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Islamic Sharia'a- Compliant Project Finance

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ABSTRACT

The development of infrastructures and the Islamic “Project Finance”

Project Finance is a project of investment optimisation aimed at creating public works or structures for public use, such as roads, bridges, railways, aqueducts, industrial sites, commercial centres or airports, in such a way as to enable the public authorities to transfer the construction costs, in full or in part, to private investors who will subsequently collect a variable percentage of the proceeds generated by the project

In the Islamic context Project Finance may play a fundamental role in the development of the infrastructure network, by tracing alternative financial sources to the incomes of the oil industry and, in the final analysis, to public expenditure. The World Bank has frequently pointed out, in its periodic reports, that any improvement in the infrastructure network of a country has a direct impact on the increase of the gross national product.

Theoretically, Project Finance may be divided into two categories: Private-Public Partnerships (PPP), in which public bodies or government agencies contribute to funding, and Project Finance Initiatives (PFI), in which the costs of construction are entirely borne by private entities.

Generally, the sponsors of the project constitute a commercial enterprise with a minimum capital, known also as a SPV (special purpose vehicle) and rely on the capital of other financiers (banks, government bodies and private investors) to cover the cost of the project.

Once the construction is completed the SPV manages the operating stage of the project for a certain number of years, so that the initial capital, the construction costs and the loans may be repaid by the operating returns.

In order to successfully conduct a Project Finance initiative private entities must set a rate of return that is acceptable in comparison with the risks. Normally, a high risk coefficient may only be accepted in the case of projects with high yield margins. In addition, since many Project Finance initiatives involve services to the public, private entities must have the necessary know-how for providing a high quality public service at a competitive price.

The aim of this essay is to demonstrate how Project Finance initiatives may be realised in an Islamic context, in spite of the fact that many of the financial solutions developed in the Western world do not conform to the Sharia'.

As well known, in the Islamic context religious demands govern all aspects of life, including finance and economy, imposing great restrictions on conventional financial instruments.

We will attempt to explain briefly how these restrictions may be by-passed and how the Islamic instruments available on the market may be used in the 'Islamic' Project Finance.

At first sight there appears to be a striking contrast between the Project Finance structure, which is essentially based on the loan, and the prohibitions imposed by the doctrine of the interested party (riba). The definition of riba (literally translated as 'increase') is, in fact, much broader than the modern concept of 'usury' and prohibits any form of gain that is not justified by the presenting of a service or the remuneration of a risk.

Consequently, receipt of interest relating to a mere bank deposit or loan is considered immoral and contrary to general benefit.

In the Islamic context potential profits on capital invested in a commercial transaction are not prohibited but, rather, encouraged, as we can see from the main characteristics of typical Islamic contracts, based on the sharing of profits and losses, such as the mudaraba and the musaraka: the musaraka is a joint venture in which all the shareholders contribute to the capital and are bound to a system of profit-sharing approved by the contracting parties; the mudaraba is an association of capital and labour involving a business managing entity (mudarib) and a passive investor (rabb al-mal), the profits of which, again, are redistributed between the contracting parties.

In contracts of the sharing of profits and losses (known also as PLS – profit and loss sharing) the investor assumes both the risk of obtaining a remuneration of capital if the commercial activity is successful and the risk of losing part of the capital invested if it is not. The Islamic concept of proportionality between risk and yield, therefore, adapts perfectly to the basic logic of the Project Finance initiatives.

In the traditional build-own-transfer (BOT) structures, in which the ownership of the project is transferred to the public body at the end of the operating stage, the profit and loss sharing contracts may find interesting applications in the planning of the project company structure.

For instance, a public concession may be imagined as the association of a public body and private investors – the project company would, in actual fact, be a diminishing musaraka, in which the public body contributes the real estate rights and the private investors provide the capital. In the diminishing musaraka the participating share in the project company owned by private shareholders would gradually decrease over time until the public body eventually has full ownership at the end of the concession contract.

It may also imagine the project company as a mudaraba in which the private shareholders agree on the gradual reduction of their shares in favour of the public body. In this case, the long-term investors are assimilated to the capitalist (rabb al-mal), while the other subjects, such as the project sponsors, the building company and the public body, may be assimilated to the mudarib, inasmuch as they share the entrepreneurial responsibility.

In the past fifteen years the Islamic Project Finance has enabled local and international funds to be channelled towards the realisation of power plants, petrol-chemical plants, roads, airports, desalination plants, and gas and oil pipelines.

Islamic financial instruments are also used to finance projects involving fixed income, such as the construction of buildings to be rented to public authorities, through the Islamic leasing contract (igara) – in this case, the investor purchases a share in the ownership of the economic units and receives periodic payments as rent. This structure is useful in the case of projects without positive cash flows, such as schools, hospitals and prisons. A similar mechanism was used for the construction of a light underground railway in Malaysia, in which the civil service sold the entire structure to a SPV, which, in turn, leased it to the government on the basis of a bay-istighlal (sale and lease back contract).

The SPV then issued profitable certificates (sukuk) that gave the subscribers the right to receive a proportional share of the positive flows relating to the rents.

In the past years we have seen interesting changes in the Islamic capital market, which has gone from the mobilisation of funds for specific projects to multi-project investment funds.

Regarding this, a number of real estate investment funds have been set up, which are geared to the development of new residential and commercial complexes in the US, in Europe and in South East Asia.

The present-day and future development of the sukuk market and the Islamic investment funds is a fundamental prerequisite for guaranteeing the participation of the average investor in the financing of infrastructure projects. It is important to emphasise that in Project Finance the sponsors or the SPV may need not only money but also machinery or buildings suitable for the project. In this case, financiers may purchase these goods for third parties, leasing them to the sponsors and the SPV by means of an Islamic leasing contract (igara) or through a markup sale with deferred payment (murabaha).

In order to guarantee the success of a Project Finance initiative it is essential that the risks relating to the project are transferred or shared with leading insurance companies.

The Islamic national health insurance market (takaful) has been developing very rapidly in the past few years, in spite of the fact that since 1903 conventional insurance contracts have been declared unacceptable due to their excessive uncertainty (gharar) and their aleatory (maysir) nature.

Following the increasing demand for an acceptable form of insurance against risks of loss relating to unfavourable events, in 1985 the High Islamic Council authorised certain insurance practices (takaful) based on shared responsibility, mutuality and a widespread logic of solidarity.

Takaful companies currently operate throughout the world using financial instruments based on the sharing of risks and profits, with methods similar to those of the mudaraba, in which the assured (rabb al-mal) pays a premium and the insurer (mudarib) administers and manages the business.

The mechanism of compensation and participation in the profits may vary according to the type of insurance granted, whether life insurance or insurance against unfavourable events.

In Project Financing various types of risk may be shared or transferred to a takaful company. First of all, in the construction stage, a series of unfavourable circumstances may jeopardise the realisation of the project or delay its handing over.

Construction firms may reduce the risk of delays and non-fulfilment by requesting coverage for environmental damage, adverse weather conditions, force majeure, vandalism, theft and accidents.

Likewise, in the operating stage, certain events may influence negatively the cash flows generated by the project. In this case, the project company may rely on Islamic insurance to reduce the risk of service discontinuation due to accidents, adverse weather conditions, natural disasters and machinery breakdown.

In initiatives based on the conventional Project Finance, which involve large investments and a high degree of complexity, insurance companies generally sign a series of secondary agreements with reinsurance companies in order to limit their financial exposure.

For a long time the Islamic financial market has not succeeded in developing reinsurance companies capable of assuming the high risks relating to infrastructure projects, and has therefore resorted, temporarily, to conventional reinsurance companies.

The growth of the Islamic reinsurance market (retakaful) will probably be one of the most important keys to the success of the Islamic Finance on a worldwide scale.