NAUKI O FINANSACH FINANCIAL SCIENCES 1(6) • 2011
ISSN 2080-5993

Hanna Kociemska
Wrocław University of Economics

ISLAMIC PROJECT FINANCE. BASIC FEATURES

Summary: The purpose of the article is to present the essence of Islamic project finance and the challenge against conventional project finance. The author introduces the basic rules of Islamic finance and the key instruments used in modern Islamic project finance structures. Islamic project finance's value is demonstrated by the evidence of fast market development and the proper methods used to conduct key infrastructure investment. Even in spite of a strong financial crisis, there is an influence on the market.

Keywords: project finance, Islamic finance, GCC countries, crisis, government revenue, Islamic project finance.

1. Introduction – project finance

Project finance is known as the long term financing of infrastructure and industrial projects based upon the projected cash flows of the project rather than the balance sheets of the project sponsors. It is a way to finance an activity using debt where the debt is repaid from the project cash flow generated by the activity [*The Quar'an...*, pp. 16-17]. Project financing is often very complex and the most commonly used structure within the field of infrastructure projects such as transportation, waste management, water supply system, telecommunications, utilities, mining industries, and health care sector. Primarily, a project financing structure involves a number of equity investors, as well as a syndicate of banks and risk security agencies. The loans are most commonly non-recourse loans, which are secured by the project assets and paid entirely from project cash flow, rather than from the general assets or creditworthiness of the project sponsors. The financing is typically secured by all of the project assets, including the revenue-producing contracts. Project lenders are given a lien on all of these assets, and are able to assume control of a project if the project company has difficulties complying with the loan terms. Oftentimes a company conducting project finance will set up a different corporation known as a "special vehicle company" or other entity for the project to shield the remainder of the company from liability if the debt goes into default. The basic features of project finance are as follows:

- non-recourse financing;
- stand loan;

- two stages: construction and operation;
- "made to measure";
- only for large scale investment;
- aimed at tangible assets;
- assets are pledged;
- high financial leverage;
- long term financing up to 30 years;
- debt is repaid entirely from project cash flow;
- pledge of owner's equity interest;
- income tax shield.

Some of those features will be described further, according to Islamic project finance structures. The basic sector where the project finance structure might be applied are power generation, transmission, distribution assets, upstream, midstream, downstream assets in oil and gas industries, desalination plants, airport, bridges, roads, rail systems, telecommunications systems, public-private real estate projects, and other infrastructure projects [Yescombe 2007, pp. 16-17].

2. The basis of Islamic finance

Islamic finance is finance under Islamic law principles known as *Shariah* [Kabir Hassan and Soumare 2007, p. 4]. The basic sources of *Shariah* are the *Qur'an* and the *Sunna*, which are followed by the consensus of the jurists and interpreters of Islamic law. The central feature of the Islamic finance system is the prohibition in the *Qur'an* of the payment and receipt of interest [*The Quar'an...*]. The other pillars of Islamic finance are:

- ban on uncertainty or speculation (named *gharar*); however, risk taking is allowed when all terms and conditions are clear and known to all parties;
- ban on financing certain economic sectors: weapons, alcohol, pork and gambling, deemed unlawful by *Shariah*;
- profit and loss sharing principle: parties in the financial transaction share rewards and returns, capital must have a social and ethical purpose beyond pure, unfettered return;
- asset based principle: each financial transaction must refer to a tangible, identifiable underlying asset [Rahali 2008, p. 89].

Islamic financial institutions are relatively new types of entities – one of the first Islamic banks was set up in Egypt in 1963. Although the origin of modern Islamic banking was in Egypt, it probably would not have developed as an important financial force without the strong support of Gulf countries investors. The Islamic Development Bank (IDB) was established in 1975 and gave momentum to the Islamic banking development. It was the first time in modern Islamic history that an international financial institution had committed itself to conduct its activities in conformity with the *Shariah*. Instead of working on the basis of interest, the bank was authorized to

levy a service fee to cover its administrative expenses. Since the creation of the IDB, a number of Islamic banking institutions have been established all over the world and some countries have taken the necessary steps to organize their banking systems along Islamic rules. The first private Islamic commercial bank was the Dubai Islamic Bank, which was founded in 1975 [Errico and Farahbaksh 1998, pp. 6-7].

Because of the restriction on interest-earning investments, Islamic banks must obtain their earnings through profit-sharing investments or fee-based returns. When loans are given for business purposes, the lender, if he wants to make a legitimate gain under the *Shariah*, should take part in the risk. If a lender does not take part in the risk, his receipt of any gain over the amount loaned is classed as interest. Islamic financial institutions also have the possibility to engage in leasing transactions, including leasing transactions with purchase options. Traditionally, an Islamic bank offers two kinds of services:

- those for a fee or a fixed charge, such as safe deposits, fund transfer, trade financing, property sales and purchases or handling investments;
- those that create partnerships in investments and the sharing of profits and losses.

Islamic financing contracts have been designed to avoid risk-free return and money from money, as well as uncertainty and gambling. They have to be carefully structured so that the exchange involves goods for money or partnership shares for money over time. The Islamic financial model exists on the basis of risk sharing. The main financial instruments used in Islamic finance are as follows.

Qardh Hasan is a risk-free asset with a nominal rate equal to the inflation rate. Thanks to it, the real rate of return is zero.

Murabahah is a process of credit facility, which enables customers to purchase goods without having to take out an interest bearing loan. The buyer of an item is the bank. Then, bank sells it on to the customer on a deferred basis. The payment of the sale price is usually deferred for a future date or dates. This scheme is frequently used in trade financing and working capital financing.

Table 1. Features of *Ijara* contract

Lessor	Contract	Lessee
• Ownership/ leasing of the leased assets • Assumes full ownership risks (loss, damages etc) • Keeps leased assets in good working order • Responsible for cost of insurance and maintenance • Costs not related to performance of leased assets can be on lessee	• Lease contract has to be clear, with no ambiguities • Specify the terms and conditions of the lease agreement • Specify duties and responsibilities of both Lessor and the Lessee • Specify rent • Specify term of contract • Option to buy asset in case	• Enjoy full and unrestricted use of the leased assets • Pays the agreed periodic rental • Asset under him as trust • Provides security to guarantee payments

Sources: Author's own study.

Ijara, which means operating lease, is a leasing agreement whereby the bank buys a productive asset for a customer and then leases it back over a specific period. The client avoids initial capital outlay. In some cases, the client is able to buy the item at the end of the contract.

Mudarabah (investment management): this is a contractual arrangement between a group of investors and a manager. The investors put up capital which the manager invests in return for a share in the profit. It offers specialist investment in which the project owner and the investor share profits. It does not guarantee any fixed rate of return. The investor receives a share of the profit or bears the losses generated by the business venture, and the principal is paid at the termination of the contract.

Table 2. Features of *Mudarabah*

Investor	Contract	Mudarib-manager
• Contributes the funds • **Bears risk of loss** • Passive investor	• Restricted or unrestricted • Specifies clearly: • Parties involved • Profit sharing ratios • Investment objectives • Fixed tenure or open-ended • Funds commingled or separated • **No guarantee of a return or principal**	• Contributes management expertise and know-how • No guarantee of performance • But liable for mismanagement, negligence and breach of contract • **Shares in profits** • Incentive profits, if contracted for

Sources: Author's own study.

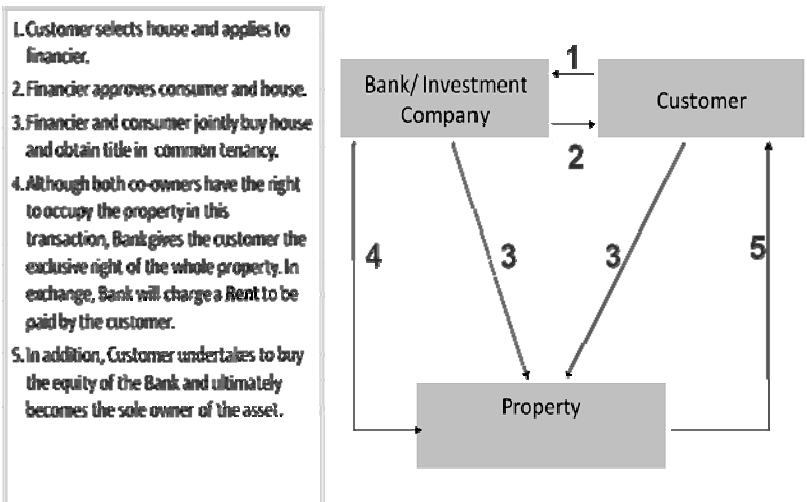

Figure 1. Residential mortgages under the law of diminishing *Musharakah*

Sources: Author's own study.

Musharakah is an investment partnership in which profit sharing terms are agreed in advance, and losses are pegged to the amount invested. The ratio of profit may differ from the proportion of investment but the loss must be shared proportionately. Any of the contracting parties have the right to participate in project management. Islamic banks often use diminishing *Musharakah* in corporate finance, including project finance for funding working capital and fixed assets. Diminishing *Musharakah* is the case shown below wherein one party agrees to pay out his counterparty gradually [*Islamic Finance*… 2006, p. 2].

Proponents of Islamic finance have repeatedly argued for its implementation mainly because it can promote higher real investment and growth rates by encouraging risk and return sharing. However, Islamic financial institutions have so far focused on a bigger scale on debt financing rather than equity financing, precisely because of concerns over risk. Equity financing may be conducted by the structrure of *Mudarabah* and *Musharakah*, which are the most important profit-and-loss sharing instruments of Islamic finance. These instruments are highly flexible as they allow projects to be partly or fully financed by lenders or shareholders. Those financial structures can be also considered as high risk instruments because of the high uncertainty of return to financial institutions, in which the return depends on project performance, and in addition to credit risk, they involve business risk.

Accordingly, equity financing by Islamic financial institutions requires a high degree of trust in both parties and implies larger cost to financial institutions in terms of project evaluation, monitoring and supervision. To reduce the level of risk and its influence on equity financing in Islamic financial systems, the use of collateral has been allowed. But it has its own barriers. *Shariah Law* permits the use of collateral as a guarantee against fraud, negligence or misconduct on the part of the entrepreneur. The law does not permit compensation of shareholders or fund providers in the case of losses or business failure owing to genuine reasons. Reliance on collateral creates limitations on Islamic finance similar to those created by conventional finance. It manifests itself in limited access to finance for new and less established entrepreneurs who lack acceptable security sources, as well as incentives for banks to prefer low return projects because they are secured by adequate collateral.

3. Islamic project finance

There are a number of factors showing that Islamic project finance is challenging the conventional, among others:

- irresistible demand among Muslims;
- *sharia* banking that dominates the personal finance market;
- change in official attitude;
- development of *sharia-compliant* products;
- global credit and liquidity crunch;

- increased government and major industrial participants are requiring that at least part of the financing structures include some Islamic finance component, if not completely;
- continued economic expansion in the GCC [*Conventional*… 2010].

Islamic financial instruments experienced an annual 15% growth from 2005 to 2008. Islamic banking assets topped 700 billion USD in 2008 of which 285 billion USD in the GCC. By 2012 the Islamic banking assets are expected to hit one trillion USD. According to project finance, it is estimated that by 2012 Islamic project finance will reach projected value of 30 billion USD [Keenan 2010, p. 2]. When compared to general Islamic banking and *sukuk* market the Islamic tranches are usually integrated with much wider multi sourced financing arrangements, accompanied by conventional lenders, multinational development banks and export credit agencies [*Conventional*… 2010].

The market for Islamic project finance is constantly developing. Table 3 presents the major Islamic project finance deals between 2001 and 2007.

Table 3. Major Islamic project finance deals between 2001 and 2007

Name of the Project	Value in USD million
Equate (2001)	200
Shuweihat IWPP (2001)	250
Alba (2003)	250
Qatargas II (2004)	530
Taweelah A2 (2004)	150
Bapco (2005)	330
Saudia (2005)	480
Dolphin (2005)	1,000
Sohar Aluminium (2005)	260
Shuaibah IWPP (2005)	268
Petro-Rabigh (2006)	600
Yansab (2006)	846.8
Al-Waha (2006)	526
Kuwait Parazylene Production Co (2007)	347
Maaden/Sabic (2007)	1,800

Source: [*Conventional*… 2010].

The presented project's value (see Table 3) confirms the huge market potential. Despite the financial market crisis in those years, most of the Islamic project finance investments have not been stopped or changed significantly. The irresistible demand for infrastructure and investment projects development has been sustained.

It has to be underlined that the global credit and liquidity crisis influence the Gulf countries in a positive way. While for many GCC countries the effects of the crisis have been mild compared to the rest of the financial market, its eventual impact may be severe if the appropriate macro fiscal and monetary policies are not properly implemented [Rehman 2009, p. 5]. Many GCC countries have made great efforts in strengthening their policy frameworks and robustness to shocks, stimulating healthy economic growth, improving current account balance, foreign reserve, sovereign wealth fund and the general financial systems [Kabir Hassan, Soumare 2007, p. 2]. It also enables to develop huge infrastructure projects through the Islamic project finance structure.

For GCC economies, government spending, which includes participation in project finance deals, is a key tool to continue economic growth in the nearest future. The governments that are able to expand their spending will most likely be the first to get out of the recession first and recover faster. Most Gulf region countries have planned to increase their government spending significantly to boost economic growth for 2009 and the following years [*Saudi Phosphate*… 2010]. The increased levels of public spending concentrated at modernizing the infrastructure has been a significant factor in the diversification of GCC countries toward the non-oil sector, and at the same time to develop Islamic project finance. The increasing requirements from government and industrial participants that at least part of the financing structures must include some Islamic finance components, if not completely, ensure that during the crisis period the Islamic projects remain feasible, secured and profitable afterwards as well. Moreover, the modernization of important sectors such as the financial sector, education, and tourism have attracted a wider group of investors (from both Islamic and conventional fields), thus compelling the private sector to strengthen its competitive capacity [Saif 2009, p. 6].

Table 4. The Role of Oil in GCC Countries' Government Revenues, Exports and GDP (2002-2006)

	Bahrain		Kuwait		Oman		Qatar		Saudi Arabia		UAE		GCC	
Year	2002	2006	2002	2006	2002	2006	2002	2006	2002	2006	2002	2006	2002	2006
Governments revenues	67.3	77	88.4	90.8	73.1	64.8	63.7	55.2	78	89.7	71.5	80.5	77.4	85.9
Export	30.7	54.3	91.5	83.3	71.3	76.2	62.7	66.1	76	81.7	31.9	38.8	60.9	67.6
GDP	24.2	26	38.4	55.2	29.9	22.7	56.8	57.3	30	32.4	21.2	38.2	30.8	40.1

Sources: Central Bank of Bahrain 2008, Central Bank of Kuwait 2003, Central Bank of Oman 2003--2007, Central Bank of Qatar 2003-2006, Saudi Arabia Monetary Agency 2007.

The high level of public revenues is moving towards the wide possibilities of investment that are mainly combined with creating or servicing society with public goods with high importance for the economies and societies of these countries. The described model of implementation the Islamic finance into project finance would

therefore ensure maintaining the stability of the financial system in those countries, the development of the financial markets and investment in conjunction with the public and private, conventional and Islamic financial institutions. Based on the principles of Islamic finance, it turns out to be a tool for safe and fragile financial markets. Financial engineering instruments described in accordance with *Shariah* may apply in such complex structures as project finance. The same ensures on the one hand the stability of the projects, on the other hand, opening to western markets through to possibility of various connections with conventional financial solutions.

4. Conclusion

Financial instruments that has been featured in this article according to *Shariah Law* turn out to be adequate to be implemented into project finance. At the same time, the high level of Islamic government revenues gives the possibility to continue the investment in spite of the financial crisis consequences. The market of Islamic project finance is developing dynamically. This is the evidence for Islamic financial instruments maturity and those countries' stable macro-economy systems. Project finance structures are being developed thanks to skilful combination of conventional and Islamic finance instruments, thanks to opening the financial markets for innovation, maintaining at the same time basic rules of S*hariah Law.* Such a huge potential growth in this field has been tenable owing to the governments openness for co-operation with private partners that in project finance play significant roles as sponsors or partners in special purpose vehicle company.

References

Central Bank of Bahrain (2008), *Report*.

Central Bank of Kuwait (2003, 2006), *Report*.

Central Bank of Oman (2003, 2007), *Report*.

Central Bank of Qatar (2003, 2006), *Report*.

Conventional and Islamic Project Finance (2010), Bahrain Institute of Banking and Finance, Manama, Kingdom of Bahrain, [training course].

Errico L., Farahbaksh M. (1998), *Islamic Banking Issues in Prudential Regulations and Supervision*, IMF, [working paper].

Islamic finance basic principles and structures (2006), Freshfields Bruckhause Deringer.

Kabir Hassan K., Soumare I. (2007), *Financial Guarantee as Innovation Tool in Islamic Project Finance*, [working paper 0713], University of New Orleans, Department of Economics and Finance.

Keenan R. (2010), *Islamic Project Finance. Structures and Challenges*, Project Finance Newswire, Chadbourne & Parke LLP, Dubai.

McMillen M.J.T (2000); Islamic Shari'ah-compliant project finance, *Fordham International Law Journal*, Vol. 48.

Rahali A. (ed.) (2008), *Islamic Finance*, Globe Law and Business.

Rehman A.A. (2009), *The Relevance of Islamic Finance Principles to the Global Financial Crisis*, Islamic Finance Project, Harvard Law School, Panel Discussion, 16.03.2009.
Saif I. (2009), The oil boom in the GCC countries, 2002-2008. Old challenges, changing dynamics, *Middle East Center*, No. 15.
Saudi Arabia Monetary Agency (2007), *Public Finance Statistics, Annual Government Revenues and Expenditures*.
Saudi Phosphate Deal Helps to Define the Islamic Project Finance Boom (2010), www.zawya.com (date of access: 07.11.2010).
The Quar'an 6:104, www.islamic.org.uk/I4wm/conclusi.htm.
Yescombe E.R. (2007), *Project Finance*, Oficyna Wolters Kluwer Business, Kraków.

PROJECT FINANCE W FINANSACH ISLAMSKICH. PODSTAWOWE CECHY

Streszczenie: Celem niniejszego artykułu jest wskazanie podstawowych założeń w Islamskim modelu *project finance* w porównaniu z konwencjonalnymi projektami tego typu. Autorka wskazuje na podstawowe zasady finansów islamskich i główne instrumenty finansowe wykorzystywane w islamskich *project finance*. Wskazuje się na rozwój rynku islamskich *project finance* poprzez empiryczne dane rynkowe dotyczące tego typu inwestycji oraz braku wpływu kryzysu finansowego na trendy rynkowe w tym obszarze.