Public-Private Partnerships in Islamic Finance

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I. Introduction

Whilst Islamic Finance is not a newcomer in the international financial arena, the use of Shari'ia Law- compliant securities for funding Public Private Partnership operations (PPP) is a recent and promising addition.

In fact, the use of and demand for Shari'ia-compliant financial instruments in structured financial operations are on the rise in an increasing number of countries.

According to a study carried out by the National Commercial Bank in Saudi Arabia, the value of *sukuks* (the Islamic bonds) issued worldwide reached $85 billion in 2011, and this year is estimated in excess of $100 billion, up by 20 %. According to S&P, this growing rate is likely to rally in a staggering way for the period 2011–2015, reaching an estimated aggregated value of $1,000 billion by the end of the five-year period.

These data are remarkable and highlight the growing confidence of the international financial markets in this kind of asset as well as the raising appetite of international investors.

Such momentum is no longer limited to the traditional Islamic regions (Middle East, North Africa, the Gulf) and it is now gradually expanding in all financial arenas worldwide. In 2011, a significant issue of sukuks took place in Malaysia, Kazakhstan and Indonesia. Thanks to a 70% of sukuks issued in the first semester of 2012, Malaysia is by far the largest sukuk market in the world.

In Europe, the first sukuk was placed by the German *Land* Sachsen-Anhalt in 2004; since then, the sukuk European market has been on a steady growth especially in London, where the appetite for these low-risk, steady return securities has spread amongst Islamic and non-Islamic investors alike.

II. The Principles of Islamic Finance

Islamic finance does not come forward as an alternative to the conventional one. Instead, we could rightly say that it is usefully complementary to the latter. Its principles are different and are inspired by the Shari'ia ethical rules, but still generally compatible with the traditional lending business, except for some specific aspects (which are discussed below) that need some extra care when structuring operations. The result is nevertheless satisfactory as there are more and more cases of a successful use of Islamic finance, both on its own or together with traditional instruments, in structuring operations of project finance.

The first difference between Islamic finance and the traditional one lays in the concept of *interest paid on debt* (*riba*). Claiming and paying interest on loans is considered an act of usury by the Shari'ia scholars and it is therefore against the principles of Islam, since it allows the lender an unfair gain without incurring in the risks associated with the deal.

Based on this principle, a lender is forbidden from lending money on interest and having a return solely based on time passing by, but he is allowed to take part in the operation and share the risks, so that he would consequently gain or lose based on the success or the failure of the deal.

Translated into PPP language, this means that whoever funds the operation is not just a mere lender, but steps in with a more active role within the operation, acting either as a shareholder (like in *musharaka* financing) or an owner (the case of *ijara* financing).

The above principle introduces a second difference between Islamic and conventional finance: the *ownership* that the lender must take up on the object of the deal. A lender must acquire ownership, even for a very short time, on the asset of the agreement in question.

In the case of PPPs, this translates into a real right of the lender on the infrastructure, for example full ownership or leasehold (building rights, otherwise called *musataha*). Based on experience, we know that in many cases of project finance in public works, the granting of such rights is incom-

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patible – or in conflict, to say the least – with the public interest.

On the other hand, claiming a real right to counterbalance a loan in a PPP – which theoretically should be a no-recourse arrangement – is not typical of Islamic finance only. In the author's experience derived from many conventional transactions, banks often claim building or other real rights, even in cases involving typical public assets (such as hospitals or transport infrastructures) for which such rights are not quite suitable. Things are not too different in Islamic finance, with the advantage that real rights on the asset can be retained just for a short period and then transferred to the grantor upon payment of a royalty rent or against deferred payment.

The third principle of the Islamic finance is the prohibition of *excessive risk* (*gharar*). According to this principle, an agreement that does not clearly state the object of the contract, price, features, quantities and timeframe of the transaction is not permitted under Shari'ia Law. In the same way, open or unspecified clauses or payments left to the uncertainty of events out of control of the parties lead to the invalidity of a contract according to Islamic principles. The *gharar* is often in conflict with the object of a PPP contract, the latter being usually a piece of work yet to be built for which economic returns are only approximately quantifiable.

Structuring a PPP operation using Islamic finance is not easy, even more so if combined with traditional financial instruments of commercial lending. Rating structured projects, establishing a scale of payments, repaying lenders in case of default are just a few aspects that need further attention when using a mix of financing sources.

However, there are solutions already tested that have become well established best practice in Shari'ia-compatible PPP operations.

First, the simultaneous use of a building (*istisna'*) and an operating lease (*ijara*) contract for the construction and management of an infrastructure open to economic returns. This model has been successfully adopted for the construction and management contract of Queen Alia International Airport of Amman. There, the granting Public Authority did not award the PPP contract directly to the grantee but through the lending banks. It was up to lenders to award first the building tender to the winner with an *istisna'* agreement and subsequently its management through a *ijara* against payment of a predetermined royalty rent. In this way, the lenders retained ownership but they granted the use of the asset to the grantee, who took up both the technical as well as the economic risks involved in the operation, as set out by a PPP contract. The *ijara* requires a purchase undertaking to protect lenders in case of default or loss of the asset. On lending contract termination, the granting Public Authority regains full ownership of the asset.

In the case of the Haji terminal in Jeddah, Saudi Arabia, the *istisna'* was agreed directly between the grantee and the granting government body, the General Authority of Civil Aviation (GACA). Upon building completion, GACA transferred the management rights to the lenders and from them to the project company (HTDC) for the payment of royalty rent through an *ijara* agreement. In this way, it was possible to fully cover HTDC debt amounting to 205 million dollars.

In both cases, the lenders retain a material right on the infrastructure and their risk is mitigated by the secured existence of the asset, the predetermination of royalty rent and the granting period. In this way, the Islamic principles of observance of ownership, risk reduction and absence of interest on debt are all preserved.

III. Project Bond and Sukuk

Fifteen years after issuing its first law on project finance for public works, Italy meritoriously passed a regulation in January 2012 to facilitate the issue of project bonds as part of a decree on competitiveness. This is in line with a growing, broadening debate all over European financial institutions on how to foster the use of project bonds for funding PPP arrangements. The *sukuks* would be well suited to accomplish this task as they are, by nature, instruments linked to project lending far more than corporate lending. The next step could be a series of provisions aiming at facilitating the introduction of these instruments in PPPs financing both in Italy and elsewhere in Europe. European PPP markets could then benefit from a larger pot of investors and capture the attention of new financial markets of increasingly potential, such as Golf Cooperation Council and South East Asia.

Turning to investors' return, an interesting comparison can be made between the *sukuk* price and yield and those of a traditional bond.

We sometimes hear in traditional financial markets that, as a lending instrument, the *sukuk* is more expensive for the borrower than a bond. This may be true only in some specific circumstances but not in absolute terms; In fact, we often see evidence of the exact contrary.

To quote an example that the author is familiar with, the Abu Dhabi Tourism Development & Investment Company (TDIC), a government body owner of some of the largest public estate developments in the Emirates, issued in 2009 two separate securities, namely a conventional bond and a *sukuk*, both denominated in the same currency (US dollar) and carrying same maturity (2014), issuing value (1 billion dollars), and placing and trading platform (London Stock Exchange). Except for being one conventional and one Islamic, the only difference between the two assets was the issuing nominal value rate: 6.5 % for the bond and 4.95 % for the *sukuk*. Their actual market price still reflects such spread to date.

In terms of yielding, the very first difference is that *sukuks* are often denominated in currencies affected by a higher cost of money. The spread on a UAE dirham denominated *sukuk* is greater than the one on a US Treasury bond, but if the former were to be issued in US dollars, it would probably show a lower rate. The second difference is undoubtedly the fact that the *sukuk* is far less liquid than a bond, as the tendency amongst savers is to keep it all the way to maturity, making its offer inevitably smaller on the secondary market.

IV. Conclusion

To conclude, the market of publically tradable *sukuks* linked to PPPs is in its early days and very limited. With more available investment opportunities, the spread with conventional bonds, if there is one, will gradually lessen over time.

There are valid reasons to look further into the use of Islamic finance to support project financing-based transactions, particularly those aimed at delivering public infrastructures, whether economic or social ones. In times where stringent fiscal rules are tightening public budgets and commercial lenders are wary of providing more capital resources, the results would surely be all but disappointing.