way of profit derived from a commercial risk taken by the banks.

Unfair enrichment/ Unfair exploitation: Contracts where one party is regarded as having unjustly gained at the expense of another are prohibited under Shari'ah law.

Speculation (Misr): The contract should not rely on chance or speculation. Ordinary commercial risk-taking is acceptable, but transactions that amount to gambling are not permitted. Hedging is generally permitted provided it is used to hedge a particular risk and not used in a purely speculative manner.

Uncertainty (Gharrar): There must not be uncertainty in the contract. The subject matter, price and time for delivery must be known at the outset.

Prohibited Investments: Certain investments are prohibited, including those involving alcohol and gambling. The extent to which the prohibition is applied to projects depends on the views of the scholars on the Islamic bank's Shari'ah supervisory board.

The type of Islamic financing products used in a project financing largely depends on the views of the Shari'ah advisory board of the Islamic bank (conservative or more liberal), the nature of the project and assets involved, local law considerations (including tax issues) and whether the product is to be used to fund the construction phase or the operating phase of the project. In the Middle East, projects are most often structured by combining the use of Istisna'a and Ijara arrangements, although other Islamic financing products are also used.

An Istisna'a arrangement is essentially a procurement contract where the project company requests phased payments (disbursements) from the banks to pay for construction of the Islamic assets. The price of the assets and the date of delivery are specified in the contract at the outset, although actual payment and delivery of the assets are deferred to future dates. Upon delivery of the assets to the banks, title to those assets will transfer (directly or indirectly) to the banks, who will then be responsible for all rights and obligations associated with the assets.

As the use of an Istisna'a arrangement does not provide a profit component to the banks as would an interest payment on a conventional loan, it is usually combined with an Ijara arrangement, which is the Islamic finance equivalent of a lease. In order to enable banks to receive a return during the construction phase of a project, a form of Ijara known as Ijara Mawsuffah fi Al Dhimma may be used. This is a forward lease arrangement where advance rental payments (equivalent to interest during construction) are made prior to project completion and actual rental payments (equivalent to principal plus interest) commence on project completion.

Other types of structures make use of a Musharaka arrangement which involves co-ownership of the assets between the sponsors and the banks. This may be combined with Ijara and purchase and/or sale arrangements. Under this structure, for the term of the Ijara arrangement, the banks sell incremental units of their ownership interest in the leased assets to the project company, which is the economic equivalent of repayment of principal. The banks also lease their ownership interest to the project company, which is the economic equivalent of interest. As time passes, the banks continue to lease a decreasing share of the leased assets to the project company, with payment streams under the lease being structured accordingly.

A reverse Murabaha (Tawarruq) may also be used both in respect of the construction phase and operating phase of a project. This is essentially a synthetic product involving the sale of commodities by the lender to the project company at cost plus a mark-up, on deferred terms. This product can be used to replicate closely a term loan facility. Some Shari'ah scholars consider this financing technique a sham and do not approve of its use.

Banks need to review a project in detail in order to satisfy themselves as to various issues which may arise on any project funded by Islamic finance. For example, in multisourced financings, all banks (including conventional and Islamic) are usually treated equally, so the Islamic banks (which will own the assets in lease- based structures) will grant security over the Islamic assets in favor of all the finance parties.

In the event of enforcement against the collateral, proceeds will be shared pro-rata among all the banks. Both the Islamic and conventional finance documents must be drafted in a manner whereby all draw-downs and prepayments are made pro rata across the tranches and all payment obligations are pari passu at all times. Occasionally, banks may agree to draw-downs and prepayments not being pro-rata in order to accommodate a given Shari'ah compliant financing structure.

Commitment fees are not permitted in Islamic financings. They may, however, be structured as part of the upfront or arrangement fee or as a component of advance rentals in an Ijara structure. Although some Islamic banks may keep these amounts, others will donate them to a charity nominated by the Shari'ah supervisory board of that bank.

Banks need to consider legal issues arising from ownership of the assets, including whether local law allows for ownership of the assets by foreign companies, and whether appropriate assets can be identified to form the basis of the Islamic portion of the financing. The transfer of title to the assets — initially from the contractor to the banks, and then from the banks to the project company — may have tax and/or accounting implications which will need to be considered on a case by case basis.

Proceeds generated under an Islamic financing should not be used to repay interest to conventional banks. This can usually be achieved through effective drafting in the financing documents with regard to the payment waterfall and segregating "Islamic proceeds" into separate accounts.

Given capital restrictions and lack of appetite for financing long-term projects, a large number of international banks have realized that global funding for projects needs to be diversified. Islamic financing has proved to be, and will continue to be, an effective source of funding, as long as all parties carefully consider the particular issues that arise when using Shari'ah compliant techniques in a traditional project financing.

Islamic finance has seen a steady rise in prominence in the Middle East over the last decade. The double impact of globalization and decreasing availability of conventional funds makes it very likely that the markets will see an increasing use of Islamic finance in non-Islamic countries in the future.

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