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Islamic finance: basic principles and structures

A focus on project finance

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Introduction

Islamic finance is finance under Islamic law (or *Shari'ah*) principles. The basic sources of *Shari'ah* 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 (or *riba*).

The strong disapproval of interest by Islam and the vital role of interest in modern commercial banking systems led Muslim thinkers to explore ways and means by which commercial banking could be organised on an interest-free basis.

Development

Islamic financial institutions are relatively recent creations: 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 Saudi investors. The Islamic Development Bank (IDB) was established in 1975 and gave momentum to the Islamic banking movement. It was the first time in modern Muslim history that an international financial institution committed itself to conduct its activities in conformity with the *Shari'ah*. Instead of working on the basis of interest, the bank was authorised 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 organise their banking systems along Islamic lines. The first private Islamic commercial bank, the Dubai Islamic Bank, was founded in 1975.

Main principles

The main principles of Islamic finance include:

- the prohibition of taking or receiving interest;
- capital must have a social and ethical purpose beyond pure, unfettered return;
- investments in businesses dealing with alcohol, gambling, drugs or anything else that the *Shari'ah* considers unlawful are deemed undesirable and prohibited;
- a prohibition on transactions involving *masir* (speculation or gambling); and

- a prohibition on *gharar*, or uncertainty about the subject-matter and terms of contracts – this includes a prohibition on selling something that one does not own.

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 *Shari'ah*, 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 flexibility 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; and
- those that involve partnerships in investments and the sharing of profits and losses.

The *Shari'ah* board

One distinct feature of the modern Islamic banking movement is the role of the *Shari'ah* board, which forms an integral part of an Islamic bank. A *Shari'ah* board monitors the workings of the Islamic bank and every new transaction that is doubtful from a *Shari'ah* standpoint has to be cleared by it. These boards include some of the most respected contemporary scholars of *Shari'ah* and the opinions of these boards are expressed in the form of fatwas. In addition, the International Association of Islamic Bankers, an independent body, supervises the workings of individual *Shari'ah* boards while its Supreme Religious Board studies the fatwas of the *Shari'ah* boards of member banks to determine whether they conform with *Shari'ah*.

Shari'ah law is open to interpretation and *Shari'ah* boards often have divergent views on key *Shari'ah* issues. In this regard, there is no practical guide as to what constitutes an acceptable Islamic financial instrument. A document or structure may be accepted by one *Shari'ah* board but rejected by a different *Shari'ah* board.

Certain basic methods of Islamic financing

There are several methods of Islamic financing. However, in the world of commercial financing and more particularly, project financing, certain methods are more commonly encountered than others. These are set out below.

***Murabaha* (cost-plus financing)**

The *Murabaha* is a method of asset acquisition finance. It involves a contract between the bank and its client for the sale of goods at a price that includes an agreed profit margin, either a percentage of the purchase price or a lump sum. The bank will purchase the goods as requested by its client and will sell them to the client with a mark-up. The profit mark-up is fixed before the deal closes and cannot be increased, even if the client does not take the goods within the time stipulated in the contract. Some Islamic banks use an agency arrangement, where the client takes delivery of goods from the seller as agent of the bank. Payment will usually be over time by instalments.

***Mudaraba* (profit sharing)**

The *Mudaraba* is a profit sharing contract, with one party providing 100 per cent of the capital and the other party (the *mudarib*) providing its expertise to invest the capital, manage the investment project and, if appropriate, provide labour. Profits generated are distributed according to a predetermined ratio, but like the capital itself, cannot be guaranteed. Losses accrued are therefore borne by the provider of capital, who has no control over the management of the project. *Mudaraba* structures are often used for investment funds, with investors providing money to the Islamic bank, which it invests as *mudarib*, taking a management fee.

***Musharaka* (partnership financing)**

The *Musharaka* involves a partnership between two parties who both provide capital towards the financing of new or established projects. Both parties share the profits on a pre-agreed ratio, allowing managerial skills to be remunerated, with losses being shared on the basis of equity participation. One or both parties can undertake management of the project. As both parties take on project risk, it is relatively rare for banks to participate in *Musharaka* transactions.

***Ijara* (leasing)**

The *Ijara* is a contract where the bank buys and leases out equipment required by the client for a rental fee. The duration of the lease and rental fees are agreed in advance. Ownership of the equipment remains with the lessor bank, which will seek to recover the capital cost of the equipment plus a profit margin out of the rentals payable. There are two types of *Ijara*: operating leases and lease purchase. In a lease purchase, the obligation to purchase the equipment at the end of the lease and the price at which the assets will be bought is pre-agreed. Rental fees already paid constitute part of the final purchasing price.

Where an asset is financed through floating rate funds, the owner will usually pass the risk of rate fluctuations down to the lessee

through the rentals payable by the lessee. This creates a problem under Islamic finance principles as lease rentals cannot be expressed by reference to interest rates. This difficulty is partly surmountable. In leasing transactions the lessor is providing an asset, not funds, so the return is in the form of rent, rather than principal and interest. In an *Ijara* lease, the amount and timing of the lease payments should be agreed in advance, though the amount of those payments may be subject to adjustment on a predetermined basis.

Ways in which the problem has been overcome therefore include: referring to the rent payable under the lease at the date of signing but subject to adjustments by reference to provisions in other documents; or adjusting the rent by cross-reference to LIBOR or to a fluctuating rent payable under a non-Islamic lease signed at the same time. Such structures may be cleared by some *Shari'ah* boards but not by others.

***Istisna'a* (commissioned manufacture)**

As noted above, the principle of *gharar* prevents one from selling something that one does not own. The technique of *Istisna'a* has been developed as an exception to this. As defined by the Islamic Development Bank, *Istisna'a* is 'a contract whereby a party undertakes to produce a specific thing that is possible to be made according to certain agreed specifications at a determined price and for a fixed date of delivery'. Accordingly, the technique is particularly useful in providing an Islamic element in the construction phase of a project, as it is akin to a fixed price turnkey contract. As the *Istisna'a* contract is one of procurement and sale of an asset, it also lends itself to non-recourse financing.

In an *Istisna'a* transaction, a financier may undertake to manufacture an asset and sell it on receipt of monetary instalments. As banks do not normally carry out manufacturing, a parallel contract structure will typically be used. The ultimate buyer of the asset will commission it from the bank, which will institute a parallel contract under which the bank commissions the asset from the manufacturer. The bank charges the buyer the price it pays the manufacturer plus a reasonable profit. The bank therefore takes the risk of manufacture of the asset.

The risks and pitfalls of Islamic finance

Uncertainty

Shari'ah is a body of religious principles applied to law and 'life and behaviour' in various ways in the world's numerous Islamic jurisdictions. There is no single, absolute set of rules that constitute a universally applicable *Shari'ah* and much of the classical law emerged at a time when many financial concepts did not exist. The

manner in which banking institutions ensure that they act according to *Shari'ah* principles is by submitting themselves to the *Shari'ah* boards. As mentioned above, a document or structure may be accepted by one *Shari'ah* board but rejected by a different *Shari'ah* board. For example, though it is a well-established method of financing, it should be noted that there is some debate among *Shari'ah* scholars as to the permissibility of the mark-up charged by the bank.

A positive aspect is that Islamic finance contracts can be subject to English or New York law (or any other law). In a recent judgment, the English Court of Appeal upheld the decision of the Commercial Court in *Shamil Bank of Bahrain EC v Beximco Pharmaceuticals LPD & Others* that where the parties agree that English law governs their contract, provided they can show that they have taken the normal necessary steps to ensure compliance with *Shari'ah* law (for example, obtaining approval by a *Shari'ah* board) the English court will neither look at how that certification was obtained nor find to the contrary and will confine itself to applying English legal principles when looking at the contract. This decision reinforces the suitability of English law as a prudent and reliable choice for Islamic financial contracts.

Ownership risks/tax

In nearly all methods of Islamic financing, the lender is at some stage the owner of the financed goods. In some cases, the asset will be retained for a considerable period and therefore the legal issues surrounding ownership, such as risk, insurance and maintenance become important. These issues include:

- whether the proposed structure is treated for tax purposes in a manner which is disadvantageous relative to a conventional loan, including whether asset-related tax risks arise, for example tax exposures connected with the physical location or operation, or the particular characteristics, of the asset. It may be possible to manage such issues through the use of vehicles in tax neutral jurisdictions or double taxation treaties;
- whether the party raising finance suffers a tax treatment that is adverse relative to conventional borrowing (interest payments on loans generally being tax-deductible, the same not necessarily being true for profit participating payments or payments related to dealings in assets);
- issues relating to asset risk (ie if the asset is destroyed or becomes unfit while the financier owns it) – which fall on the financier so long as the client did not cause the damage;

- potential liability incurred through owning or supplying the asset must be considered by the financier; and
- responsibility regarding insurance and maintenance of the asset.

Responsibility for these issues is allocated between the borrower and the financier on a transaction-by-transaction basis. In the Islamic element of a syndicated project financing, the majority of risks will be borne by the borrower, who will be responsible, for example, for insuring the financed asset and naming the financier as an insured party. This is consistent with the usual provisions of non-Islamic financings.

Security/recourse

A bank financing a transaction may expect to receive a mortgage over an asset as security and the availability of such security will tend to reduce the price of the transaction. The law of the jurisdictions involved varies and will have to be considered in determining whether appropriate security is available. In certain Middle Eastern countries, mortgages over movable assets are forbidden and a financier can only take security if it takes a pledge of the asset, which will often defeat the aim of the financing as a pledge will require the financier to have possession of the asset. Other factors such as registration, notarisation and payment of fees and documentary taxes may also have an effect on the attractiveness of security in the transaction structure. The types of security available under English law are more varied and retention of title is possible in certain circumstances. There are, therefore, benefits in choosing a governing law for the transaction that enables the security objectives to be achieved, so long as the transaction can be declared *Shari'ah*-compliant by a *Shari'ah* board.

Certain security issues in respect of *murabaha*, *mudaraba*, *Ijara* and *Istisna'a* transactions are discussed in more detail below.

- As a *murabaha* contract involves the provision of goods to the buyer on a deferred payment basis, the Islamic lender may wish to take security to ensure that the buyer will make the required payments. Such security may be the assets covered by the *murabaha* contract but as the assets are in the possession of the buyer, this may be difficult in jurisdictions that require security to be by way of a pledge. Frequently, therefore, security is taken over other assets or can involve other types of collateral such as a third party guarantee, an assignment of payments or security over the buyer's account with the Islamic bank.
- As a *mudaraba* involves a joint venture arrangement between the Islamic bank and the party managing the project, the main concern of the bank is that the managing party carries out its obligations

appropriately. The contract between the bank and the *mudarib* will impose conditions for management of the project but in the absence of negligence or misconduct, the *mudarib* cannot be held liable for losses. The bank may therefore seek a performance bond or guarantee from a third party.

- In an *Ijara* structure the bank, as lessor, has title over the leased asset. Therefore, the concerns of the bank are similar to the concerns of a lessor in a conventional lease. For example, the bank will aim to ensure that the lessee does not dispose of the asset or reduce its value.

  In contrast with most conventional leases, in an *Ijara* lease the responsibility for maintaining and insuring the leased asset remains that of the lessor throughout. Therefore, the owner/lessor will agree in the lease to procure the maintenance and insurance of the asset. The conventional position of the lessor relieving itself of these burdens can be achieved within the *Ijara* framework if the owner/lessor recovers the insurance costs by increasing the rental payments and if the lessor appoints the lessee or another third party as its agent to obtain the required insurance in return for a fee. Maintenance obligations can be dealt with in a similar way, where the lessor agrees in the lease to perform all maintenance and repair obligations but appoints the lessee or another third party to perform such obligations on behalf of the lessor in return for a fee. The extent to which maintenance responsibilities have been transferred is usually reflected in the lease payments due from the lessee.

- In an *Istisna'a* transaction, the bank's security arises through its ownership of the asset. The contract between the bank and the ultimate buyer can provide that title will not be transferred until the full purchase price has been paid.

Default

Conventional financing transactions usually provide for default interest on late payment of amounts due, which is not possible in Islamic financing. In Islamic financing, the same effect can be achieved in different ways. For example, some form of discount formula can be provided for where an agreed rate of discount is applied for each day that payment is made prior to a backstop date. The backstop date is chosen to reflect the latest date in which funds might be expected to be paid. However, if payment is made after the backstop date then the financier cannot recover any additional amount. In other transactions, we have seen late payment fees replace the conventional default rate of interest.

Documentary complexity

The majority of the difficulties brought into a transaction by the *Shari'ah*-compliant elements are surmountable, even if this means that the documentation will be more complex than in a conventional financing. For example, in a structure that combines conventional debt with Islamic equity, the equity cannot be a party to the same document as the debt (for example, a participation agreement). This has been resolved in some cases by making the equity a third party beneficiary to such document.

Islamic finance in action

General

Given the added complexity and uncertainty, it may be asked why non-Muslims would agree to use Islamic finance structures. The principal answer is that Islamic finance provides an opportunity to tap into the significant funds of Islamic investors seeking *Shari'ah*-compliant investments.

In addition, Islamic finance can be combined with conventional funding sources and export credit agency (ECA) support. For example, Dubai's Emirates airline recently closed an innovative transaction combining Islamic investment with ECA support.

Islamic finance has continued to expand both geographically and in product richness despite the difficult conditions in the global financial markets and the regional uncertainties. Retaining 'conventional style' documentation and a bankable governing law together with a greater consistency in approach among the *Shari'ah* boards seem to be key aspects in the growth of Islamic finance. The Islamic Financial Services Board, an association of central banks, monetary agencies and governmental organisations[1], was established on 3 November 2002 to develop universal *Shari'ah*-compliant finance standards and harmonise practices in the Islamic financial services industry.

Once viewed as the realm of a small number of specialised institutions, Islamic finance has now moved into the mainstream, with specialised regional Islamic institutions experiencing a significant growth and global banks such as HSBC, Citibank and UBS coming into the market. There has been a diversification of Islamic structured products, including real estate, aircraft financing, shipping and trade, as well as project finance.

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1 See www.ifsb.org/

The UK: Islamic mortgages and changes to tax laws

Recent developments in the UK illustrate how Islamic financing is becoming 'mainstream' and is recognised as an alternative method of financing to conventional bank financing. In particular, commercial banks have begun offering *Shari'ah*-compliant mortgages in order to attract Muslim customers, while the UK government has amended the tax laws to clarify the way in which certain Islamic structures will be treated.

Islamic mortgages

In 2003, HSBC was the first mainstream UK bank to offer mortgages in the UK designed to comply with *Shari'ah* using the *Ijara* structure, shortly followed by the launch by United National Bank Limited of its first Islamic product in the UK, the UNB Islamic Mortgage, also based on the *Ijara* model.

HSBC's structure involves the bank purchasing a house and then leasing it out to the customer. The customers' payments include a contribution to the purchase price, a rent for use of the property and insurance charges. At the end of the finance term, when all the payments have been made, the customer can exercise a right to have the property transferred into its name. This structure was greatly facilitated by the UK government's decision in April 2003 to remove double stamp duty on home purchases under *Shari'ah*-compliant borrowings (previously stamp duty would have been charged on the purchase of the property by the Bank and then again on the purchase by the customer). The UK Islamic mortgage market is now undergoing significant growth.

Taxation treatment of Islamic financing structures in the UK

In recognition of the growing importance of Islamic methods of financing in the UK, the Finance Act 2005 introduced provisions to clarify the tax treatment for what it defines as 'alternative finance arrangements'. The intention is to put these arrangements and the people who use them on an equal footing with conventional finance arrangements and their users.

'Alternative finance arrangements' are defined as those giving rise to an alternative finance return or to a profit share return. Broadly, arrangements give rise to an alternative finance return if they involve the purchase by a financial institution of an asset and its onward sale to another person, the sale price is greater than the purchase price, and the difference equates in substance to interest. At least one of the parties must be a financial institution (section 47)[2]. Arrangements give rise to a profit share return if they involve the

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2 Unless otherwise specified, statutory references in this paragraph are to the UK's Finance Act 2005.

deposit of money with a financial institution, which money is then used by that institution with a view to producing profit. A proportionate part of that profit is then returned to the depositor (section 49).

Where a company is a party to an arrangement giving rise to an alternative finance return or to a profit share return, the loan relationships provisions of the Finance Act 1996 (part 4, chapter 2) are to be applied to the arrangement in the manner provided. Broadly, the purchase price is to be treated as if it were a loan and the return as if it were interest (section 50). In the case of individuals, trustees and other non-corporate persons, the alternative finance return or profit share return are to be treated as if they were interest (section 51). Where an asset is sold by one party to another under an alternative finance arrangement, the effective return is to be excluded in determining the sale and purchase consideration for all other purposes of the tax acts or the Taxation of Chargeable Gains Act 1992 (section 53). A profit share return is not to be treated as a distribution under the Income and Corporation Taxes Act 1988 s 209(2)(e)(iii) (section 54).

Aircraft finance

Islamic finance structures are increasingly used in the field of aircraft finance and are not restricted to lessees based in Islamic countries. These structures provide an opportunity to tap into the significant funds of Islamic investors seeking *Shari'ah*-compliant investments and can be combined with conventional funding sources and ECA support (Dubai's Emirates airline recently closed an innovative transaction combining Islamic investment with ECA support).

In addition, the aviation industry is in principle *Shari'ah*-compliant and the financing is asset based, making it a good choice for Islamic investors. Emirates has frequently used Islamic leases to finance its fleet expansion. Other Asian carriers such as Thai Airways, Syrianair and Royal Brunei Airlines have also leased aircraft under Islamic-style leases.

The international Islamic bond (*sukuk*s) market

The international Islamic bond (*sukuk*s) market, which did not exist in 2000, reached $6.7bn in 2004, up from $1.9bn in 2003[3]. 2003 was itself was a record year, in which the landmark $400m IDB global *sukuk* was brought to the market in August and was the first AAA-rated Islamic bond ever launched. The offering, which was enthusiastically received by investors, was followed by Qatar's $700m *Ijara sukuk*.

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3 According to the Islamic Finance Information Service (IFIS).

In the conventional system of bond issues and trading, interest is at the centre of any transaction. In the Islamic alternative, the underlying income stream for the bond must not be based on interest, while the *sukuk* must avoid the obvious system of interest in bond trading.

Different forms of Islamic bonds or *sukuk*s, based on the acceptable methods of financing and purchasing in Islamic law, are widely accepted; for example, income streams arising from *Musharakah*, *Murabahah* and *Ijara* structures, or a combination of them. However, it should be noted that although some of these instruments have been generally accepted as being in compliance with Islamic principles so that they can be traded in the secondary market, the negotiability of certain others is still a point of debate and controversy.

Ijara bonds are securities representing the ownership of well-defined existing and well-known assets that are tied up to a lease contract. *Ijara* bonds are negotiable and can be traded in secondary markets. *Ijara* bonds offer a high degree of flexibility from the point of view of their issuance, management and marketability. Financial intermediaries or both public and private asset owners can issue these bonds.

The 2003 Qatar issue was structured (by HSBC) so that the issuer purchased a substantial land parcel, designated for the development of a medical city, from the Qatar government. The issuer, in turn, leased the land to the government to enable it to carry out the proposed development and issued floating rate trust certificates (*sukuk*s) to investors, with pricing referenced against Qatar's sovereign credit risk. The lease rental payment from the government to the issuer exactly matches the payments payable on the trust certificates. The issue is listed in Luxembourg.

In May 2005, the IDB began the Trust Certificate Issuance Programme for the issue of *sukuk*s. The trust certificate documentation is similar to typical medium term notes. Each *sukuk* represents an ownership interest in a special purpose company, which owns a number of *Shari'ah*-compliant assets, including assets that were on the IDB's balance sheet.

Islamic documentation in project financing: an example

Islamic financing structures are increasingly used in the project finance domain, particularly in projects in the Middle East. In most Islamic financings incorporated within a multi-sourced project financing, the Islamic financing element of the project is provided *pari passu* with the other senior debt. *Istisna'a* and *Ijara* elements are

frequently used. For example, Dolphin Energy signed a $1bn Islamic financing agreement with 14 local and international banks in September 2005, which was the largest *Shari'ah*-compliant funding to be completed in the oil and gas sector at the time. Banks involved included BNP Paribas, ABN AMRO, Citigroup, Dubai Islamic Bank, and Gulf International Bank. The loan has a four-year tenor and is structured as an *Istisna'a*.

Below is an example of another transaction that we were involved in, summarising the structure and the documentation used. It should be noted that this transaction is simply an example of one Islamic financing and should not be considered as representative of all other Islamic project financings or as a template for future transactions.

Summary of key documents

In the relevant transaction, the finance providers under the Islamic facility (the Islamic finance providers) established an Islamic SPV to operate as their financing vehicle to own certain project assets and lease those assets to the borrower. The Islamic finance providers and the Islamic SPV appointed an Islamic bank as facility agent (the Islamic facility agent) to perform each of their respective obligations under the Islamic financing documents, which included the following:

Islamic facility agreement

This credit agreement set out the terms regarding conditions precedent, representations and warranties, covenants, events of defaults and payment provisions on broadly identical terms to the obligations in the non-Islamic-compliant documents, other than for the payment of interest and procurement of insurance.

Istisna'a

This operated during the construction phase. The borrower agreed to develop, construct and deliver the project assets according to certain specifications and sell the project assets to the Islamic SPV. The Islamic SPV agreed to pay for the project assets by phased payments (equivalent to advances of finance) to the borrower. If the borrower failed to deliver the project assets by the due date, it was liable to pay liquidated damages.

Subject to the intercreditor agreement (and therefore the relationship with the non-Islamic financing documents), acceleration of the Islamic facility agreement would lead to termination of the *Istisna'a*. Upon termination, the borrower was to reimburse to the Islamic SPV all payments received less the amount of any liquidated damages paid, and the Islamic SPV was to waive all its rights and claims to ownership and title to the assets. The *Ijara* would also not come into effect.

Ijara

This operated after completion of the construction. Following delivery of the project assets under the terms of the *Istisna'a*, the Islamic SPV agreed to lease the project assets to the borrower for the period of the lease and the borrower agreed to pay lease payments (equivalent to debt service) to the Islamic SPV. As owner of the assets, the SPV had de facto security over them.

Akin to the restrictions and covenants placed upon the borrower according to conventional debt facilities, the borrower undertook to use the leased project assets solely for the purposes contemplated in the Islamic facility agreement. Furthermore, The Islamic SPV and the Islamic facility agent made no representation or warranty as to the project assets so that risk of title, defects etc lay with the borrower who waived any claim caused by the project assets. The Islamic SPV's rights to take any enforcement action (ie remedies following events of default) were governed by the terms of the intercreditor agreement.

The borrower was entitled to terminate the *Ijara* voluntarily by giving notice. Upon termination (including payment of the final lease payment (ie maturity)), the Islamic SPV was to sell the project assets to the borrower according to the sale undertaking (see below) and the Islamic facility agreement. Subject to the terms of the intercreditor agreement and the other non-Islamic documents, the *Ijara* could be terminated following certain events of default.

During the term of this *Ijara*, the ownership of the project assets remained with the Islamic SPV. The borrower could require the Islamic SPV to repair, reinstate or replace project assets that were damaged or destroyed, save to the extent that such damage or destruction was caused by the borrower's wilful misconduct or gross negligence.

The Islamic SPV remained responsible for the major maintenance (maintenance of a capital nature) of the project assets so that they continue to provide the service for which the borrower rented them, although it was acknowledged that these maintenance obligations (and the procurement of insurance) would be sub-contracted to the borrower under the service agency agreement (see below). As with the 'operational covenants' contained in conventional financing of this nature, the borrower was responsible for 'ordinary maintenance' (eg inspections of the project assets, maintaining such assets in good and serviceable repair and maintenance of records).

Investment agency agreement

The Islamic finance providers and the Islamic SPV authorised the Islamic facility agent to act on their behalf to exercise their respective

rights and perform their respective obligations under the Islamic finance documents. The Islamic finance providers, the Islamic SPV and the borrower acknowledged that the payments made by the Islamic facility agent directly to the borrower (sourced from the Islamic finance providers under the Islamic facility agreement) were payments satisfying the Islamic SPV's obligation to pay consideration for the project assets under the *Istisna'a* agreement.

Service agency agreement

The Islamic SPV owned the assets and appointed the borrower as its service agent to operate and maintain the leased project assets, keep such assets fully insured and pay any applicable ownership taxes, thereby restoring certain of the risks of asset ownership to the borrower.

Sales undertaking

The Islamic SPV undertook to sell the leased assets to the borrower upon payment of a lease termination payment (ie discharge of all outstanding amounts owed, effectively allowing prepayment of the Islamic facility and release of the rights of the Islamic finance providers upon discharge of the Islamic financing).

Purchase undertaking

The borrower undertook to purchase the leased project assets from the Islamic SPV upon payment of a lease termination payment (ie effectively acceleration of the Islamic facility).

Some other key features

Intercreditor arrangements

Given the principles behind Islamic financing outlined above, the Islamic finance providers were not party to the other finance documents. However, each of the Islamic finance providers was, through the Islamic facility agent, bound by the intercreditor agreement with the non-Islamic lenders and was therefore subject to the intercreditor provisions governing the relationship between the lenders. These provisions included: the method of voting and decision-making; arrangements for joint consultation and actions regarding approval rights and waivers; limitation of the parties' rights of enforcement upon default; and the application of proceeds upon enforcement.

Conditions precedent, warranties, covenants, events of default etc

This Islamic facility agreement contained various representations and warranties, covenants and events of default by the borrower.

Guaranteed returns

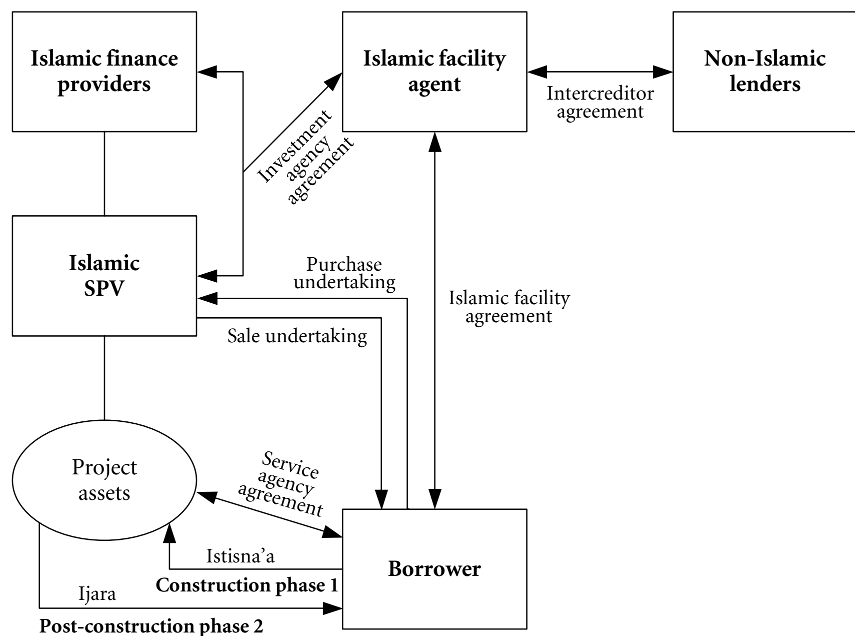
Unlike conventional financing, the Islamic facility agreement did not provide a guaranteed interest rate of return, as the prohibition of interest is a significant principle of Islamic financing. As an

alternative, the Islamic finance documents provided for advance amount payments (providing an effect similar to interest calculated on the outstanding principal on or before the lease began and a lease variable element (providing an effect similar to interest calculated at any time after the lease began)).

While the Islamic finance documents did not contain any express provision for the payment of default interest, failure by the relevant party to pay any amount owing under the applicable Islamic finance document resulted in an obligation to make a payment connected to the delay. If an Islamic finance provider received a payment that was solely attributable to the borrower's delay in payment, that participant was required to hand over the net amount (after deducting the actual costs and expenses suffered or incurred by it as a consequence of the borrower's failure to comply with the applicable Islamic finance document) to such charitable foundation or scientific or medical institution as it selected.

The diagram below illustrates a typical project finance transaction which incorporates an Islamic financing structure.

Islamic documentation in project financing: an example



1 Construction phase – borrower develops, constructs and sells project assets to Islamic SPV. As consideration, Islamic SPV makes phased payments to borrower (equivalent to loan advances).

2 Post-construction phase – Islamic SPV leases projects assets to borrower. Borrower makes lease payments (equivalent to debt service).

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