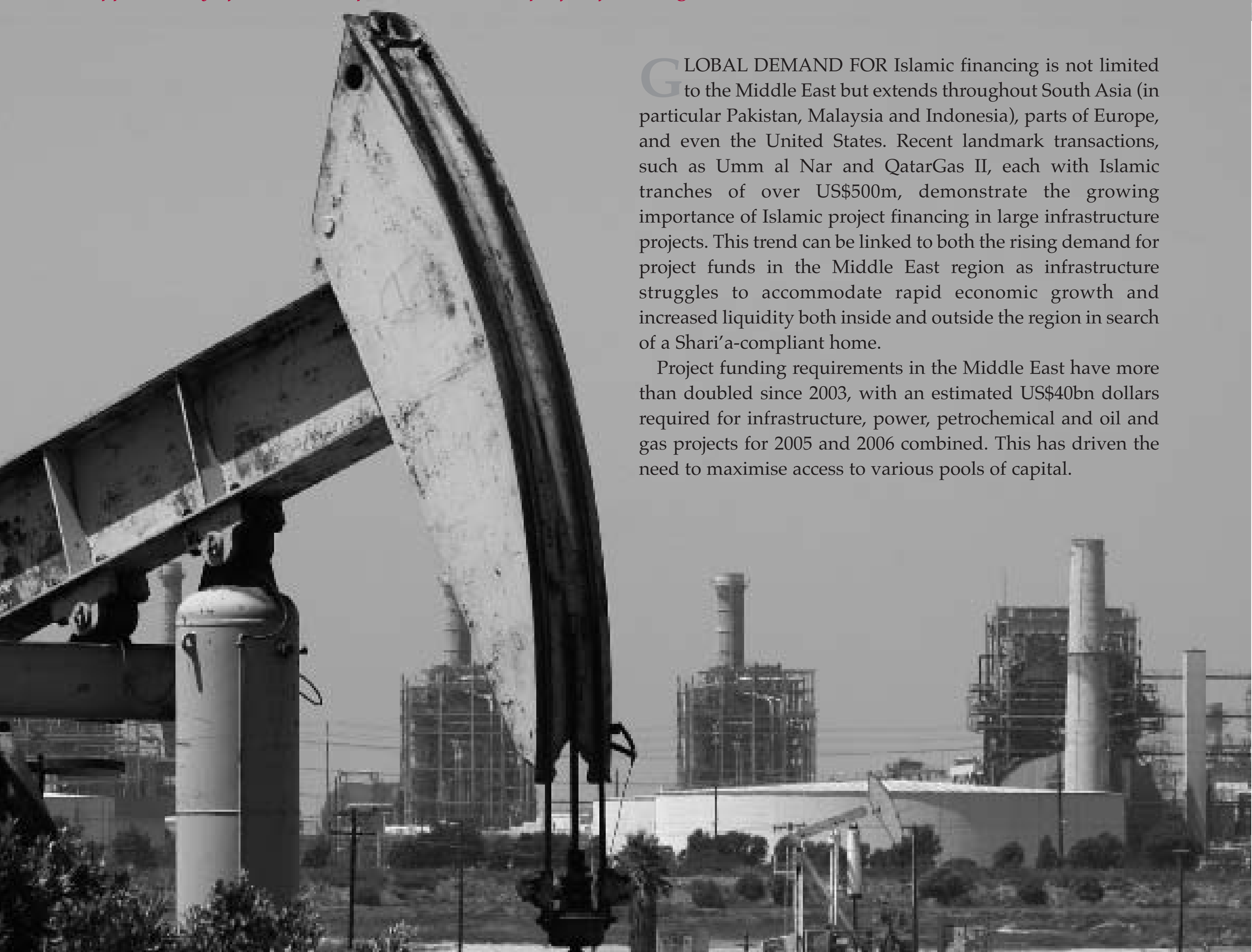
THE GROWING COMPLIANCE OF PROJECT FINANCE

Islamic compliant financing structures are growing in complexity and diversity. The inclusion of Islamic compliant tranches in limited recourse project financings throughout the Middle East is increasingly common. Guy Ranawake, Director, and Rhiannon Davis, Analyst, at Taylor-DeJongh, describe the growing diversity and applicability of Islamic compliant tranches in project financing structures.



GLOBAL DEMAND FOR Islamic financing is not limited to the Middle East but extends throughout South Asia (in particular Pakistan, Malaysia and Indonesia), parts of Europe, and even the United States. Recent landmark transactions, such as Umm al Nar and QatarGas II, each with Islamic tranches of over US$500m, demonstrate the growing importance of Islamic project financing in large infrastructure projects. This trend can be linked to both the rising demand for project funds in the Middle East region as infrastructure struggles to accommodate rapid economic growth and increased liquidity both inside and outside the region in search of a Shari'a-compliant home.

Project funding requirements in the Middle East have more than doubled since 2003, with an estimated US$40bn dollars required for infrastructure, power, petrochemical and oil and gas projects for 2005 and 2006 combined. This has driven the need to maximise access to various pools of capital.

Above: *The construction site of the Oryx Gas to Liquids plant in Ras Laffan Industrial City, north of Doha, Qatar. The plant is expected to come on stream in 2006 and is a joint venture between South Africa's Sasol and state-owned Qatar Pertroleum that will convert natural gas into clean burning diesel fuel, as well as smaller amounts of other liquid.*

Opposite: *Doubling up on projects. Oil pumps in the foreground and electrical power plants in the background.*

As part of this wave of new investment, there has also been an increase in the size and number of the larger infrastructure projects that are costed in excess of US$1bn, such as Aluminum Bahrain, QatarGas II – IV, QChem II, Ras Laffan, Rabigh and Yanbu. The size of these projects has meant that traditional financing sources such as export credit agencies (ECAs) and international commercial banks are no longer able to provide sufficient lending capacity to borrowers – although, of course, there are course exceptions such as Taweelah B, where the Japan Bank for International Cooperation (JBIC) provided sufficient support to the project such that no Islamic tranche was used. In the search for new sources of capital, borrowers and their financial advisers have looked to international, regional and local banks which can provide Islamic financing.

On the supply side, there is enormous liquidity being generated within the Islamic world, supported by strong oil and gas revenues and rapid domestic growth. Looking at Central Bank statistics, Qatar has experienced a 28.8% or US$4.5bn increase in liquidity over the same period last year; the UAE experienced a 23.1% or US$16.5bn increase; Saudi Arabia's liquidity grew by 19.5% or US$23bn; and Malaysia's liquidity increase topped US$19.7bn, growing at 12.8%.

Islamic institutions play an important role in managing this liquidity. There are between 250 and 280 Islamic banks operating globally, managing funds totalling approximately US$200-250bn. Key players – excluding conventional banks – in the region include: Islamic Development Bank, ABC Islamic, Dubai Islamic, Abu Dhabi Islamic, Bahrain Islamic Bank, Bank Al-Jazira, Kuwait Finance House, and Gulf Investment Corporation. In addition, there are approximately 100 Islamic equity funds worldwide, with total assets exceeding US$5bn and growing at 12-15% per year. Equity capital markets have also performed well adding to liquidity in the region. The top 10 Organisation of Islamic Conference (OIC) stock markets grew at an average rate of 99.9% between 2003 and 2004 – although there has been some recent retrenchment. In contrast, the top 10 global stock markets, including New York, London and Tokyo, grew at an average of 19.8%.

Interestingly, there is no single definition of Islamic finance. However, in order to have access to Islamic funds, the project and related financing must conform to Shari'a law or "divine law," which dictates how Islamic financing is to be carried out. Islamic banks retain a Shari'a board to evaluate compliance with Islamic law in their banking practices. Financing structures cannot contain riba, or any unlawful increase or gain from a loan (which includes interest), or gharar, which means deception, speculative risk, uncertainty or peril.

In addition, a distinction must be drawn between those countries where Shari'a compliance is desirable but where commercial codes govern commercial activity (for example Egypt) and those countries where Shari'a is the supreme law of the country (for example Saudi Arabia).

INTEGRATION OF ISLAMIC AND CONVENTIONAL FINANCING

There has been a growing integration of Islamic banks and financing tools, and conventional banks and products in

recent years. Conventional banks (such as HSBC and BNP Paribas) are opening Islamic subsidiaries or "Islamic windows" to service the market, and Islamic financial institutions are targeting non-Muslims with increasingly diverse Islamic products. Islamic banks are being established outside the Islamic world (such as the Islamic Bank of Britain in the United Kingdom), and many transactions are taking place outside the Islamic world in cooperation with and sometimes through conventional institutions.

Within the region, borrowers are not generally compelled to go to Islamic banks for Islamic financing or banking products. At the same time, conventional banks across the globe are catering to and winning Islamic clients. In particular, there is still sometimes a preference for a sponsor to appoint an international bank rather than a regional or local bank (either conventional or Islamic) to lead the financing for a particularly large or complicated transaction where structuring skills are given high priority. Over time, we should see this preference disappear as regional and local banks, both conventional and Islamic, build up their track record and experience.

Large projects in particular offer opportunities for Islamic and conventional banks (including export credit agencies) to collaborate. Here, there are often a number of tranches in a given deal, which allows for separate financial, legal and contractual structuring, managed through an inter-creditor agreement. As a general rule, conventional banks and Islamic banks rank pari passu in all respects, although complete parity may not be possible.

There is a growing convergence in the terms of Islamic and conventional financing structures and terms which assist in the development of such inter-creditor arrangements. Like conventional banks, institutions retaining large holds and related up-front fees have little appetite for syndication risk.

In terms of tenor, Islamic tranches can be pushed to match or even exceed those of the international tranches, despite some maturity mismatch between deposits and loans.

However, there is still a preference for some Islamic institutions to favour tenors of under 7-8 years, particularly given the returns available in retail banking. Pricing is usually comparable to that of conventional banks as a result of intense competition from conventional banks. Islamic banks

THE PRINCIPAL TYPES AND PROJECT FINANCING APPLICATIONS OF ISLAMIC FINANCING STRUCTURES

There are a number of reasons why infrastructure projects lend themselves to Islamic financing:

- they require large amounts of funding;
- they are asset-based and usually limited or non-recourse;
- they are typically long-term and non-speculative projects; and
- they often entail some socio-economic benefit.

The growing interest in Public Private Partnership (PPP) projects outside the traditional oil and gas sectors should also benefit from this growth of Islamic finance, driven by the increased available liquidity from Islamic sources and the perceived public benefit that comes with PPP ventures.

There are a range of Islamic financing structures that cover equity and debt products. The current list includes Mudarabah financing, or trust financing, Salam, which involves forward purchase and Musharakah, involving profit sharing, preferred stock and debt-like Islamic financial products.

Another form, Murabaha financing, is a trade financing concept whereby the bank makes a profit on the price it pays for a commodity and that commodity's resale price to the client. The resale price is pre-arranged, and a third party manufacturer must always be involved. This type of financing arrangement is typically used to provide working capital-type facilities to existing corporates. Most recently, a US$2.1bn Murabaha facility has been used as an 18-month bridge facility to finance Etisalat's acquisition of a Pakistan telecom company.

Ijara financings, meanwhile, are leasing style structures. In sale and lease-back structures, the financier purchases an asset and leases it to the borrower at a specified amount. In retaining ownership of the asset, the financier shares risk with the borrower and his profits from the transaction are derived from the asset or business, not the time-value of the money lent. There is also a variation on this arrangement where the borrower assumes ownership of the asset at the end of the lease (Ijara wa Iqtina). Recent examples of this type of sale and leaseback facility are found in Bapco's US$330m Islamic tranche for its oil refinery in Bahrain and the US$530m Islamic tranche for QatarGas II, where Taylor-DeJongh advised the export credit agencies.

Future sale contracts, or Istisna'a, are also used in Islamic

tend to be more flexible on terms than pricing, compared to conventional banks.

The potential downfall is that Shari'a committees can be unpredictable and are the slowest part of the process, with inconsistencies sometimes arising between and within Shari'a committees. In the recent past, issues such as client loan default and compensation for risk-sharing were points of contention between Islamic and non-Islamic banks. Many of those concerns have now been surmounted through flexibility and creativity on the part of Islamic institutions and conventional institutions offering Islamic products.

Even so, while both lenders and borrowers are aware of precedents, documentation continues to be a time-consuming process and can add substantially to legal bills. With increasing familiarity, the complexity and cost of the documentation process should reduce over time.

FUTURE OF ISLAMIC FINANCING

The future of Islamic banking offers great potential as well as a few obstacles to overcome. Projects such as Dolphin Energy and Etisalat, along with increasing liquidity throughout the Muslim world, point to larger Islamic tranches in future transactions.

In addition to increasing depth and breadth in the market, we expect to see Islamic financing products becoming more standardised with the help of regulatory agencies such as the Islamic Rating Agency, as well as institutions such as the Islamic Development Bank, the newly formed Dow Jones Bahrain Index and the recently proposed Global Islamic Bank.

However, regional and local Islamic financiers and banks do face certain challenges. Remaining competitive with regional/local conventional banks, for instance, which have substantial liquidity, as well as international banks with Islamic windows and products, is a necessity while persuading borrowers that regional and local banks have sufficient structuring expertise to manage complex transactions is a further requirement. The need to continue to improve the consistency of Shari'a committee decisions and to reduce the legal cost of additional documentation is also paramount. However, we do not expect that any of these challenges should present a long-term barrier to the continued development of Islamic financing for the infrastructure market.

financing. In this type of contract, a financier or financing institution agrees to purchase an item from a manufacturer, which has been tailored to the borrower's specifications, and then to resell the item to the borrower at a pre-determined price. Because these contracts can only exist between the manufacturer and the final buyer, they are often utilised in pairs, back to back. The financier/ financing institution must either act as the manufacturer or end-purchaser of the item; the lender can not function as an intermediary.

Istisna'a cannot occur simultaneously for the same item, therefore in the first contract the lender will be the end-user and purchase the borrower's item from the real manufacturer. On delivery of the item, that contract will be completed and a second contract can then be activated with the borrower. The lender becomes the "manufacturer" and sells the item to the borrower on a deferred pay-back schedule. Between contracts, the lender has sole possession of the item, incurring some of the related risk and maintenance responsibilities. This type of contract can be used in the asset-financing or off-take phases of a project.

The Dolphin Energy pipeline deal in Qatar, which is expected to include a projected US$1bn Islamic Tranche – the region's largest ever for oil and gas project financing – will consist of an Ijara (sale and lease-back arrangement) and an Istisna'a (a forward purchasing contract).

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Finally, Sukuk bonds allow numerous Islamic financial institutions and corporations to invest their surplus liquidity in certificates containing an interest in certain specified assets. Under this scheme, Islamic banks transfer their interest in assets owned by them and leased to the project company, or special purpose vehicle (SPV), to an offshore SPV. The project company or SPV then declares a trust of those assets in favour of the sukuk holders and issues a note to each sukuk holder. The Umm al Nar IWPP project, which closed in July 2003, was the first to issue sukuk bonds. The Taweelah A2 IWPP refinancing followed suit in March 2004 with a US$150m Islamic tranche that included a sukuk offering. Bahrain-based Liquidity Management Center (LMC), which has aided in the development of a secondary market for Islamic financial products and issued nearly $1bn in sukuk bonds over several occasions, hopes to establish an inter-bank market for these securities. Another variation on this theme is Muqarada, that are revenue bonds issued by a company to investors in order to fund a project that falls outside the realm of that company's standard activities. Muqarada bond holders are not paid interest or a pre-determined profit, but instead receive a share of the project's profits that is proportional to their investment. Investors also share in project losses.