A promising future

Masood Khan Afridi of Afridi & Angell compares Islamic and conventional project financing, and explains why careful documentation is so important

As economies continue to seek private sector participation for developing infrastructure projects, banks and financial institutions continue to provide debt to fund such projects on a limited recourse basis. Project finance has developed as a very useful tool for funding infrastructure projects, particularly given the fact that banks and financial institutions are amenable to extending long-term repayment schedules for such projects. A long-term repayment schedule is often necessary given the tariff structures usually associated with off-take arrangements in project finance transactions.

Debt by itself is not enough to either fund or manage a project. Funding is provided on a limited recourse basis in order to encourage private sector participation for infrastructure project development. In project finance transactions, investors have limited exposure and funding obligations. Their funding obligations are usually restricted to their equity participation, along with a limited exposure to project cost-overruns and (one time) funding of cash reserves.

Given the availability of *shariah*-compliant funding and the fact that private sector participation in infrastructure projects is rapidly growing in the Middle East, it is inevitable that Islamic financing will play a major role in project finance in the region and eventually beyond. It is also very likely that conventional banks will participate along with *shariah*-compliant institutions to fund projects as such projects require substantial debt, which is often contributed by several banks and financial institutions.

Traditional structures

In order to appreciate the impact of Islamic financing within a project finance transaction, it is helpful to understand the basic principles of non-recourse financing.

Limited Recourse

While we often describe a project finance transaction as non-recourse financing, it is typically structured as limited recourse financing. Lenders will often secure the sponsors' equity obligations upfront, along with a limited commitment to fund cost overruns beyond contingencies available within the project costs that are being funded. This still leaves the lenders largely dependent on contractual terms for adequate risk allocation.

In order to restrict the scope of liability, the borrower is usually incorporated as a special purpose project company, with liabilities and obligations flowing through the project company by virtue of a series of contracts with key project parties. It is important to ensure that the key terms of the contracts are consistent, so that the liabilities of the project company are adequately compensated by the party ultimately responsible for the events leading to the claim. The contractual structure is designed to insulate the project company from defaults of contracting parties, so that the party that is responsible for a default, and is in the best position to compensate, is to be held ultimately liable.

Ideally, the project company (and its sponsors) should not be required to compensate a project party by using their own funds for any defaults that are caused by any other project party. Apart from liquidated damages, key contractual terms such as *force majeure* should also be consistent to ensure that the project company is not held accountable for any gaps in the application of such provisions.

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Cash-flow integrity

Lenders look to the projected cash flows as their primary source of repayment. As such, the off-take arrangement is carefully reviewed to ensure consistency with loan repayment schedules, as are the timing of payments and liquidated damages in various contracts. Consistent terms reduce the requirement for additional funding in the form of working capital, for the project company. However, adequate cash reserves are often a requirement, to ensure availability of funds on repayment dates.

Lender Control

Given the fact that the lenders will confine security to the project and its assets, the lenders will typically maintain very strict control over all material decisions to be taken by the project company in order to safeguard their interests. Finance documents often have strict covenants (both negative and positive undertakings) with respect to all aspects of the underlying project and its operations and management. This structure facilitates Islamic financing, as sufficient control may be asserted to ensure compliance with *shariah* principles in certain circumstances. For example, where there is surplus cash flow, we may insert covenants restricting the scope of permissible investments to ensure that they are *shariah* compliant.

There are also very strict default provisions that permit lenders to step in and effectively take over the project in the event of any project document default or potential default. The project company is therefore required to assign all its rights under the project documents, as part of a very robust security structure. The security is typically placed within the custody of a security trustee for and on behalf of the lenders, who become the secured parties. Where there are any off-shore bank accounts (or other off-shore project assets during construction), there may be two sets of security trustees to account for the on-shore security and the off-shore security.

Common terms agreement

A traditional project finance transaction often has a central document between the borrower and the lenders known as a common terms agreement, or a Master Agreement. This document contains all the relevant terms common to the finance facility providers. While a common terms agreement may not by itself constitute a funding agreement, it provides the key terms that are common to all lenders to the project. The individual lenders would then enter into separate facility agreements which would be part of an integrated package of financing documents.

This structure allows multiple lending institutions with different lending documents to participate in a project. This approach works well when you have a group that includes multilaterals, commercial banks and Islamic financial institutions, each with a unique approach to lending. This structure permits a *shariah*-compliant lender to enter into a separate facility agreement with the borrower, upon terms consistent with *shariah* principles.

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Each facility agreement would then refer to terms in the common terms agreement, which will typically contain terms regarding the key covenants, representations and warranties and events of defaults. The common terms often address the application of the project revenues, commonly known as the waterfall, as well as circumstances or events leading to dividend suspension. This mechanism, along with the requisite cash reserves that are common to project finance structures, ensures that lenders are provided with an optimal structure for repayment, after taking into account the operational costs.

Being at the bottom of the waterfall, the investor is only entitled to a distribution where there is sufficient cash in the project to fund operational costs, debt repayment, and the debt service and maintenance reserve accounts.

Multiple Lenders

Given the funding requirements of infrastructure projects, a project finance transaction would typically involve several banks. Lending institutes may range from multilaterals to export credit agencies and commercial banks. This is typical of an infrastructure project, where there are several driving factors: a multilateral may have a political will to promote infrastructure growth within a certain region; an export credit agency is keen to promote the sale of plant, equipment and machinery from its domestic manufacturers; and commercial banks wish to participate to diversify their portfolio and to further enhance their market share and relationships.

The common terms agreement provides a convenient forum for stipulating the key terms that define a project finance structure, while each Facility Agreement permits the respective lending institution to participate while conforming to their policies and objectives.

As it is not practical for the borrower to interact with each lending institution within a transaction, there is typically an agent bank that coordinates with the borrower and acts on the instructions of the lenders based on an agreed voting arrangement. In addition, there is also usually a security trustee, which acts as the custodian of the security interests and as trustee for and on behalf of the lenders. The security trustee is also responsible for the

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enforcement of security and distribution of proceeds.

In light of the fact that funding is advanced on a limited recourse basis, banks tend to look to the project's revenues as the primary source of repayment. As such, the banks would normally enter into the arrangement on a *pari passu* basis with respect to all obligations, including disbursements and repayment schedules, as well as security interests. Projects may require further funding in the form of working capital lines or for purposes of securing sponsor support commitments towards reserve accounts or cost overruns. Such funding is normally procured on a subordinated basis, upon terms acceptable to the senior lenders.

Initially, project finance transactions were spearheaded by conventional financial institutions. My first exposure to Islamic financing was in the form of working capital, which was provided by a local *shariah*-compliant lender. The working capital line was provided on a subordinated basis, and structured as a buy-back of fuel stock, which was to be procured and stored by an independent power producer. With the limited scope of such funding, there was no requirement to infuse Islamic financing principles within the senior debt financing documents. However, as the need for infrastructure projects grew in the Islamic world, the introduction of Islamic financing as senior debt became inevitable. What follows is a short description of the principles of Islamic financing and the impact of *shariah* financing within a project finance structure.

Islamic financing

Islamic finance has fast become a major source of funding, particularly in predominantly Muslim-populated states. It is estimated that this form of funding is growing at a rate close to 20% per year. Islamic financing took on a new lease in the aftermath of the September 11 2001 attacks on New York, and the 2008 subprime crisis, which resulted in a search for alternatives to conventional banking and finance.

Islamic finance is essentially a form of funding which is consistent with *shariah*, or Islamic law. In order for transaction to qualify as an Islamic mode of financing, such transactions must be *shariah*-compliant. There are several elements which define compliance with *shariah* principles. These include: the subject matter of the investment; risk sharing; no interest; and financing based on a real asset. There are divergent views as to what constitutes *shariah*-compliant financing. However, certain types of financing such as the *murabaha* and *ijarah,* are types of contracts that are widely accepted as conforming to *shariah* principles.

In the classic *ijarah* structure, the lessor holds the title to the asset being leased. However, the risk of use of the asset is borne by the lessee. The rental amounts are determined and fixed at the commencement of the contract for the tenure of the lease. *Ijarah* works well for large-scale infrastructure projects as it also creates a potential for securitisation which may lead to issuance of Islamic bonds or *sukuks*, which may be sold to investors. This in turn provides a potential for increased liquidity.

In the case of *ijarah* or lease structure, there must be an underlying asset, which is owned by the lessor. In project finance transactions where you have more than one participating bank, the *ijarah* structure would conflict with the classic security structure, where assets are secured for and behalf of all participating banks. The *ijarah*-driven structure would therefore cause a disruption to the security sharing structure that is characteristic of a project finance transaction. This presents certain challenges while integrating an *ijarah* facility as part of the senior debt in a project finance transaction.

Integration of Islamic financing

Where more than one bank is involved, it is important that they are all treated equally as far as is possible, but there may be practical restrictions such as the policy restrictions of certain lenders. By way of example, a particular multilateral would only lend to a borrower of a project within a member nation, and to the extent that such membership is suspended for any reason then the multilateral may no longer be able to continue to participate. Such multilaterals may therefore have a preferred right to accelerate its payments and exit the project. Other banks may have strict policies regarding social and environmental standards. As such, it is possible for certain qualifications to emerge with respect to equal treatment of lenders where specific policy events of default may allow one lender to withdraw from the project. This permits an Islamic lender to stipulate policy defaults which may conflict with *shariah* principles. However, these are exceptions to the rule of equal treatment with respect to the application of terms within a common terms agreement.

With Islamic financing, the Islamic facility would necessarily require either a buy-back or lease of assets. This structure would conflict directly with the other lenders' desire to have security over the entire project. Given the fact that the lease arrangement must also be linked to the purchase and lease of a particular asset or assets, there may be certain discrepancies with regard to pro-rata disbursements as well. This issue may be addressed by reviewing supply contracts and identifying assets that would form part of the Islamic lease arrangement in such a manner so as to structure as close as possible (and perhaps within a permitted tolerance) a pro-rata schedule for disbursements by all lenders.

However, the lease arrangement does present issues regarding the security structure, which is normally held by the security trustee, and not by any individual lender in preference to the other participating lenders. This issue may be addressed by the Islamic lender entering into parallel security documents which would effectively convey the Islamic lender's interest in the assets to the security trustee, who in turn would hold the same for the benefit of all participants, equal to their share or contribution. In order to effectively, assign its security interests, the Islamic lender would typically enter into parallel security documents such as an assignment deed and a fixed and floating charge.

Assignment Deed

The assignment deed would create a security interest in the agreements forming the lease arrangement that is entered into by the lessor. The type of documents required for a lease arrangement in a project finance transaction and which would be assigned pursuant to the Assignment Deed, would include: the basic lease document, which provides for the duration and payment terms, which may include fixed and variable rental payments; the lease agency agreement, which appoints the Lessee as the agent of the Lessor, and permits the Lessee to take delivery of the assets "purchased" by the Lessor for purposes of the lease arrangement; and an early settlement agreement, which provides for a payment in the event of a termination of the lease arrangement.

The assignment deed would also secure all proceeds to be received thereunder to form part of the security for the benefit of all the secured creditors (including the lessor). The terms of the assignment deed would provide that all monies received by the lessor following an event of default shall be held in the separate trust account on behalf of the security trustee. The security trustee on its part would declare that it shall hold the benefit of the assignment upon the trust created within the security document package for and on behalf of all of the secured creditors.

Fixed and Floating Charge

A fixed and floating charge essentially provides that the assets purchased and then leased by the lessor are charged in favour of the security trustee by way of a fixed charge on the date of purchase for the benefit of the secured creditors (including the lessor). A similar floating charge is created over such assets that are not otherwise effectively charged by way of a fixed charge. The security trustee may convert the floating charge to a fixed charge where there is an event of default or where it has reasonable grounds for considering the assets to be in danger of being seized or sold under any form of distress, attachment or other legal process. Any monies received by the security trustee (or any receiver) upon enforcement of the fixed or floating charge are applied in accordance with the agreed disbursements pursuant to an intercreditor arrangement agreed to by the lenders.

In an effort to integrate Islamic financing, the project documents have to be sensitive to terms that are consistent with *shariah* principles. By way of example, in the common terms agreement, references to principal and interest should be expanded to include references to fixed and variable rental payments in order to account for *shariah*-compliant financing arrangements. Similarly, off-take agreements and tariff structures that account for repayment of principal and interest as part of the tariff-pricing mechanism should also be mindful of the terminology that is consistent with Islamic financing.

A promising future

With the growth of Islamic financing, there is a need to integrate *shariah*-compliant debt with infrastructure projects, as there is a need to access a greater debt pool. As explained above, the document structure of a project finance transaction allows for an Islamic financing facility to form part of the debt package without compromising *shariah*-compliant principles. With the *ijarah* structure, Islamic financing institutions may also use *sukuks* to attract a wider capital base within the Muslim world.

The Islamic Development Bank recently closed a deal along with the Asian Development Bank, the International Finance Cooperation, Proparco and other local commercial banks for the funding of an independent hydroelectric power plant in Kashmir. This was a watershed project as it introduced the Islamic Development Bank to private sector funding in infrastructure projects. This was also its first joint venture with the Asian Development Bank and it provides an excellent model for the Islamic Development Bank's ability to fund such projects in other member states.

Given the available capital with Islamic institutions and the requirement for infrastructure development in the Muslim world, the future for Islamic financial participation in infrastructure projects would appear to be very promising.

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