

# Key Considerations of Islamic Finance in Assets Recycling

## Full Description

### **Strategic assets (sovereign ownership)**

Recyclable sovereign assets (including oil, gas, real estate, shopping malls, apartment complexes, farms, hotels, power plants, toll roads, ports, airports, fiber-optic networks and pipelines) could be monetized to start a powerful multiplier effect for the economy. Strategic assets can refer to government assets of tremendous value (such as profitable sovereign owned enterprises) or government assets of vital necessity (such as water or electricity generation plants). Understandably, governments must think twice before recycling any strategic asset. Consideration must be given to the public sentiment towards recycling a particular strategic asset and what form should the asset recycling take, in light of the shape and demands of the funding itself, and the public sentiment surrounding the recycling of the strategic asset.

Concerns over national security have been one reason why state governments may be reluctant to recycle government assets. In 2016, the Australian government chose to block an asset recycling transaction with Chinese and Hong Kong parties citing national security considerations. Asset recycling transactions have also been the subject of negative public perception due to job cuts in past asset recycling transactions where the control and management of certain government assets passed to the private sector. Asset recycling transactions are often contested by unions as well as opposition parties because of this. Other concerns such as the risk of private information leaks, errors and fraud have similarly been raised in asset recycling transactions.

One way to manage public perception is to be firm and transparent in the clauses that a prospective secured party must abide by if it takes control of the recycled asset. These can be set out at the time the asset is identified publicly as a potential asset for recycling and should include clear protection for government employees and end users. The need for contractual protections will depend on the level of control and management rights that have been passed down from the government to the private sector. In asset recycling structures where the government still maintains a high level of control over the recycled asset, contractual protections will not be as necessary. Examples of such contractual stipulations include:

- a. Composition of board members: governments can retain a level of participation in the decision-making boards of the recycled strategic assets. For example, the Australian Government through TransGrid Company recycled its high voltage electricity transmission network with a consortium including the Abu Dhabi Investment Authority and the Kuwait Investment Authority. In this transaction, the control of the electricity transmission network has passed to the consortium. However, Australian Government required that half the board managing the electricity transmission network be Australian citizens.
- b. Stake holding by foreign parties: governments can limit the control, or percentage of ownership, foreign parties can have in the recycled strategic asset. For example, the Australian Government recycled its coastal Port Darwin harbor with Chinese-owned company named Landbridge Group. However, the Australian Government required that 20% of share in the harbor be held by a national Australian company.
- c. Employment guarantee: governments can require the new private operator to keep a certain percentage or number of the original eligible staff for certain durations post enforcement over the recycled strategic asset. This is especially relevant in automatable industries. For example, the Australian Government recycled its general cargo Port of Melbourne and as part of that transaction, the counterparty, called Lonsdale Consortium, were not permitted to terminate or change the existing employees of the port for a period of two years.
- d. Pricing limitation: governments can set fixed utility prices and toll rates. Price caps can be stipulated as part of the asset recycling transaction. For example, the Australian Government recycled one of its

electricity distribution companies, Ausgrid Company. As part of that transaction, the Australian Government required an electricity price guarantee to ensure that utility prices will remain within a certain agreed range notwithstanding the asset recycling transaction and any future change of control to Ausgrid Company.

Beyond the public perception of what assets are acceptable for asset recycling transactions, a government must also set out a clear definition of the assets, if any, where it will not entertain asset recycling transactions, or at least put in place certain restrictions relating to it. The EU and the Australian government are among the government bodies which have put in place guidelines for 'critical infrastructure', although there is no single definition for this term. Each government can then put in place their own specific regulations de-scoping assets which a government wants to maintain complete control over.

### **Tangible versus intangible assets (including emissions reduction credits)**

When developing an asset recycling scheme, governments should not limit the scope of eligible assets to tangible assets. Intangible assets (for example, mobile airtime) could equally be considered Shari'ah compliant assets for an Islamic finance structure. A good asset for recycling is one that is: (i) cost-effective to hold, (ii) operationally easy to use, and (iii) easy to take delivery of and to liquidate. Falling short on any one of these attributes inhibits the effectiveness of the recycled asset. In addition, the systems used to manage the recycled assets need secure, central, digital ownership records with transparent data and asset status that allow for the real-time flow of information.

This leads to "Cap & Trade" programmes and emissions reduction credits ("ERCs"). Cap & Trade is a common term for government regulatory programmes designed to limit, or cap, the total level of emissions of certain polluting chemicals, particularly carbon dioxide, as a result of commercial industrial activity. The government sets the limit, or "cap" on emissions permitted across a given industry. It issues a limited number of permits that allow companies to emit a certain amount of the pollutants that drive global warming.

The total amount of the cap is split into allowances. Each allowance permits a company to emit a certain amount of emissions (usually one ton of emissions). The government distributes the allowances to the companies, either for free or through an auction. Companies are taxed if they produce a higher level of emissions than their permits allow. They may even be penalised for a violation. On the other hand, companies that reduce their emissions earn ERCs which can be sold to other companies that pollute more or banked for future use.

Governments can also lower the number of permits each year, thereby lowering the total emissions cap. That makes the permits and ERCs more expensive. Over time, companies have an incentive to reduce their emissions more efficiently and invest in clean technology as it becomes cheaper than buying permits. ERCs can be suitable assets for recycling as governments can easily create a legal framework to ensure that they are (i) cost-effective to hold, (ii) operationally easy to use and (iii) easy to take delivery of and to liquidate. Governments can easily set up a secure, central, digital ERC ownership register with transparent data and asset status that allow for the real-time documentation of ERCs recycling transactions or any other transaction involving ERCs. Furthermore, it is typically the governments that control the emissions "cap" and can issue ERCs making them an attractive asset for recycling.

We are not aware of any country that has utilized the idea of asset recycling in congruence with ERCs. Despite that more recently as of 2022, Abu Dhabi Global Market (ADGM) collaborated with Air Carbon Exchange (ACX) to launch the world's first fully regulated carbon trading exchange. Corporates will be able to exchange and finance carbon credits using the same legal framework as other financial assets, enhancing involvement and investment in global carbon reduction.

There is currently no consensus amongst the Shari'ah scholars that ERCs could be treated as Shari'ah compliant asset. Taking into account that Islam promotes the share management of natural resources, it is

however perceived that ERCs could be considered as Shari'ah compliant asset.

Despite the uncertainty between Shari'ah scholars as to whether ERCs are to be considered a Shari'ah compliant asset, plans were made to launch the first Shari'ah compliant carbon-trading platform. Advanced Global Trading (AGT) a London based company proposed the idea to GCC investors to trade carbon credits that is Shari'ah compliant. Unfortunately, these plans did not come to fruition; the project had not had any more updates since 2013.

## Other issues

It's equally important that a government truly understands the assets in which the private sector is interested in recycling. A government, often through a designated infrastructure agency, can maintain regular dialogue with national and global fund providers to ensure an up-to-date understanding of recycling preferences and expectations. Mismatched expectations regarding the assets available for recycling would have the potential to undermine the success of an asset recycling transaction.

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