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Assets Recycling Process in Islamic Finance, Dubai Skyline

Assets Recycling Process in Islamic Finance

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On this page: *Find following Asset Recycling Process below, or visit the Guidelines for Implementing Asset Recycling Transactions Section Overview and Content Outline, or Download Full Report for more.*

Assets selection and eligibility criteria

a. **Bankability**

In simple terms, the bankability of an asset refers to the willingness of fund providers to fund against such asset as collateral. Bankability is assessed through a number of factors depending on the nature of the asset, but, apart for the actual value of the asset, most factors revolve around four elements:

i. **liquidity and marketability**: how quickly and easily can cash be generated from the asset, whether through operating the asset or through disposing of the asset in the market;
ii. **transferability**: how quickly and easily can the legal ownership and the control over, or possession of, the asset be transferred;
iii. **appraisability**: how quickly and easily can the asset's worth be evaluated and ascertained; and
iv. **value stability**: how consistent would the asset's market value be and how widely would its value fluctuate.

It is to be noted that it is not the fund providers nor the commercial banks that make an asset bankable. Rather, it's their role to assess the bankability of an asset and, if found acceptable, provide the funds. As this is a subjective measurement, what constitutes a bankable asset will vary depending on the asset itself as well as the fund provider. In asset recycling, the key aspects that fund providers typically consider when determining if an asset is bankable include:

i. **Market risk**: The fund providers may ask the following questions to determine market risk of an asset:
    A. How will the asset's cash flows be earned?
    B. Is there to be a fixed long-term contract to generate profit from the asset?
    C. Is there a real market/demand for the asset or is the government the only user / beneficiary of the asset?
    D. To what extent is the fund provider at risk from price volatility or usage volatility?
    E. Is the price of operating the asset likely to be an issue?
ii. **Change in law risk**: The fund providers do not want to be subject to the risk of losing the bankability of an asset as a result of a change in law adversely affecting the asset. This risk is especially relevant where the asset is government owned and subject to public policies. A high traffic toll road could be a perfect example for this. The introduction of a law limiting the tolls that public roads may charge or excluding certain drivers from toll payment will adversely affect the bankability of this toll road.
iii. **Force majeure risk**: The fund providers may want to see the risk of force majeure events adequately covered and mitigated by:
    A. Passing the risk to the government;

B. Insurance; and
C. the establishment of reserve funds

iv. **Bribery and corruption risk**: The fund providers will be concerned to avoid any reputational damage that they might incur by being associated with assets that are tainted with bribery or corruption in some form.

b. **Single assets versus portfolio of assets**

For fund providers, collateralising of a portfolio of assets can rise the probability of repayment and decrease the need to monitor the government (and the related costs). The value of the portfolio of assets is affected by how easily it can be enforced; if collateral is difficult to enforce, it is no longer obvious what creditors can expect to recover. Nonetheless, collateralising a portfolio of assets can in principle allow lending in risky situations that would not otherwise be financed.

For governments, collateralising a portfolio of assets can increase market access and reduce financing costs. But, it can also have negative impacts. The collateralising of a portfolio of assets can raise the risk of debt distress by making it easier to over borrow. Complex collateralisation portfolios can both raise costs and contribute to transparency problems.

Governments should avoid recycling complex forms of portfolios. Greater complexity makes it more difficult to assess all-in costs, especially in countries where capacity is weak. It can also translate into higher transaction costs and legal risks. Complexity can also contribute to non-transparency and corruption. Asset recycling transactions generally involve complex elements, often consist of different related agreements, and may involve additional costs such as export credit agency fees, remuneration of financial intermediaries, legal fees, and non-monetary "costs", such as step-in rights, and other controls over the management and disposal of the recycled asset. Adding to this complex base with other features or complications - for instance, complex collateralization portfolios - is thus highly undesirable.

c. **Standard versus green**

Green assets are those assets that have a favourable impact on the natural environment. They can be companies or projects committed to the conservation of natural resources, pollution reduction, or other environmentally conscious business practices. While recycling green assets may attract fund providers keen to support green initiatives, green assets can be as valuable as traditional assets.

Governments can also grant tax incentives such as tax exemption and tax credits, making green assets more attractive for recycling compared to a traditional value comparable asset. These tax advantages provide a monetary incentive to tackle prominent social issues such as climate change and a movement toward renewable sources of energy.

Green assets become of greater relevance in sukuk based asset recycling transaction where the sukuk will be offered to the general public. While this may vary from country to country, individual investors have been found to prefer green investments over traditional investments.

d. **Key eligibility criteria**

For any secured fund provider, the recycled asset is of little benefit and cannot motivate improved terms and conditions unless it is enforceable. A government must weigh the benefit of improved borrowing terms against the potential loss of recycled asset, which in some cases could have a significant political impact on the government and society. Enforceability depends on the type of

recycled asset and the governing law of the jurisdiction in which it is located. Generally speaking, large escrow accounts in the secured fund provider's jurisdiction are the most readily enforceable (but typically cover only a small portion of the funds), followed by assets which are located outside the governments' jurisdiction (e.g., equity shares in a company). Movable assets (e.g., oil cargoes) can also be subject to enforcement actions. Assets within the government's jurisdiction are typically harder to enforce.

Due diligence process

In any financing transaction, the fund providers generally perform a due diligence exercise over the obligors' business activities and general financial condition to assess the risks of the transaction and, therefore, the likelihood of repayment. However, in asset recycling the fund providers depend more on the revenue stream generated by the asset in question. This nature of asset recycling transactions means that the asset and its revenues will need to ring-fenced to ensure that they remain available for repayment of the funds advanced by the fund providers.

The fund providers in an asset recycling will dig beyond the usually limited balance sheet of the government into the details of the asset's potentially complex web of contractual rights and obligations and government authorisations and consents to gain a full understanding of the economic value of the asset.

As a general rule, an asset recycling due diligence exercise will focus on identifying the matters that could materially affect the economic viability of the asset (for example, potential excessive liabilities on the asset, premature termination of an important offtake or supply agreement or the loss of a key license, authorisation or property right) and the availability and effectiveness of security to be crated over the asset to support the financing (for example, whether any provision of the asset related agreements or feature of underlying local law would materially impair the fund providers' available recourse to the asset).

Additionally, the due diligence process should include a Shari'ah compatibility analysis with the aim of identifying and resolving any potential Shari'ah breaches. The Shari'ah compatibility analysis would look into the structure of the transaction, the recycled assets and the transaction documents. In certain countries, an external Shari'ah audit may be required before an asset recycling transaction can be described as being Shari'ah-compliant.

Other than as discussed above, an asset recycling due diligence exercise will generally follow the same process of an investment or privatisation due diligence including:

a. appointing external legal, technical, insurance and environmental advisers;
b. conducting public searches (such as corporate, insolvency, real property, sanctions, money laundering and financial crime searches);
c. preparing due diligence request lists;
d. question and answer sessions; and
e. interim and final reports.

Governments should be prepared to respond to the due diligence request lists and provide the requested information for the asset recycling due diligence exercise to complete and achieve its goals. If a certain aspect of request lists cannot be addressed or disclosed, reasonable justifications ideally should be provided. Cooperation with the due diligence exercise makes the asset recycling transaction smother and increases its success likelihood.

Underwriting process

Underwriting has more than one meaning depending on the context in which it is used. In the context of asset recycling through Islamic finance, the financiers (usually the arrangers) which promise to extend the underwritten sum of money to the obligor, if the financing is not fully subscribed at the end of the syndication period.

A financing may be arranged on an underwritten or a best-efforts basis (or best endeavours). If it is underwritten, the underwriting financiers (the "underwriters" and usually also arrangers) guarantee the entire commitment and then syndicate the financing facility. If the financing is not fully subscribed, they will extend the underwritten sum of money to the obligor themselves. An underwritten financing will typically attract higher fees than syndicated financing on a best-efforts basis.

The syndicated financing market is a major contributor to debt finance, particularly for large-scale financing. A syndicated financing is offered by a group, or a syndicate, of financiers to an obligor. When a large financing is needed that a single bank cannot manage alone, a group of banks can pool together and offer a syndicated financing. The benefit of a syndicated financing is that the credit risk is spread over the participants in the syndicate, and the individual bank can participate in a financial transaction it would otherwise not be able to manage alone.

The key players in an assets recycling can be the same as in a typical syndicated financing including lead banks, bookrunners, mandated lead arrangers (MLAS), a coordinator, participant financiers, documentation bank/agent, facility/investment agent, trustee/security agent and credit ratings agencies.

Key structuring issues and legal documentation

a. **Late payment**

   In the case of a default by the obligor in the payment of any amount on the due date under a financing agreement, the financiers cannot increase the amount due to them in response to the obligor's default and missed payment due date. However, the obligor may be required to undertake in the relevant financing agreements to pay a prescribed amount for a charitable purpose in the case of the late payment in lieu of a fine or equivalent late fee / payment increase. The payment so recovered by the financiers from the obligor shall not form part of the income of the financiers. The financiers are generally required, as per the principles of Shari'ah, to spend the late payment amount for a charitable purpose on behalf of the obligor after deducting any actual and direct costs incurred by the financiers due to such late payment.

b. **Investment agency agreement and investment agent**

   Where more than one financier is involved in a financing, it is expected that an investment agency agreement would be entered into between the financiers. Pursuant to an investment agency agreement, the financiers will appoint one of the Islamic finance participants or an external financial institution as their agent in relation to their participation in the financing and (if the financing structure so requires) to hold title to the assets on their behalf and for their benefit. An investment agency agreement includes the financier's and the investment agent's rights and obligations, the funding allocation and disbursement mechanism. While it is not an essential requirement for an obligor to be a party to an investment agency agreement, oftentimes the obligor is made a party to this document. Where the financiers choose to establish an SPV for holding title to the assets, the investment agency agreement may set out provisions for the establishment of the SPV and the rights and obligations of the SPV.

c. **Use of a special purpose vehicle (SPV) by financiers**

The financiers may choose to use a special purpose vehicle ("SPV") to act on their behalf in an Islamic finance transaction. As Islamic finance is an asset-based or asset-backed financing, the use of an SPV in certain types of Islamic finance structures may provide certain benefits to both the financiers and the obligor. In the case of the financiers, they are protected from the risks associated with the ownership of the underlying assets; for example, environmental liability. In the case of the obligor, because the assets are not held by the financiers directly, the obligor and the assets are isolated from the risk of insolvency of an financier.

The use of a SPV may also help overcome issues preventing foreign ownership (in jurisdictions where such restrictions apply). However, incorporating an SPV could be time consuming and administratively burdensome. Also, the parties may not agree to incur the relevant costs involved in incorporating an SPV. The use of an SPV may raise some structuring issues related to the impact of the intervening SPV on the contractual relationships between the financiers and the obligor. Holding title to the underlying assets by an SPV may also have some tax implication in some jurisdictions. Accordingly, proper due diligence will be conducted before using an SPV in the financing structure.

d. **Common documents in an asset recycling transaction**

Set out below are a list of transaction documents which are generally common in a financing transaction where two or more financiers extend financing on separate financing arrangements to an obligor:

i. **An intercreditor agreement**: if the obligor chooses to obtain financing from two or more financiers on separate financing arrangements, or from both conventional and Islamic financiers, the rights of each set of financiers (including the Islamic financiers' rights to take any enforcement action in relation to the assets) may govern by the terms of an intercreditor agreement entered into between all such financiers. An intercreditor agreement generally regulates the respective rights and ranking of different sets of financiers in a financing. Usually an intercreditor agreement regulates, among others, two sets of rights: (i) prior to any enforcement of security, the rights to receive payments (such as principal, profit and fees) from the debtor, and (ii) the rights to enforce security over the assets of the debtor (i.e., the obligor); and

ii. **A common terms agreement**: where both conventional and Islamic financiers or two or more different sets of financiers extend financing on separate financing arrangements to a obligor for the same transaction, different sets of financiers may choose to have a common terms agreement which typically includes common provisions applicable to all such financing arrangements. A common terms agreement generally sets out the terms that are common to all the financing arrangements and the relationship between them (including definitions, conditions, order of drawdowns, project accounts, voting powers for waivers and amendments). A common terms agreement greatly clarifies and simplifies the multi-sourcing of finance for a project and ensures that the parties have a common understanding of key definitions and critical events related to the obligor and the project or the transaction.

e. **Tax issues for Islamic Finance**

As Islamic finance is an asset-based / asset-backed financing, Islamic finance transactions often require multiple title transfers of underlying assets, which may trigger double or even triple tax charges in some jurisdictions. Because of the tax implication, utilizing certain Islamic finance products could be

costly and uneconomical in some jurisdictions.

Certain jurisdictions have made some changes to their tax laws to create a "level playing field" so that Islamic finance products are taxed in the same way as equivalent conventional financial products. In some jurisdictions, certain Islamic finance structures are favored over other structures due to the tax implications which need to be carefully examined on a jurisdiction-by-jurisdiction basis.

Both the provider and recipient of an Islamic finance facility should carefully consider tax issues before choosing an Islamic finance product and the structure involved in implementing such product. Furthermore, it needs to be carefully considered whether any payment related to an Islamic finance transaction would be subject to withholding tax as well as whether an Islamic finance mechanism should be accounted for as a debt financing arrangement or otherwise both for the obligor and for the financiers (in terms of accounting and tax deductibility purposes).

f. **Shari’ah compliant hedging**

Hedging in general is permitted by the principles of Shari'ah. From an Islamic finance point of view, hedging is an attempt by a party to mitigate or reduce the level of risk inherent to a financing transaction. Many forms of Islamic hedging instruments have been developed in recent years. Shari'ah compliant hedging instruments currently available in the market include Islamic forward FX, Islamic options, Islamic profit rate swaps and Islamic currency swaps.

The Bahrain-based International Islamic Financial Market (IIFM) and the International Swaps and Derivatives Association (ISDA) have jointly developed certain types of Shari'ah compliant hedging instruments (including, Islamic foreign exchange forward, Islamic cross-currency swaps and profit rate swaps) which are reported to be widely used by market participants.

In an Islamic finance transaction, the financiers may require that an obligor use one or more Shari'ah compliant hedging instruments to mitigate certain risks (e.g., currency or profit rate) related to the obligor's obligations under such financing. A financier may also hedge its own exposure to a financing transaction.

g. **Takaful or Shari'ah compliant insurance**

Takaful or Shari'ah compliant insurance is a form of insurance based on principles of mutuality and co-operation, encompassing the elements of shared responsibility, joint indemnity, common interest and solidarity. Some Islamic financiers may require that the insurance to be procured by an obligor be placed with Shari'ah compliant insurers on a takaful basis if adequate and viable relevant insurance cover is available from satisfactory and creditworthy insurers on commercially reasonable terms.

Whilst takaful products have been available in the market for some time, only a handful of institutions may offer takaful products relevant to an asset recycling transaction. The Islamic Corporation for the Insurance of Investment and Export Credit (ICIEC), a member of the Islamic Development Bank Group (IsDBG), is a pioneer in this respect, and is leading the efforts of offering insurance service to cover sovereign risk based on takaful principle.

While the use of takaful is recommended, Shari'ah scholars allow conventional insurance to be used in a transaction that are financed wholly or partially by Islamic finance if Islamic insurance products are not available or are not economically feasible.

h. **Legal documentation for sale and leaseback transaction**

The following legal documentation are expected to be required to implement a sale and leaseback transaction:

i. **an assets sale agreement**: pursuant to an assets sale agreement between the obligor and the financiers, the obligor sells the underlying assets to the financiers (or to a special purpose vehicle for the benefit of the financiers);
ii. **a lease agreement**: pursuant to a lease agreement, the financiers (as owner of the underlying assets) lease the underlying assets to the obligor for periodic rental payments (which include both principal amount of the financing and profit on the same);
iii. **a service agency agreement**: pursuant to a service agency agreement, the financiers appoint the obligor as the service agent to: (i) carry out structural, major maintenance and repair of the underlying assets; (ii) procure insurance against all risks related to the underlying assets; and (iii) pay ownership taxes relating to the underlying assets. The financiers, in their capacity as lessor in relation to a lease financing transaction, are required to bear the aforementioned costs. However, such costs will be a component of the lease rental payments payable by the obligor under the lease agreement;
iv. **a purchase undertaking**: a unilateral purchase undertaking (put option) is required to be provided by the obligor in favour of the financiers pursuant to which in the case of: (i) an illegality, (ii) a mandatory prepayment, or (iii) the occurrence of an event of default, the obligor undertakes to purchase the underlying assets from the financiers at a purchase price to be determined in accordance with a pre-agreed formula; and
v. **a sale undertaking**: a unilateral sale undertaking (call option) is required to be provided by the financiers in favour of the obligor pursuant to which the financiers undertake to sell the underlying assets or part thereof in the case of: (i) a cancellation of participation for a single facility participant; (ii) a voluntary early payment (in full or part) of the financing facility by the obligor at a price to be calculated in accordance with a pre-agreed formula; or (iii) full and final maturity of the financing facility at a nominal price.

i. **Legal documentation for long-term lease and short-term lease (head lease and sub-lease) transaction**

The following legal documentation are expected to be required to implement a long-term lease and short-term lease (head lease and sub-lease) based transaction:

i. **a long-term (head) lease**: pursuant to a long-term (head) lease agreement, the obligor (as owner of the underlying assets) leases the underlying assets to the financier (either to an agent of the financiers or an special purpose vehicle to be incorporated for the purpose of a financing) for a long-term (for example, 99 or 49 years or any other long period agreed between the obligor and the financiers) for a onetime lump sum amount (which is the equivalent to the agreed financing amount to be provided by the financiers to the obligor). For a long-term (head) lease agreement, the lessee / the financers (being the owner/holder of the long-term usufruct of the underlying assets) may be required to undertake to: (i) carry out structural, major maintenance and repair of the underlying assets; (ii) procure insurance against all risks related to the underlying assets; and (iii) pay ownership taxes relating to the underlying assets (together the "Assets Related Obligations"). The obligor and the financiers may also agree that the obligor (being the ultimate owner of the underlying assets) retain the Assets Related Obligations;
ii. **a short-term (sub) lease agreement**: pursuant to a short-term (sub) lease agreement, the financiers (as the owner/holder of the long-term usufruct of the underlying assets acquired pursuant to the long-term (head) lease agreement) lease the underlying assets to the obligor for a shorter period on a periodic rental payment (which include both principal amount of the

financing and profit on the same) basis;

iii. **a service agency agreement**: to the extent the financiers are required to perform the Assets Related Obligations under the long-term (head) lease agreement, the financiers pursuant to a service agency agreement may appoint the obligor as the service agent to perform the same Assets Related Obligations. The financiers' costs for performing the Assets Related Obligations through the obligor (as service agent) will be a component of the lease rental payments payable by the obligor under the short-term (sub) lease agreement;

iv. **a purchase undertaking**: a unilateral purchase undertaking (put option) is required to be provided by the obligor in favour of the financiers pursuant to which in the case of: (i) an illegality, (ii) a mandatory prepayment, or (iii) the occurrence of an event of default, the obligor undertakes to purchase the long-term usufruct of the underlying assets from the financiers at a purchase price to be determined in accordance with a pre-agreed formula; and

v. **a sale undertaking**: a unilateral sale undertaking (call option) is required to be provided by the financiers in favour of the obligor pursuant to which the financiers undertake to sell the long-term usufruct of the underlying assets or part thereof in the case of: (i) a cancellation of participation for a single facility participant; (ii) a voluntary early payment (in full or part) of the financing facility by the obligor at a price to be calculated in accordance with a pre-agreed formula; or (iii) full and final maturity of the financing facility at a nominal price.

j. **Legal documentation for sukuk al-ijarah transaction**

In addition to the documents listed under "Legal documentation for sale and leaseback transaction" above, the following documentation are expected to be required for a sukuk al-ijarah transaction:

i. **a declaration of trust / agency agreement (as relevant)**: pursuant to a declaration of trust / agency agreement, the financiers will appoint one of the financiers or an external financial institution as their trustee / agent in relation to their investment in the sukuk al-ijarah and to hold the sukuk assets in trust / as agent for and on behalf of the sukukholders (i.e., the financiers) and the sukuk will represent an undivided ownership interest of the sukukholders in the sukuk assets;

ii. **a payment administration agreement**: pursuant to a payment administration agreement, the obligor (as issuer) and the sukukholders' trustee / agent (on behalf of the sukukholders) will appoint a payment administrator and an account bank to record certain agreed arrangements in relation to the payments to be made in respect of the sukuk; and

iii. **a placement agency agreement**: pursuant to a placement agency agreement, the obligor (as issuer of the sukuk) will appoint one or more banks and/or financial institutions as joint lead managers (or arrangers, bookrunners and/or underwriters) as its agent for the purposes of coordinating the placing, the distribution of the sukuk and/or underwriting the sukuk.

Incorporating sustainability and green standards into Islamic finance products

Islamic finance is based on assumptions of fairness and social responsibility and the fundamentals of Islamic finance share a lot with sustainable finance in terms of custodianship of the earth and responsible and ethical financing. The prospects of Islamic green finance are tremendous. Shifting trends of many institutional investors towards becoming responsible investors reflect that the demand is on an upward trend. There is an optimistic outlook on the gradual but steady growth of Islamic green finance as a broad range of investors are showing continuous interest in green investment products. Islamic finance can be a catalyst for the growth of green developments globally.

The concepts of Islamic and green finance have the commonalities that are deeply rooted in the underlying principles of Islamic finance that make clear requirement for the protection of the environment. Furthermore, the Islamic green finance market serves itself as a new marketplace where economic, political and social agents representing different roles and capacities come together. These different agents' interests converge into a shared goal in supporting sustainable growth.

Islamic green finance however has to deliver innovative products to set future trends in sustainable financing. Such innovation must be harnessed by having more potential green project issuers coming into the market through creating different types of products and projects. Incorporating sustainability and green standards could be done by establishing a green Islamic finance standard similar to the European green bond standard.

Regulations can set a standard for how companies and public authorities can use Islamic finance including green sukuk to raise funds through assets recycling or on capital markets to finance large-scale investments, while meeting tough sustainability requirements and protecting investors. This will be useful for both obligors/issuers and investors of green assets recycling or green bonds. For example, issuers of green bonds will have a robust tool to demonstrate that they are funding legitimate green projects aligned with the EU taxonomy.

Green bonds, unlike its counterpart green sukuk, are increasing in issuance growth. In contrast, green sukuk is heading over the opposite direction. There are many reasons as to why this is the case such as the high issuance coast and limited but growing opportunities to fund decarbonization projects. However, there has been growing optimism in this regard since Shari'ah compliant investors would have no choice but invest in green sukuk rather green bonds in the future as more projects arise and grow.

Despite the down turns, efforts have been made with new projects appearing annually. The Islamic Development Bank ("IsDB") has been one of the leading Islamic financial institutions to promote and participate in green and sustainably sukuk. In accordance with its US$25 billion sukuk issuance programme, this multilateral entity raised EUR 1 billion from its 5-year sukuk issue under the programme. The IsDB were to use the proceeds from the first green issuance to fund a variety of green and climate change projects in its 57 member nations. Projects for sustainable water and wastewater management, clean transportation, energy efficiency, pollution prevention and control, and environmentally sound management of natural resources and land use are among these.

Related Content

- **Guidelines for Implementing Asset Recycling Transactions (Download PDF version)**

Additional Resources

- PPP Processes and Institutional Responsibilities
- PPP Process

This section has not been prepared with any specific transaction in mind and are meant to serve only as general guidance. It is therefore critical that the content will be reviewed and adapted for specific transactions.

This is a new section of the website and is currently in draft form. For feedback on the content of this section or to suggest additional links or materials, please contact the PPP Resource Center using the feedback form.

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