Points to Ponder in Islamic Finance

By:
Dr. Mohamed A. Elgari BinEid
Associate Professor of Economics,
King Abdulaziz University, Jeddah

Points to Ponder in Islamic Finance

Mohamed A. Elgari

1) Islamic financial products best fit for infrastructure projects:

Due to its participatory nature, Islamic finance lends itself very nicely to infrastructure finance, especially within the Private Public Partnership (PPP) approach. Infrastructure finance is basically, a project finance process. The cash flow generated from the project itself should be sufficient to pay back to the financiers, cost and profits of the project. Such PPP program is not new to Islamic finance. For hundreds of years BOT was the predominant scheme of building and rebuilding Awqaf properties.

Currently, many infrastructure projects have successfully been finance on the basis of Islamic finance. One of the well known structure is one that consists of Istisna'a and forward Ijarah. Private financiers may establish an SPV which will enter into a procurement contract (Istisna'a) with the public entity which will ultimately own the project, then enters into sub contract to carry out the building up of the project as well as a forward lease contract with a promise to sell. After completion project will be delivered to the SPV being the owner of these assets. The public entity as lessee will use the asset and pay rentals. At the end of the lease term, the asset is sold or gifted to that public entity.

2) A Project Finance Structure for Green Energy:

Energy projects are usually quite sizeable. Due to their nature corporate finance may not be capable to support them. They are usually structured as project finance. Conventionally, project finance is one form of lending where earnings are just part of the security. In Islamic finance, a project finance structure is based principally on Istisna’a and a Forward Lease. It works as follows:

- A project company is established as an SPV where funds from financiers will be going through.
- The project company will enter into a procurement contract, usually with the obligor to build the power generating station.
- Another contract is signed with the obligor this time a Forward Lease whereby the usufruct of the power station is sold for say 20 years at a variable rate.

- The obligor starts making the payment immediately after signing the Forward Lease Contract.

3) **Benefitting from Spain's experience:**

Spain today stands tall in the development of green energy alternatives. Being ahead of most other countries means it has a lot to give to the rest of the world in terms of knowledge and experience. This is something our area of the world needs. Electricity demand in the Gulf States is growing by 3 times the world average. It is estimated that no less than $200 billion are going to be invested in the energy sector in the next few years. In the GCC members Saudi Arabia has allocated more than $110 billion for this program as reported by the media to produce 2000 megawatt of new electricity generation each year for the next 10 years.

The bulk of the new power plants are most probably going to fuelled by natural gas. However the government of Saudi Arabia is keen to develop alternative energy sources. KAUST, the internationally acclaimed new university is building a new solar plant as part of a program focusing on clean energy research and development. It is most interesting to know that

Saudi Arabia, so far, is not considering nuclear power as an alternative to fossil fuel based power generation unlike other gulf states.

Spain can play a vital role in this respect. However, this role will be defined by Spain's ability to present a total solution programs which are not limited to the technical part of a green energy projects but also include the financial segment. It goes without saying that this will include a feasible program of public private partnership based on Shari'ah approved modes of finance. What is meant here is structuring the PPP programs which can tap financial resources already existing in this region.

4) The Islamic asset securitization model:

Asset securitization refers to the process of issuing securities backed by receivables or mortgages and their cash flows. This boils down to sale of debt obligations which is not permitted in Shari'ah.

However, the general purpose and obligation of securitization may not be contrary to Shari'ah. Hence, we see quite a number of securitization programs. In an Islamic setting the securities must represent the ownership of real assets which generate cash flow in the form of rentals or the like.

Therefore, it is possible to pool leased autos and issue securities against the same but then each represent an undivided share in the ownership of the leased cars. The security holder is entitled to get the cash flows generated from rental collection in lieu of their ownership of these autos. The same thing can be done with a pool of leased houses or equipments. Many Shari'ah boards have applied the rule of majority thus permitting the inclusion of receivables emanating from auto installment sales or Murabaha in the pool. Provided the tangible assets remain more than 51% of the pool in terms of value.

While the subject of securities can’t be debt, it can be tangible assets, usufructs, rights but not money.

Securitization differs from Sukuk issuance. In the former investors take the risk of the assets including the credit risk of the end users of autos or houses. In Sukuk investors take the risk of the issuer entity itself.

5) **Sustainability of Sukuk issue:**

Sustainability means the capacity to endure. So far Sukuk appears to be quite sustainable. Sukuk are defined as traded financial instruments representing the undivided beneficial ownership of real asset, rights or usufruct which are characterized by low risk limited tenor and predictable income structure. They are not exactly bonds nor equity as such. They are “hybrid” of sort. It is quite possible that a project is financed via the issue of Sukuk. Telling from the rate of growth, Sukuk have only one way to go up. On the part of users of funds, they are mega projects that require significant financial resources on the basis of equity debt and Sukuk. Sukuk will be quite effective in tapping the huge reservoir of savings especially in the Gulf region. On the other hand, the growing capital markets in the Gulf region are basically equity exchanges. They are so keen to diversify and the only way to go is one that is agreeable to the preference of investors and issuers. Sukuk will be the best choice.

Recently some Sukuk issuer faced difficulty which brought to the service the question whether Sukuk are sustainable. In fact almost all the cases at hand failed due to causes which have nothing to do with the Shari'ah aspects of Sukuk. Certainly, Shari'ah is no guarantee against failure or default. Therefore, we see no reason to doubt the sustainability of Sukuk.

6) **Refinancing:**

The standard refinancing program includes replacement of an existing debt obligation with a debt obligation bearing different terms. It is sometimes called debt restructuring or rescheduling. It is resorted to when the indebted entity is in cash flow problem.

In the language of Shari'ah this is a case where creditors saying to a debtor in distress: I will give more time if you give more money (i.e. interest). This is the form of usury that no Shari'ah scholar will dispute the prohibition of. Hence, this refinancing program can't be applied in the context of Islamic finance.

A small minority of scholars, nevertheless, while firmly upholding such prohibition, permitted entering, by creditor, with the indebted entity in a transaction that creates new debt provided that such entity have no problem doing the same with a third party. This means he is not distressful enough to the point that other find it too risky to do that. If it was possible to get finance from third parties, then might as well performed by the creditor himself, even if this meant that the new debt will be used to settle the old one.

7) Credit enhancement in Sukuk structure:

When securities represent simply debt obligation and carry basically credit risk, the credit enhancement will facilitate getting a higher rating by rating agencies thus attracting more investors and reducing cost to issuer.

Schemes like over collateralization, reserve accounts, surety bonds and guarantees are standard in this regard.

It is not likely any of the above will be used in the context of Islamic finance simply because Sukuks are not supposed to be a debt instrument, therefore, credit enhancement may not be of much use.

The only thing that resembles a credit enhancement in a Sukuk program would be the promise to purchase provided by the issuer for the benefit of Sukuk holders.

In essence it is an undertaking whereby the issuer if he failed to make any due payment, he undertakes to buy the underlying assets at par.

Reserve accounts are used in a Sukuk program but only for smoothing the periodical payments. In some Sukuk issues, the issuer may extend credit support to the reserve account meaning that he will be provided liquidity in the form of qard Hassan in case of shortage. But it is always subject to settlement at maturity. No Shari'ah board has permitted that such a liquidity facility be undertaking by the issuer on its own account.

8) Islamic finance and non-Muslim countries:

Islamic banking is guided and self regulated by Shari'ah rules and principles. However, Islamic banking is not itself a religious practice similar to worship. Therefore, Shari'ah to Islamic banking is simply a governing law which is not too different in its objective from any other human legal system, justice, equality and fair play. However, it differs in its means and its emphasis on certain aspects of human relationships.

Islamic banking is, therefore, open to everybody. In Malaysia for example the majority of Islamic banking customers are non-Muslims and the Islamic bank of Britain has many non-Muslim customers. In fact the first account opened in that bank was owned by a non-Muslim. Nothing confirms this more than Sukuk.

One of the earlier issues of Sukuk was the state of Saxony-Anhalt in Germany, where Sukuk were issued by the local government there.

Corporate Sukuks, on the other hand are no longer confined to any geographic boundaries they are truly global.

We have to be very careful in interpreting this fact. Though we think Sukuks are superior in every respect to conventional bonds we do recognize the attracting factor is not this. Since most wealthy Muslim investors will shy away from usury based financial instruments, getting them to participate in any investment scheme, it must be designed to be in line with their religious preference.