ISLAMIC PROJECT FINANCE

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ABSTRACT

As Islamic project finance develop in strength and scope, it interacts more frequently with conventional financial structures, governments, multinational enterprises and international organizations. The emerging Islamic project finance and the international system of project finance are reshaping one another at the same time as they are transforming the world economy. This coexistence between systems is not a simple “domestication” of burgeoning Islamic practice by western-dominated structures, but an improved series of reciprocal influences and mental adaptations that could evolve into an international process of collective learning and cooperation[2].
The last decade has witnessed a global surge in private project financing especially in infrastructure development creating major opportunities for Islamic banks and institutions. This growth was as a result of a renewed government focus and a tremendous growing appetite for infrastructure investments. We should not underestimate the importance of liquidity in bringing Islamic finance into the mainstream. The potential to target capital from Islamic countries is enormous. In addition, the pressing infrastructures needs of the Middle East and the North African region are also huge[3]. This paper aim to pull together the key elements regarding the road ahead for Islamic project finance.

INRODUCTION

Large scale industrial infrastructure or real estate projects present unique financing challenges. It requires mobilizing necessary resources through equity investors (often the sponsors of the project) and the availability of debt financing usually on a non-recourse or limited recourse bases. The non-recourse party – the lender – will only look to the cash flow of the project for the repayment of his loan. This type of financing is extremely rare. Limited recourse financing, is the general rule, the lenders can look to the profit revenues, to borrowers shares in the project company and to the assets of the project in order to repay their loans if the borrower fails to comply with his financial obligations to the lenders[4].

The structure of a project financing is often rendered rather complex due to the involvement of a multitude of local and international parties such as investors, project companies, lenders, construction and operating companies, users, legal consultants, insurers, and sometimes governments in BOT structures. The complexity of financing structures and the multiplicity of participants are a source of a multitude of risk factors that requires a body

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[2] R.R BIANCHI, “Islamic Finance and the International system: Integration without Colonialism”, *in* “Integrating Islamic Finance into the Mainstream: Regulation, standardization and Transparency”, *Islamic Finance Project, Harvard University,* 2007, p. 133.

[33] J. Collins, “The road ahead for Islamic Finance”, *in* “Integrating Islamic Finance into the Mainstream: Regulation, standardization and Transparency”, *Islamic Finance Project*, Harvard University, 2007, p. 133.

[4] G. VINTER, *Islamic Project Finance*, Sweet and Maxwell, 1998, p. 112.

of various agreements and documents in order to identify these risks and to allocate them between the concerned partners in the project. Regardless the common desire of all these participants to maximize predictability, stability and success of the project, the nature of their interest is different, sometimes contradictory. Mc Millen is of the view that "*each party will participate in the project financing transaction bound by their existing institutional perceptions and practices with respect to such matters as risk allocation, risk coverage, underwriting criteria and accounting treatment*"[5]. Everyone in his specialty and after his viewpoint, examines the project and seeks to detect the slightest risk to not accept and support without having properly assessed[6]. Certainly, the success of project financing is based on the interweaving of the skills of project participants, their teamwork and a global reflection on the structure of financing, the costs of the project and risks to be taken by the various project participants[7].

Co-financing including Islamic tranche (as opposed to fully funded projects on a sharia-compliant basis) are the most frequently encountered structures capable to reconcile different financial approaches. These structures will allow both investors – Islamic and Western – to operate within a context of predictability, stability and certainty that is acceptable to all parties.

This present paper undertakes evaluating the basic elements in traditional Western project finance and Islamic finance in order to understand the parallels and the similarities between both systems (I). It will also identifies risk factors facing the operation of project finance and analyses these risks allocation and management (II). Finally, it will discuss the coexistence of traditional project finance with Sharia compliant structures (III).

I. SIMILARITIES BETWEEN TRADITIONAL PROJECT FINANCE AND ISLAMIC FINANCE

Certainly, there are profound differences between Islamic finance and conventional finance from the point of view of origin, architectural and legal and fiscal environment. But in practice, particularly in the field of project finance there are several points of convergence. Historically, we can note striking similarities between project financing and some classical Islamic financing techniques used in the past. These similarities are not coincidental, they arise out of the very nature and conceptual basis of project finance itself[8]. While Muslim traders in the Ottoman empire financed their maritime projects using the profit sharing

[5] M. J.T. MC MILLEN, "Islamic Project Finance", *in* "Handbook of Islamic Banking", *Edward Elgar Publishing limited*, 2007, p. 202.

[6] A.M. TOLEDO, P. LIGNIERES, *Le financement de proj*et, Joly, 2002, p. 8.

[7] A.M. TOLEDO, P. LIGNIERES, *Le financement de proj*et, Joly, 2002, p. 8.

[8] M. KHAN, « Designing an Islamic model for project finance », International Financial Law *Review*, 1997, p. 16.

instrument of *Mudaraba* , the Crown of England, in the thirteenth century, was associated with Italian bankers Frescobaldi through a production payment loan – a quasi-equity facility as a structure to finance the silver mines in the area of Devon. Italian bankers exploited the mines for a period of two years and were repaid their loans by the results of mining[9].

In addition, political, economic and cultural ties and exchange between the Muslim world and the West throughout history have meant that the financial structures put in place can be quite similar. One can also cite the reforming efforts of the Islamic doctrine in the field of finance in order to fulfill the contemporary financial needs while respecting the requirements of Islamic law.

A. Conceptual parallels

Islamic finance, which is an important component of Islamic economics, is broadly based on some prohibitions and encouragements. The structure of Islamic finance revolves around the prohibition of any interest or any *ex ante* return derived on a loan/debt (*Riba*). *Gharar* is also prohibited, it involves risk, uncertainty, lack of adequate value-relevant information (*jahl*) and speculation. *Kimar* and *maysir* (gambling and games of chance) are also prohibited. Any trade in *haram* prohibited good is not accepted in Islam. In addition to these major prohibitions, Sharia has enunciated a set of principles that provide a basic framework for the economic activities in general, and for the financial and commercial contracts in particular. These principles are the Profit and Loss Sharing PLS and asset backed business and transactions. Moreover, Islam shares with the Western societies a common moral/behavioral standards such as justice, fair dealing, documentation and transparency, paying liabilities, mutual cooperation and free marketing[10]

It is pertinent to observe that Islam is not alone in prohibiting usury. Over 1400 years Judaism and Christianity have all opposed usury. Any form of interest was prohibited, but gradually with growth of commerce the practice of interests was accepted. What is important here is to understand the rationale for the prohibition of interest, why all these revealed religions have prohibited interest?. According to all relevant texts and principles of Islamic law, Sharia ban all kind of interest to prevent injustice, encourage work, and productive efforts, seek equitable form of transaction and block the means that lead to the accumulation of wealth in a few hands.

In Talmudic law, although the interest was only prohibited among the brothers and fellow members of the tribe or the adherents to the common faith, the concept of interest was considered as a practice against the principle of social justice. It creates an imbalance of benefits between the parties. On the one hand, the borrower is forced by need or by

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[9] R. L. KLARMANN, *Islamic project finance*, Thesis, University of Lausanne, 2003, *t.*, p. 81.

[10] M. AYUB, *Understand Islamic Finance*, John Wiley & Sons Ltd., 2007, p. 64.

circumstances, to borrow with interest. On the other hand, the lender withdrew from just lending a profit without any effort or risk[11]. Under Christianity, St Thomas Aquinas, has condemned usury because '*it leads to inequality which is contrary to justice*". Prohibition of usury in biblical sources referred to poor people, widows and orphans and was allied to several ethical notions such as "lend freely to poor hoping for nothing thereby" and justice. To the canonists, interest lead to the inequality between parties, wealthy receives an unearned income from the unfortunate, according to them, usurer is anyone who sells his goods on credit and ask for higher price because of the lapse of time in the transaction[12]. These similarities between the attitude of the three revealed religions to interest are striking. They all agree that interest implies gaining profits without giving anything in exchange. Money is not used in a productive manner, it will lead to an ever-increasing share of risk-free capital vis-à-vis risk related capital. These parallel are hardly surprising, since Islam, historically is the third revealed religion. It comprises like the other two religions a set of principles that guide and regulate mankind spiritual and material life. It also builds on, sustains and fulfils the message of its two monotheist antecedents. On top of that, Muslims should believe in Jesus and Moses as messengers of God, and all the prophets[13].

If we turn to the forbidden *bay al-gharar* , Professor M. Al-ZARQA says that " *bay al-gharar is the probable sale of items whose existence or characteristics are not certain"*. Ambiguity in the terms of trade can lead to error and to exposure to excessive risk. Ignorance of the nature of the goods traded, price or conditions of sale is likely to cause an imbalance benefiting one party over another. In order to ensure that risk are shared rather than sold, Islamic law has ruled the consumer information and standardized named contracts to ensure a balance of benefits and protect the weaker party - consumer - in the transaction. In the field of Islamic finance, a valid financial contract, should be lawful, its object should be clearly defined at the time of conclusion of contract and Its quantity and its value must be clearly defined. Finally its delivery should be possible, certain and immediate. However, in order to better adapt Islamic law to the needs engendered by modern economic activity, Muslim jurists have allowed two exceptions to the prohibition of the sale of future goods : the sale to be delivered (*Bay al-Salam*) and commission to manufacture(*Istisna*). These two contracts were permitted under certain conditions, they have to specify the term of the contract, the price to be paid and the characteristics of the item.

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[11] S. SCHWARZFUCHS, « A. weingort. Intérêt et crédit dans le droit talmudique, Revue de l'histoire des religions, tom 199, n°2, 1982, p. 207.)

[12] R. H. TAWNEY, *Religion and the Rise of Capitalism*, Harcourt Brace, 1926, P. 59-61.

[13]M. LEWIS, "Comparing Islam and Christian attitudes to usury ", *in* "Handbook of Islamic Banking", *Edward Elgar Publishing limited*, 2007, p. 69.

Similarly, the French consumption law protects the consumer in its contractual relationship with the professional[14]. The lack of information on essential characteristics of a product will constitute error on its essential qualities that causes a significant imbalance between the rights and obligations of parties to the contract. Indeed, to protect the consumer's consent, there are a number of legal obligations of information to the consumer. Under the article L. 113-3 of the Code of Consumption, "any vendor of a product or a provider of a service must, by the mean of marking, labeling, displaying or any other suitable method, inform consumers about the price, the limitations of contractual liability and the special conditions of sale ". L. 114-1 also regulates the obligation to provide information on delivery time, in any sale or service contract the vendor must specify the date by which he agrees to deliver the goods or perform the services especially when the delivery is not immediate and if the agreed price exceeds the limit set by regulation. It is so, in terms of readability of terms and conditions of contracts between professionals and consumers, according to article L. 133-2 of the Code of consumption, they must be presented and written in a clear and understandable manners.

When it comes to the Islamic prohibition of trade in all immoral activities affecting the interests of mankind, disturbing the moral and damaging the economy such as transactions related to alcohol, narcotics, pork, pornography, armaments etc ... This principle implies that every act must secure in the purpose and usefulness of its subject justice, equity and balanced mutual benefits of the contracting parties. Ethics is an integral part of Islamic law, it guides individuals in their relationships. Under French law, protection of public order and morality "*bonnes mœurs* " are core principles that provide contractors with guidelines and impose certain behaviors, sometimes, mandatory. Indeed, under Article 6 of the French Civil Code "you cannot waive, by private agreement, the laws of public order and morality. "

In addition to its special function, Islamic financial Institutions through project financing, like any other aspects of Islamic society, are expected to "*contribute richly to the achievement of the major socio-economic goals of Islam*"[15]. The most important of these goals, are the economic well-being through justice and the equitable distribution of income and wealth, full employment and a high rate of economic growth, stability in the value of money and the mobilization and investment of savings ensuring a fair profit sharing to all parties involved in the project[16]. These ethical goals join the requirements and the objectives of the concept of sustainable development which is defined and set by the World Commission on Environment and Development of United Nation. According to the Commission "*humanity has the ability to make development sustainable to ensure that it meets the needs of the present without compromising the of future generations to meet their own needs. The concept*

[14] Y. PICOD et H. DAVO, Droit de la consommation, Armand Colin, 2005, p. 111.

[15] U. CHAPRA, *Towards a just monetary system ; A discussion of money, banking, and monetary policy in the light of Islamic teaching*, Islamic foundation, 1985, p. 55.

[16] M. K. HASSAN and M. LEWIS, "Islamic Banking: an Introduction and Overview", *in* "Handbook of Islamic Banking", *Edward Elgar Publishing limited*, 2007, p. 5.

of sustainable development does imply limits – not absolute limits but limitations imposed by the present state of technology and social organization on environmental resources and by the ability of the biosphere to absorb the effects of human activities. But technology and social organizations can be both managed and improved to make way for a new era of economic growth"[17].

The above goals reminds us of the objectives of (*Maqasid*) Sharia. These objectives have been identified by jurists like Ghazali, Shatbi and Ibn Ashour by an inductive survey of the Holy Coran and Sunna. As per Ghazali (1058-1111) in *Al Mustasfa min Ilm Usul Al Fiqh*, the primary objectives of Sharia aim to protect human beings and their environment through five fold tenets of safeguarding and protection of religion (*dyn*) life (*nafs*), progeny (*nasl*), property (*mal*) and intellect (*akl*)[18].

Project finance is conceptually an area conducive to Islamic finance and close to the economic philosophy of Islam, it configures itself as an ideal solution, capable of meeting the economic and financial needs of projects supported by big capital and important economic returns in the medium or long term. "By its very nature, the remuneration of Islamic lender is not based on the lapse of time but based on revenues (cash-flow) generated by the project. He will act as an active partner in the project and not as a conventional creditor, therefore he will take a commercial risk, which tends to resemble the philosophy of project financing.

Project finance uses a variety of contractual and financial arrangements in order to fund specific projects of different sectors in different environments. Project finance must involve a real, useful and beneficial asset. This seems entirely relevant to the principal asset backing in Islamic law. finance structures are used to finance industrial sector (power generation, manufacturing etc..), development of natural resources (oil fields, gas or mining, etc.) and construction and infrastructure development (ports, highways, telecommunications, etc.)[19]. Similarly, Islamic finance contemplates the funding of any Islamically acceptable project by means of contracts which are in accordance with the Sharia[20].

B. Structural parallels

Islamic financing is generally structured by contracts of partnership based on the profit and loss sharing (*musharaka*, *mudaraba*), by contracts of sale of an existing commodity based on cost-plus-profit sale (*murabaha*), by contracts of manufacture or asset construction contracts of facilities or goods to be built or manufactured for future delivery (*salam, istisna*), and by leasing contracts (*Ijara*). These techniques seems to be compatible with the

[17] See report Bruntland, 4 August 1987.

[18] M. AYUB, *Understand Islamic Finance*, John Wiley & Sons Ltd., 2007, p. 23.

[19] P. WOOD, *Project Finance, Subordinated Debt and State Loans*, Sweet and Maxwell, 1995, p. 3; P. LIGNIERES, *Partenariat public-privé*, 2e édition, Litec, 2005, p.8.

[20] M. SHAHID EBRAHIM, "Integrating Islamic and Conventional Project Finance", *Thunderbird International Business Review,* Vol. 41, 1999, p. 584.

conventional modes of project financing, they can be structured as a package and may find interesting applications in designing complex project finance models.

From a structural point of view, setting up of an “ad hoc” project company, known as special purpose vehicle” (SPV) is a major key in any operation of project financing. This separate legal entity is created for a period of time, to isolate the assets financed from other assets of the promoters. It is capitalized through equity and debt funding which is used to cover project capital expenditure, to procure the design and construction of the project, and eventually to operate the project in order to generate the necessary cash flow to repay the investment[21]. The debt is usually provided by a syndicate of limited number of commercial banks, multilateral agencies as the group of the World Bank or the European Investment Bank (EIB)[22], export credit institutions, pension funds, insurance companies and participants in international capital markets, while equity is held by two types of investors (sponsors) in the project company. The first type are long-term investors who will often take little role in the management of the project company, they are more interested in the investment itself. The second type is project active sponsors whose participation in the project is not restricted to their role as investor, such as a construction company that intends to undertake or participate in the construction of the project, an operating company intending to operate the completed project and a bank providing debt for the project[23].

The project company is responsible of concluding different contracts for the project such as: agreements with governments or governments entities under concession model or a Public-private partnerships PPP, construction and operation contracts with contractors and operators and all various financing agreements[24]. Indeed, the independent status of the project company allows the confinement of the project's financial risk and simplify contractual relationships with various project partners. Debt can generally be deconsolidated, and therefore does not increase the sponsors’ on-balance sheet leverage or cost of financing. From the perspective of the sponsors, non-recourse debt can also reduce the potential for risk contamination. In fact, even if the project were not productive, this would not jeopardise the financial integrity of the sponsors’ main businesses[25].

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[21] M. OBAIDULLAH, “Designing Islamic Contracts for Financing Infrastructure Development”, in “Local Challenges, Global Opportunities”, Third Harvard University Forum on Islamic Finance, *Center for Middle Eastern Studies*, Harvard University, Cambridge, Massachusetts, 1999, p. 165.

[22] M. LYONNET du MOUTIER, *Financement sur projet et partenariats public-privé, op. cit.,* p. 200 et s..

[23] M. OBAIDULLAH, *op.cit*., p. 165.

[24] M. NUSSENBAUM, « Le METP face à la technique de financement de projet appliquée à un projet public », RGCT, N° 22, 2002, p. 164.

[25] . LYONNET du MOUTIER, *Financement sur projet et partenariats public-privé, op. cit.,* p. 26.

Meanwhile, the creation of an ad hoc structure is used as well in Islamic project financing. Indeed, this corporate structure is established to carry out operations related to Islamic financial structures, and to uphold the contractual relations with other entities of the projects. Major projects co-financed by conventional banks and Islamic banks, often require the creation of an intermediary company that manages operations related to mounting Islamic confines of the specific risks attached to Islamic financing and make the connection between Islamic lenders and the project company.

The Islamic concept of the proportionality between risk and profit adapts perfectly to the logic of the project finance. It seeks to establish cooperation and justice between partners and helps achieving economic success of the project[26]. Mohammad Ayub confirms that "*the assumption of business risk is a precondition for entitlement to any profit over the principal*" he adds that "*The important Sharia maxim: "Al Kharj bi-al-Daman" or "Al Ghunum bil Ghurm" is the criterion of legality of any return on capital, meaning that one has to bear loss, if any, if he wants to get any profit over his investment. Profit has to be earned by sharing risk and reward of ownership through the pricing of goods, services or usufruct of goods*"[27]. Similarly, conventional project financing encourages investment and infrastructure development especially in emerging countries, allowing the different project actors to participate actively, and making sure that all risks related to the project were identified, allocated among the participants and properly mitigated.

II. RISK ALLOCATION AND MANAGEMENT

Note that major infrastructure projects, whatever its financing mode -conventional or Islamic, are characterized by big risks related to construction and operation of the project. Risk mitigation and management measures in both financial structures will not necessarily be the same. In addition to these risks, there are other risk factors that arise because of the specific contractual mechanisms used in Islamic finance. These two essential types of risks and their allocation and management will be analyzed below.

A) Risks inherent to Project Finance

We can say that in project finance, as in Islamic finance, the risk analysis and risk allocation between the different project's participants are essential elements. It seems very complex to present the risks borne by each participant in a universal classification. Because these risks, assessed and managed differently depending on the party and the sector of his intervention and on the nature and level of risks during life cycle of the project. They are often intertwined and their management techniques are interdependent. A successful financing structure entails a balanced allocation of these risks among the various involved parties. The following is by no means an exhaustive list of project finance-related risks:

[26] G. LIPPA, "Islamic Project Finance", *Shirkah journal*, 2006, p. 10.

[27] M. AYUB, Understanding Islamic Finance, John Wiley & Sons, Ltd, 2007, p. 81.

1) Structuring-related risks

It must be recognized that the complexity of the contractual structure and the multiplicity of participants in the financial structures can raise some considerable conflicts between the various interests of participants who perform multiple roles. For example, in the case of some BOT models, main contractors appointed for the construction of the project can participate in the capital of the project company and play the role of a majority shareholder[28]. The problem here, is that contactors are interested in obtaining payments from the project as early as possible and on a periodic or staged basis. Meanwhile, in their capacity as shareholders (long-term investors) in the project company, who only obtain payments - dividends - after the completion of the project and during its operating phase, would wish to limit the payments to constructors to a lower reasonable level in order to control the overall development cost of the project which they finance through injection of funds into the project company[29].

Similarly, operating partners who act as shareholders would take advantage of their quality of shareholders to have as favorable agreement and conditions as possible.

When it comes to banks, playing the role of lenders and project sponsors at the same time, the probability to cause conflicts of interests and raise moral and ethical problems is very high. Banks in their capacity of lenders would impose their prior approval before distributing any dividends to shareholders and would also require the priority in the repayments of the installments of the debt to any other financial engagements of the project (dividends, construction and operating costs…etc.). Banks may also be a project sponsor, in such situation, there is a conflict of interests, they would require as much divided as possible to be paid out at as earlier as possible[30].

The above risk of conflict of interests require more profound investigation and must be minimized through appropriate stipulations in the shareholders' agreement which regulates the relationship between the participants in the project company.

2) Construction-related risks

In the construction phase of the project, the risks encountered are the risks of cost overruns, missed deadlines and defaults in construction of the facility or its non-conformity to the desired specifications. It is clear that these risks may not only significantly affect the profitability of the operation but degrade the image of the facility or the service to potential customers.

These risks often come from the following different factors:

[28] M. OBAIDULLAH, *op.cit*., p. 168.

[29] M. OBAIDULLAH, *op.cit*., p. 168.

[30] M. LYONNET du MOUTIER, « Financement sur projet : élaboration d'un test de la théorie positive de l'agence », *Finance Contrôle Stratégie*, Volume 7, N° 3, septembre 2004, p. 154.

- Any modifications or changes in the characteristics of the facility, during the construction phase, by the project administrator or by the public partner in BOT structures.
- Poor estimates of costs or construction delays.
- Technical or financial failure of the constructors.
- Application and absorption of a new technology resulting in construction and operational defects.
- Environmental damage and force majeure events. (the discovery of deposits of pollutants or archaeological sites).

The construction phase is the most risky in an infrastructure project. Different operators are outsourcing these risks through turnkey construction contracts, with fixed price and a fixed date of delivery. Generally, manufacturers bear the risks associated with construction. Indeed, the sponsors of the project company seek to transfer the risk of delay or poor performance to contractors and incorporate in the construction contract, penalty clauses for delay and damages and interests clauses for any delay or poor performance. As lenders, they can allocate a portion of the risks related to the construction jointly with the sponsors by establishing a line of credit with major additional funding to cover the additional costs or delays encountered during the construction phase.

It is recalled that the construction risks arising from political and regulatory factors are supported by the public partner in BOT structure and covered by insurance companies.
In the Islamic project finance contractual structures, the construction phase of project may be financed through *istisna* (asset construction contract) or *ijara* (asset leasing contract). It is interesting to examine risk allocation among the different parties under these Sharia-compliant structures.

Istisna is a type of contract in which a client mustasne' requiring the manufacturing or construction of an asset, orders from a manufacturer or constructor sane' an asset masnou' meeting certain specifications and to be delivered within a specified period of time[31]. usually *istisna* takes a two-tier forms that requires two contracts: first contract is between the Islamic bank as the seller and his client (the project company) as a buyer of the final facility or the product. In order to satisfy the demand of his client, the bank will enter into another contract as a buyer with the manufacturer or constructor to purchase the facility or the product which is the subject of the first contract. A question arises here as to whether these two contracts are binding or merely a promise. In other words, the issue is to know whether the client (project company) is contractually bound as soon as he has ordered the product or if he simply makes a non binding promise to buy it once it has been completed. According to classical Islamic jurists, istisna contract is revocable by either party at any time[32].

Fortunately, in order to avoid this risk, the modern Islamic scholars view in this regard, was that the *istisna* contract is binding on both parties starting from the moment the contract is concluded by offer and acceptance.

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[31] Majelle articles 338-92. See also W. Al-ZAHAYLI, *Financial Transactions in Islamic Jurisprudence*, Dar Al Fikr, 2003, p. 165-231.

[32] R. L. KLARMANN, *op.cit.*, p. 231.

We also note that, as in conventional financing, all risks caused by non-conformity of the facility to specifications will be covered by the manufacturer or the constructor of the project. Risks arising from delay or default in adhering to schedules caused by the financial difficulties (insolvency or bankruptcy) of the construction company will be mitigated by some tools used in both financing systems – conventional and Islamic – such as security on assets refundment bonds, performance guarantees and liquidated damages (damages and interests)[33]. One can notice that the penalty clause for the payment of liquidated damages, not allowed in the past, is accepted by the OIC Fiqh Academy in the Islamic contracts[34]. In addition, all risks of assets damages during construction caused by accidents, acts of war or vandalism may be covered by Islamic insurance *Takaful*.

In the case of *Ijara* leasing contract, it is a lease of an object or a service involving the transfer of the usufruct *manfa'a* (the use of an object or the services of a person) for a rent consideration[35]. The nature of the lease must be precisely defined and the rent must be for a fixed value. This fixed value of rent may cause some financial risks due to fluctuations in market conditions. In order to avoid these risks, the early termination and the renegotiation of a new lease were approved by contemporary Islamic scholars. In order to integrate with the going rate on the financial market, the lease payment can be also linked to indices (LIBOR)[36].

Another issue giving rise of discussion is the classical Ijara practice, since the lessor is the owner of the asset he is supposed to be responsible for structural maintenance and to bear the risk of wear and tear and the partial or total destruction of the asset. The lessee bears no liability for the rent once the asset is destroyed or severely damaged except when the loss is due to misuse or negligence on the part of the lessee. In order to mitigate these risks and to avoid the Islamic prohibition of the transfer of liabilities from the lessor to the lessee, the lessor can take Islamic insurance *takaful* for the leased assets and include the cost of insurance in the rent. This risk can be mitigated also by transferring some specific liabilities to the lessee (through agency contract) such as damages, theft, loss or destruction of the asset except in the case of force majeure[37]. The risk of delays or default of payment of the rent by the lessee can be covered by the advanced rentals as a security deposit against these risks.

Ijara wa iqtina (hire-purchase contract) in this type of *ljara*, the combination of the contracts of lease and the option to buy (understanding to purchase) the asset at the termination of the contract is now allowed under Islamic law, as long as it respects the prohibition of *bayatan fi bay* (two contracts in one), in other words, the lessor's promise to

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33 M. OBAIDULLAH, *op.cit*., p. 171.

34 M. OBAIDULLAH, *op.cit*., p. 171.

35 Majelle articles 404-11. See also W. Al-ZAHAYLI, *op.cit*., p. 381-434.

36 F. VOGEL and S. HAYES, *Islamic Law and Finance: Religion, Risk and Return*, Tha Hague: Kluwer Law International, 1998, p. 263.

37 S. M. HUSSAIN, "Leasing" and "lease-based Investments", paper presented at the International Capital Market Conference, Kuala Lumpur, 1997.

sell the object to the lessee and the lessee's promise to buy the object from the lessor should not be contained in the lease agreement[38].

As in the case of *Istisna*, *Ijara* involves the risk of non-binding promise, the client may not honor his commitment to rent the asset after it has been acquired by the bank for onward Ijara. To mitigate this risk, banks can shift this risk to the original supplier by using the *khiyar al-shart* framework under which the bank may retain an option for itself at the time of purchase from the supplier. This option will be expired if the bank's client respects his commitment buying the same promised asset, if the client fails to honor his commitment, the bank will exercise his option and rescind the purchase contract[39].

3) Operating-related risks

Regarding operational risks of insufficient income, they arise from a poor estimation of project revenues, of the factors used to calculate the costs of management, maintenance or renewal and major repairs. Moreover, dysfunction or unavailability of assets or equipments of the project are often detected during the operation phase and are normally borne by the operation company[40].

In addition, new regulations and increased taxes, the rate of VAT and corporate tax rates during the phase of operation, can arise high risks affecting the profitability of the project. Such risks, as risks related to construction, is normally covered by the public partner in BOT projects.

In large BOT highway infrastructure projects, there are risks of trafficking. These risks are borne directly by the project company that hires experts and consultants specialized in traffic analysis and assessment of revenues. Main lenders can be concerned by these type of risks, they also control the traffic studies by hiring experts in the field[41].

We remark, however, a project financed by Islamic techniques may encounter the same foregoing risks. As in the construction phase, these risks will be transferred or shared through the mechanism of damages and interest , specific stipulations will be included in *Ijara* agreements. These risks can be passed on to the *takaful* company.

4) Financial and other related risks

Financial risk factors due to inflation, to devaluation or depreciation of local currency of the project and interest rate changes affect significantly the profitability of the project. Also the risk of exchange rate especially when the expenditure is incurred in a currency different from that of borrowing incurred to finance the project. In this case, to cover this risk, the project company will contractually require to be paid in the currency of its expenditures[42].

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[38] R. L. KLARMANN, *op. cit*., p. 265.

[39] [39] M. OBAIDULLAH, *op.cit*., p. 172.

[40] DELELIS, « Partenariat public-privé », Juris-classeur administratif, Fasc. 670, LexisNexis SA, 2008, p. 12.

[41] M. LYONNET du MOUTIER, *Financement sur projet et partenariats public-privé, op. cit.,* p. 126.

[42] M. LYONNET du MOUTIER, *op. cit.,* p. 134.

In a conventional financing, the risk of interest rates changes may be important in the case of a variable rate financing. However, this risk can be hedged by using the technique of interest rate swaps allowing to exchange floating rate against a fixed rate[43].

As discussed earlier, In Islamic finance, even if the operations are not based on interest rates, some measures have been admitted by jurists such as regular adjustments of rents or reference to a market index such as LIBOR (London Interbank Offered Rate) in *Ijara* contract.

In addition to the above, political stability and economic environment of the host state of the project are important for assessing the conditions of the project's success. These risks might be caused by political decisions taken against the project directly or against the foreign investors such as changing tax regimes, nationalization, expropriation, confiscation or not obtaining permits. It can also be a political risk arising from a change in economic or financial rules of the country. Indeed, the host State may impose, in some cases, regulatory constraints directly affecting the profitability of the project It should be noted that changes in the political landscape such that the change of government or administrative policies of the country might affect the project or to redefine the limits and conditions for its realization. Finally, civil wars, conflicts or wars between countries and terrorist acts are serious risks that may materially affect the balance and success of the project.

Insofar as political risks cannot be controlled by the private partners in the case of PPP projects, they are usually borne by the government, which directly or indirectly by state insurance agencies or public partners. In France, the French Insurance Company for Foreign Trade (COFACE) "manages first, on behalf of the State, the public service credit insurance and guarantees all political, monetary and commercial operations of import and export risks, catastrophe risks that cannot be covered by classical insurance companies[44]. "

Note, finally, that there are international financial institutions that guarantee the loans of private banks. Indeed, affiliated institutions with the World Bank and those of regional development banks play a key role in covering political risks.

B) Risks related to Islamic finance contractual mechanisms

Although the risks related to Islamic Finance practice are numerous, we will provide a quick overview of the main risks facing Islamic project finance.

1) Regulatory and legal issues

From a structural point of view, Islamic banking is distinguished mainly by the conventional banks, in that the guidelines are issued by a supervisory board consisting of

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[43] M. LYONNET du MOUTIER, *op. cit.,* p. 134.

[44] . M. JACQUET, P. DELEBECQUE et S. CORNELOUP, *Droit du commerce international*, Dalloz, 1er édition, 2007, p. 585.

religious and independent members, called Sharia board scholars or jurists, who are both competent in Islamic law and finance. The Council role is to ensure, using the fatwa, the conformity of products and financial transactions with the principles of Shari'ah. To ensure independence, the freedom of their actions and the objectivity. their fatwas. They are usually appointed by the general assembly's or boards of banks in which they operate and have an odd number of scholars. Indeed, they represent the regulatory authority of the Islamic bank. Generally, some scholars of international reputation operating in several supervisory boards of various banks at a time.

Notwithstanding the efforts of standardization standards, documentation and operations fatwa by professional bodies such as the Accounting and Auditing Organization for Islamic Financial Institutions AAOIFI or Fiqh Academy of the Organization of Islamic Conference, some questions remain about the degree of compliance with the Shari and the impact of some differences of interpretation of the Shariah by the various Islamic scholars. Some products or services may be approved as being Sharia compliant but some Sharia board scholars but not by others. This situation may arise important risks and constitute, sometimes, barriers to the participation of Islamic banks in the syndicate project financing.

The governing law is one of the important legal issues to be solved. Most large project financings involve multiple and diverse parties and jurisdictions, and the application of multiple legal systems. The choice of law is rather ambiguous, to say the least, and raises a whole set of questions. One is whether and to what extent the parties can validly agree on Islamic law as a governing law of a financial transaction.

Ensure conformity with the principles of Sharia law of contracts subject to a law not inspired by these rules poses to investors or legal advisors of some Western developers the delicate problem of legal security. According to them, Islamic canon law, cannot be considered, in principle and as such, a national law, although in some Muslim countries, national law must be consistent with the principle conveyed by the Shari'a[45]. In practice, Western lenders and developers involved in a project finance operation, will naturally return to their international law firms, who are not entitled to put opinions in Islamic law, in order to build up the necessary contractual and financial structures. The validity of the project documentation under the principles of Sharia law will most often be the responsibility of the members of Sharia board scholars appointed for this mission. According to Kilian Bälz, in the light of the interpretative pluralism in Islamic law, it seems a difficult if not impossible task for any court to come up with an interpretation of Islamic law that will satisfy all circles[46]. This issue was taken up in *Shamil Bank of Bahrain v. Beximco Pharmaceutical Ltd. And*

[45] P. GRANGEREAU and M. HAROUN, « Financement de projets et financements islamiques: quelques réflexions prospective pour des financements en pays de droit civil », Banque et droit, 2004, p.58.

[46] K. BALZ, "Islamic Financing Transactions in European Courts", *in,* "Islamic Finance:Current Legal and Regulatory Issues*", Islamic Project Finance*, Harvard University, 2005, p.65.

Others, both the London High Court and the Court of Appeal declined to attribute any legal effect to the reference to Islamic law contained in the agreement[47].

Mc Millen explains that each participant in the project financing will be bound by his existing institutional perceptions and practices shaped by existing regulatory framework. He adds that *"For a range of reasons, the perceptions of most participants will be based upon project-financing standardized techniques and structures that have been developed in the Western interest-based economic and legal system. Some of those reasons include a) the dominance of the Western economic system over the last few centuries b) the predominance of United States and European financial institutions, lawyers and accountants in the field of project financing, c) the refinement and exportation of Anglo-American law, d) the relative infancy of modern Islamic finance e) the lack of familiarity of with the operation of legal system in most Arab and Muslim countries, f) the general lack of knowledge of, and familiarity with, the Sharia*"[48] . According to this analyses, parties will tend to have their contracts governed by either English or New York law, rather than the law of host country.

There are also certain risks related to tax issues, some instruments of Islamic finance such as *Murabaha* or *Ijara* where ownership of the asset is transferred twice (The first when the bank buys the asset from the supplier and the second when the client of the bank buys the same asset from the bank) this situation due to double taxation may involve extra costs due to the increase registration fees, this friction can seriously reduce the attractiveness of Islamic products.

2) Risks related to the role of the Islamic financer

We have discussed earlier in *Istisna* and *Ijara* contracts some of the owner and vendor risks related to the quality of the islamic bank as an owner and a vendor of assets that should be sold to the his client such as risk of loss or destruction of the asset, the liabilities and indemnities and the default of payments. We can add to this, that the classical transaction of *murabaha* which is defined as "*the sale of a commodity for the price at which the vendor has purchased it, with the addition of a stated profit known to both the vendor and the purchaser. It is a cost-plus-profit contract*"[49] involves multiple risks due to the fact that an Islamic bank has little or no knowledge of the vendor activities such as the quality and the state of goods, he does not wish to deal and take all extra costs and efforts of packing, storage, transportation, and insurance nor to provide warranty for the goods or to take the risk or not finding a final purchaser[50]. For this reason modern murabaha, as practiced by Islamic banks has been adapted to include a binding promise by the client to purchase the commodity once it has been purchased by the Islamic bank. The creation of SPV structure will help mitigating all vendor

[47] January 28, 2004, (2004) EWCA Civ 99.

[48] M. J. T. Mc MILLEN, *op.cit*., p. 202.

[49] N. SALEH, Unlawful Gain, and legitimate profit in Islamic law, 2nd addition, Graham and Trotman, 1992, p. 117.

[50] R. L. KLARMANN, *op. cit*., p. 224.

risks, the SPV will negotiate the selling terms with the supplier. Once these terms are agreed by the parties, the SPV turns to the Islamic bank and requests that he purchase the goods in order to resell it. This way the bank will maintain his role as an intermediary between supplier and purchaser. The Islamic insurance system *takaful* can provide another alternative to manage these type of risks.

3) Intercreditor issues

In case of failure of the project company, calls on collateral security and the right of ownership of Islamic financers on all or part of the assets of the project introduces an imbalance among the different groups of financers giving in certain cases a greater negotiation power for Islamic financers. For example, in *ijara* transaction, the right of ownership of the asset by the lessor (Islamic bank), place him in a more advantageous position than other lenders (conventional banks and others) who can hardly foreclose on the collateral security of this property.. To ensure an equal treatment *Pari Passu* of all lenders in projects co-financed by both – islamic and conventional tranches, the intercreditor agreement should determine precisely the terms dealing with prepayment, ranking, termination, voting and payment distributions, etc.

III. COEXISTENCE OF TRADITIONAL PROJECT FINANCE WITH SHARIA COMPLIANT STRUCTURES

It is important to understand how Sharia-compliant techniques and conventional project finance model can be adapted to one another and coexist in one structure to achieve the same economic efficiency. It is worthwhile to study before the general concepts of each type of financing separately.

A) Conventional Project Finance

As set in figure 1 and 2[51], In conventional project finance, sponsors (shareholders) of the project company, are bound together by a shareholders' agreement that defines their responsibilities and duties and limit their project risks. As stated earlier, they are interested in the first degree to the operation of the project funding, they prefer to operate projects without taking the risks on the balance sheet (off balance sheet).

In very rare cases, the construction and the operation activities of the project can be executed directly and personally by the project company. But most often, in practice, the project company subcontracts, as a project administrator, most of its commitments to specialized companies in construction and operation.

In order to secure financing of the project and establish the loan modalities, the project company will sign the financing contracts and related documents with a group of lenders 'banks and other financial institutions'. These documents includes a) loan agreement, b) documents for collateral security structure: mortgage or dead of trust on the project assets, c)

[51] P. DENIAU, Les financements de projet, seminar in banking law , University of Paris 13, 2007.

security agreements (pledges) on the personal property of the project company, environmental indemnity agreements running to the benefits of the bank, d) different guarantees: completion and technology guarantees[52]. The conclusion of financing agreements with the project company has a strategic advantage for lenders. Indeed, the project company reinforces the lenders on the project since all the money lent will be devoted to carrying out the project.

In the case of Build-Operate-Transfer BOT structure, the project company will negotiate and sign off-take agreements with the users (host government or utility companies) of the facility, e.g. a power station. These off-take agreements will often be on a "take-and-pay" or "take-or-pay" basis[53].

Finally, the project company shall discharge its risks by insurance policies (liability, risk of interruption of work or loss from operations ... etc.).

[52] M. J.T. MC MILLEN, *op.cit*., p. 204.

[53] M. OBAIDULLAH, *op.cit*., p. 165.

Conventional Project Finance

Principal project contracts

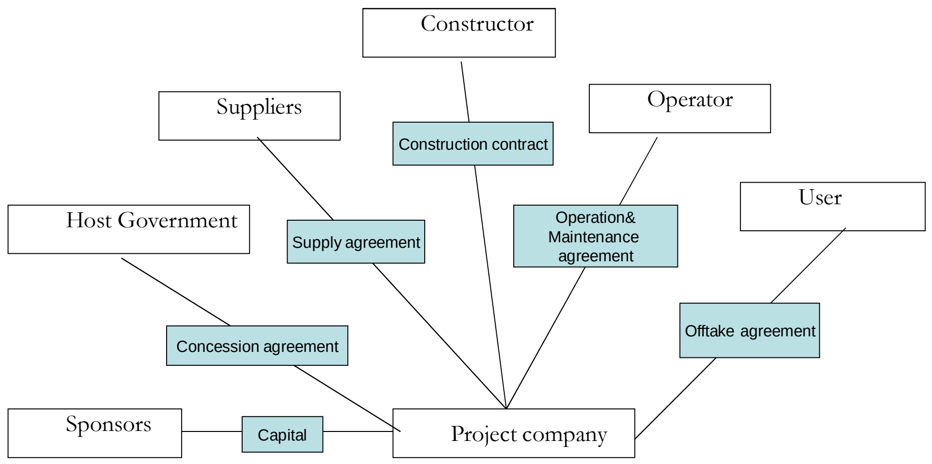

figure 1

Financing contracts

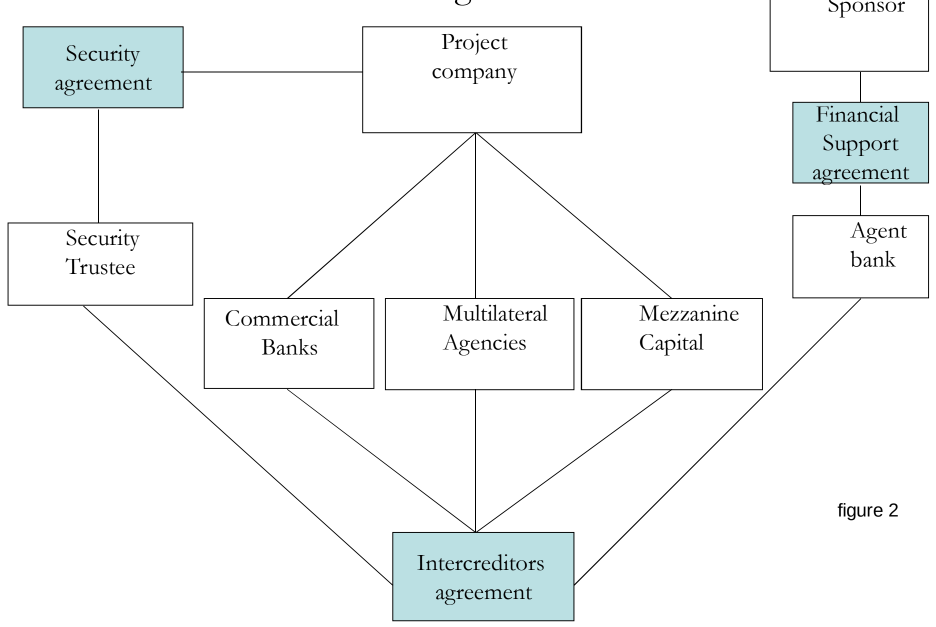

figure 2

B) Islamic Project Finance

Islamic finance techniques can be modeled in combination to offer various packages in project finance. In the following, we shall turn to analyse how these different contractual techniques can be put to use in order to participate in a project finance model for an independent power plant (IPP). figure 3[54].

This figure illustrates the application of four different Islamic contracts: *mudaraba*, *istisna*, *salam*, and *wakala* (agency). In this model, there will be 4 main participants: 1) the syndicate of lenders led by the agent, 2) the SPV set up by the agent, 3) the power producer and 4) the power purchaser (the utility).

Independent Power Plant Financing (IPP)

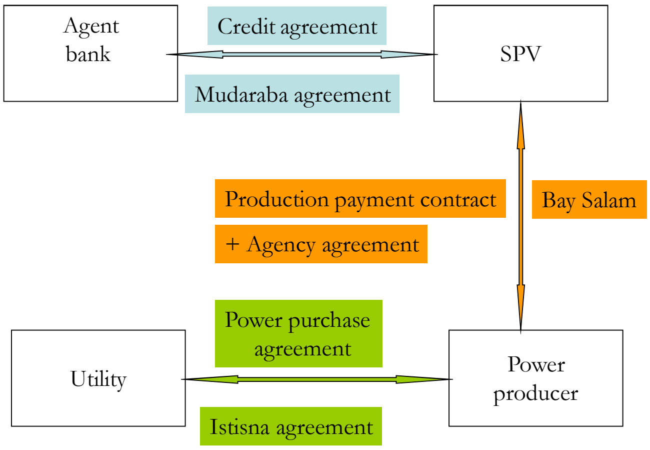

Figure 3

If we study this model, we will note that the agent leading the syndicate of lenders will enters into a credit agreement with the SPV, this transaction can be based on the Islamic contract *mudarabah*, where the lenders will act like sleeping investors *rab el mal* entrusting money to another party called *mudarib* or manager (the SPV in this model)who is to trade with the money in an agreed manner and then return to the investors the principals and the pr-agreed share of the profits, keeping for himself what remains of the profits[55].

The SPV as a manager will then enter into a production payment contract with the producer whereby the SPV will finance the project by making an advanced payment to the producer against a promise under an agreed schedule to the future delivery of electricity. This transaction can be structured by *Bay Salam* technique which is defined as the sale of an article which will be delivered to the purchaser on a future date fixed in advanced[56]

[54] M. KHAN, « Designing an Islamic model for project finance », International Financial Law *Review*, 1997, p. 15.

[55] N. SALEH, Unlawful Gain, and legitimate profit in Islamic law, 2nd addition, Graham and Trotman, 1992, p. 15.

[56] S. RAYNER, The Theory of contracts in Islamic law, Graham and Trotman, 1991, p. 134.

The producer will enter with the utility into a power purchase agreement to purchase the electricity from him. This transaction can be accommodated under the *istisna* contract which is giving an order to manufacture a definite article with agreement to pay a definite price for that article when it is completed. The difference between *istisna* and *salam* that under Salam, the price must be paid in advance, in *Istisna*, payment is flexible, it is to be paid only when the article is ready for delivery.

It is important to note that a valid *istisna* contract should be defined in details, therefore, the power purchase agreement should be very comprehensive including the description of the physical infrastructure, specifications of the required electricity, a description of the fuel and all other technical quantitative and qualitative details of the project. This document should also include risk allocation, the dispute resolution mechanism, and the financial and operational obligations of the producer and the utility[57].

The SPV will mandate the producer through an agency contract *wakala* to sell two shares of electricity to the utility. The first share is the production payment electricity which will be sold on behalf of and for the account of the SPV while the second share will be the subject electricity which represents the share of the producer to be sold to the utility on the same basis of the first share. All the revenue from the sale of production payment electricity from the utility will be transferred to the SPV after the deduction of the producer's fixed O&M costs, fixed fuel costs, insurance costs and return on equity investments.

[57] M. KHAN, « Designing an Islamic model for project finance », International Financial Law *Review*, 1997, p. 15.

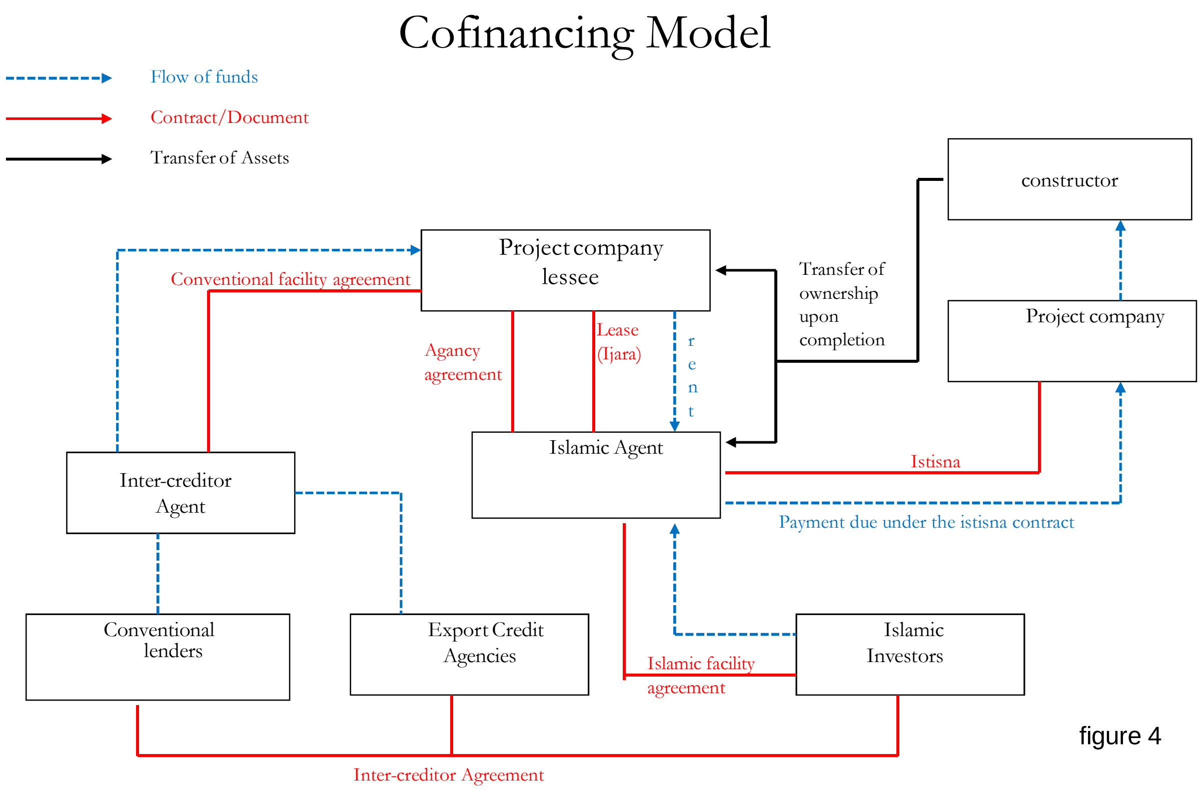

figure 4

Source: BOUREGHDA (Maya), Islamic Project Financing: Practical experiences, seminar at ESC-Lille "Ecole Supérieure de Commerce", 2009, p. 6.

CONCLUSION

It is shown here that the success in the financing of an infrastructure project, by means of project finance techniques, depends on all the parties involved satisfactorily complying with their various contractual obligations under the project finance agreements and documentation. Lenders, as well as the other participants, in accordance with the level of risk being assumed and in proportion to the benefits received from the implementation of the project, will undertake the due diligence needed to adequately measure the risks involved.

The viability of the Project Finance model is based also on the consistency and efficiency of its network of agreements. Such documents must be structured and negotiated in a consistent manner with the respective legislation applicable in the jurisdictions involved, and be constructed in such a way as to allow full implementation of their respective terms and conditions.

. Islamic finance has successfully integrated into the legal system of Common law countries who have ensured its compatibility with commercial finance. Moreover, the principles of Islamic finance also appear to be adaptable to the legal constraints of several western countries. In France, huge efforts have been undertaken to adapt the legal, tax and regulatory instruments to the requirements of the rules of Islamic law in finance while complying with French prudential norms.

This paper has emphasized the parallel points between project finance model and the Sharia-compliant financial structures. It focused also on the possibility to finance an important projects with a combination of structures and documentations from both system without compromising any religious principles or financial interests.

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