

The Current Practices of Islamic Build Operate Transfer (BOT) Financing Contracts: A Legal Analysis

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ABSTRACT

Build Operate Transfer (BOT) is a kind of legal mechanism of privatisation. It is a business venture between the government and the concessionaire, with the ownership of the project asset transferred to the government at the end of the concession period. In Malaysia, a decade after the beginning of privatisation was marked by the emergence of capital market which consisted of conventional and Islamic capital market. Both Islamic and conventional capital markets facilitate the privatisations and infrastructure projects by the issuance of bonds, equity financing securities and Islamic securities. Islamic BOT financing is a new type of contract in contemporary Islamic law, and it is resulted from the modern infrastructure development needs. Although the financing of BOT is new to the Islamic law, the specific contracts used in the structure are common to the Islamic principles of *muamalat* (i.e. Islamic transactions) like sale, partnership and lease contract. The objective of this work was to study the current practices of the Islamic BOT financing contracts in Malaysia and other countries. The study adopted an analytical approach by assessing the strengths and weaknesses of the financing contracts via the sale, partnership, and lease contract. Finally, the findings showed that sale-based financing is more popular to the Project Company of BOT in Malaysia due to the fixed return and deferred payment mechanism. On the other hand, the *mudharabah* and *musharakah* contract provides an alternative to the project since both structures are in the form of business venture and lease-based financing which exploit the beneficial interest of an asset.

Keywords: Islamic build operate transfer (BOT) financing, build operate transfer (BOT), Islamic contract, Islamic securities, Islamic financing

BACKGROUND

Build Operate Transfer (BOT) is a kind of legal mechanism of privatisation (UNIDO, 1996). It is a structure that utilizes the private investment in undertaking the public sectors infrastructure projects, apart from being a complicated process with multiple parties and contracts. In more specific, BOT is a business venture between the

government and the concessionaire, with the ownership of the project asset transferred to the government at the end of the concession period.

The privatisation of road projects in Malaysia via Build Operate Transfer (BOT) mechanism began in 1984, whereby the Federal Roads (Private Investment Management) Act was enacted to allow the privatisation of

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road constructions and management. For this purpose, the BOT mechanism was adopted because it is a “win-win situation” in which the private entity may compensate the financing via toll collection and the completed project will be transferred back to the Government at the end of the concession period.

Table 1 shows the total number of projects according to sectors, privatisation mechanism adopted, and investment. BOT is considered as one of the categories of Greenfield project. A Greenfield project refers to a private entity or a public-private joint venture which builds and operates a new facility for the period specified in the project contract. The facility may be returned to the public sector at the end of the concession period. Other categories of the Greenfield project include build, lease, and transfer (BLT), build, operate, and transfer (BOT) and build, own, and operate (BOO). On the other hand,

concession is a technique whereby a private entity takes over the management of a state-owned enterprise for a given period, during which it also assumes significant investment risk. It consists of modes such as rehabilitate, operate, and transfer (ROT), rehabilitate, lease or rent, and transfer (RLT), build, rehabilitate, operate, and transfer (BROT). Table 1 illustrates that 57 out of 96 projects opted for Greenfield mechanism in all the sectors. Two sectors with high utilization of the Greenfield technique are energy and transportation.

Table 2 highlights the total investment of the projects according to sectors. Energy and transportation sectors were high investment projects compared to others during the period. Due to the high investment nature, both projects were suitable for BOT mechanism, whereby the Government awarded the concession to the private entity to build and operate the facilities.

TABLE 1
Total number of project and privatisation mechanism in Malaysia from 1990 to 2008

Sector	Concession	Divestiture	Greenfield project	Management and lease contract	Total
Energy	0	4	22	0	26
Telecom	0	1	6	0	7
Transport	18	1	27	1	47
Water and sewerage	11	1	2	2	16
Total	29	7	57	3	96

Source: Private Participation in Infrastructure Projects Database of the World Bank, <<http://ppi.worldbank.org>>, retrieved on 20/11/2009.

TABLE 2
Total investment in projects according to type and primary sector (US \$ million) in Malaysia from 1990 to 2008

Sector	Concession	Divestiture	Greenfield project	Management and lease contract	Total
Energy	0	3,805	10,508	0	14,313
Telecom	0	2,469	7,127	0	9,596
Transport	3,626	130	12,796	0	16,552
Water and sewerage	9,422	16	706	0	10,144
Total	13,048	6,420	31,136	0	50,605

Source: Private Participation in Infrastructure Projects Database of the World Bank, <<http://ppi.worldbank.org>>, retrieved on 20/11/2009.

In the course of operation, the private entity may recoup the expenditure incurred by collecting tolls or fees from the end users. After the expiration of the concession period, the project will be returned back to the Government.

A decade after the beginning of privatisation was marked by the emergence of the capital market which consisted of conventional and Islamic capital market (Ruzian & Norilawati, 2009). Both the capital markets facilitate privatisation and infrastructure projects by the issuance of bonds, equity financing securities and Islamic securities. The Islamic capital market products provide long-term fund raising and investment.

DEFINITION OF THE ISLAMIC BOT FINANCING CONTRACT

Islamic BOT financing is a new type of contract in contemporary Islamic law (Counsel of International Islamic Fiqh Academy, 2009). It resulted from the needs for modern infrastructure development. The contractual structures of BOT financing include concession, construction, operation, and management. Although the financing of BOT is new to Islamic law, the specific contracts used in the structure are common to the Islamic principles of *muamalat* (Islamic transactions).

In determining the *Shariah* compliance of Islamic BOT financing contract, the contractual framework must satisfy the elements of a valid contract, including the offeror and offeree, the pillars of *ijab* (offer) and *qabul* (acceptance), the subject matter of the contract and consideration (Mohd Daud Bakar & Engku Rabiah Adawiah, 2008). Once *ijab* and *qabul* are performed, the contracting parties are bound by the contract.

A legitimate contract in *Shariah* needs three essential conditions. Firstly, the object of the contract is *m'Él mutaqawwam* (property that is permissible in Islam), which must also be within the means to possess (*hiyazah*) during the contract, except in certain exceptional circumstances. Therefore, it is not allowed to sell the property that is not yet acquired (Article 127, The Mejlle, 2001). An example for this

would be selling fish in the sea. In addition, the object must be precisely determined in terms of its essence, quality, and value. The object must be free from any encumbrances, like the property is not in pledge and free from any oppression, fraud, and misrepresentation (Muhammad Ayub, 2007).

Secondly, the contract must not contain any components of *riba* (interest), *gharar* (uncertainty) and *maysir* (gambling). In the context of financial transaction, *riba* technically refers to the "premium" that the borrower is obliged to pay to the lender, together with the principal amount, as a requirement for the loan or for an extension in the duration of the loan (Zamir Iqbal & Abbas Mirakhor, 2007). The researchers outlined four characteristics of the prohibited interest rate, which include a positive and fixed *ex-ante*, the premium is tied to the time period and amount of the loan, its payment is guaranteed in spite of the outcome, or the objectives for which the principal was borrowed, and the state apparatus sanctions and enforces its collection.

Thirdly, the object should exist at the time of contract for possession (*milkiyyah*). The subject matter of the contract is deliverable at the time of the conclusion of the contract. This is evidenced by the *hadith* which states that the Holy Prophet (SAW) was reported to have said that, "He who buys foodstuff should not sell it until he has taken possession of it" (Zamir Iqbal & Abbas Mirakhor, 2007). It is reported that the companion Hakim ibn Hizam had bought some commodities during the reign of Umar ibn al-Khattab and intended to sell them to others. Umar ordered him not to sell the commodities before taking their possession. Zayd ibn Thabit, Abdullah ibn Umar and Abdullah ibnu Abbas held the same view as that of Umar. However, the contract is allowed despite the fact that the subject matter of the contract does not exist at the time of contract, in exception to the contract of *salam* (deferred contract) and *istisna'* (manufacturing contract).

In addition, the contracts shall satisfy the *maqasid al shariah* (i.e. objectives of the shariah) by fulfilling the needs of the community

in providing utilities and welfare for individuals and the community. This is not the requirement for the validity of a contract but rather a compliment to the execution of a valid contract. To illustrate the point, among the benefits of BOT to the community are the constructions of bridges, highways, hospitals, and schools. A BOT structure reduces the financial burden on the state, and the state can theoretically concentrate on poverty eradication programmes. BOT projects increase the capital development in legitimate ways by providing civil projects to the private and public sectors. In a way, it provides the necessary expertise and qualifies the local communities in construction works and maintenance services to allow them to be independent in their future works.

TYPES OF ISLAMIC BOT FINANCING CONTRACT

In the early development of Islamic capital market, Islamic securities with sale based features were widely issued in the Malaysian capital market. Both BOT projects and sale based features of the Islamic securities shared the same character of long term financing, fixed return and staggered payment. The Islamic Securities Guideline in 2004 has changed the landscape of the *Sukuk* market in Malaysia, with many kinds of *sukuk* based on sale, equity, partnership and lease emerged. Some examples of the *Sukuk* issued to finance BOT projects are *Sukuk Istisna'*, *Murabahah*, *Ijarah* and *Musharakah*.

THE SALE BASED FINANCING IN BOT PROJECT

The financing of BOT is normally achieved in a form of syndicated financing, joined by a number of banks and financial institutions. These syndicated financing is also made securitizable for the consumption of a wider base of investors, institutional or otherwise. Studies on the Islamic project financing in Malaysia have shown the tendency of the banks and financial institutions involved to prefer the sale-based

mode of financing over other mode of financing (Engku Rabiah Adawiah, 2003). This is due to the general rule that the sale-based mode of financing can contractually guarantee a fixed flow of income to the financiers and investors. Other modes of financing, particularly the equity-based financing, are perceived as having or imposing a higher risk portfolio due to its inability to contractually guarantee neither profit nor capital.

The Islamic sale-based *Sukuk* is applied in financing the BOT project in the form of *al bay' bithaman ajil* (the sale of deferred payment), *murabahah* (the sale by mark up) and *istisna'* (the manufacturing contracts). This is due to the nature of the BOT projects that require sizeable funding and long concession periods. Hence, divisible and tradable financial instruments are needed. Since the financing is *shariah* compliant, it must observe the prohibitions and hindrance of valid Islamic contracts.

Bay' Bithaman Ajil Islamic Debt Securities (BaIDS)

The Islamic Securities Guidelines 2004 are defined *bay' bithaman ajil* (BBA) (sale of deferred payment) as:

A contract that refers to the sale and purchase transactions for the financing of an asset on a deferred and an instalment basis with a pre-agreed payment period. The sale price will include a profit margin.

The above definition shows three important elements of BBA; namely, the sale and purchase transaction, deferred payment in the form of instalments with a pre-agreed payment period, and the sale price inclusive of profit margin.

In practice, the mechanisms for BaIDS issuance are two layered. First, the creation of indebtedness in the form of contemporaneous buying and selling with deferred payment between the issuer and the financiers. Second, the issuer's debt arising out of the previous transactions will be securitized via the issuance

of primary and secondary notes for BaIDS. The primary note (PN) represents the capital, while the secondary notes (SN) are the profit component. In qualifying the PN and SN to be tradable, the debt must be supported by an underlying asset (Saiful Azhar Rosly, 2008). In relation to BOT projects, the underlying asset is the concession right and revenue stream of the project.

Financing of BOT projects through issuance of BaIDS involves the following processes. The issuer will first identify the asset to be used in the financing. The asset must be *Shariah* compliant and free from any encumbrances for a valid sale. In the context of the BOT project, the asset is in the form of concession right. The Resolution of the *Shariah* Advisory Council of the Securities Commission has decided that “all contracts awarded by the government, i.e. concession, construction, supply and services contracts, are accepted as approved underlying assets for structuring Islamic securities. The same principle can also be applied to contracts awarded by state governments, government agencies and government related companies.” The decision of the SAC was said to be based on the analogy with the concept of *iqta'* (government award), which was an approved practice in Islamic law.

The issuer then sells the asset to the primary subscribers at a price which is comparable to the issuer’s financing needs. The BaIDS is normally sold by way of private placement with a known or identified buyer (subscriber). The asset is then sold to the primary subscriber for cash proceeds (purchase price). Immediately thereafter, the primary subscribers sell the asset back to the issuer, on deferred payment basis

(BBA) with a mark up. The deferred price (or sale price) is a debt owed by the issuer to the primary subscribers to evidence the debt owed in the deferred sale price (BBA). The issuer issues BaIDS to the financiers to evidence the debt obligation created in the second sale and purchase contract. These BaIDS are also known as *shahadah al dayn* (debt certificate), and are tradable at the secondary market. The primary subscriber may then trade the BaIDS on the secondary market based on the permission of *bay' al dayn* (debt trading) (Securities Commission, 2006). The financiers will then pay the proceeds of the sale of bonds to the issuer, as the payment of the financiers’ purchase price in the first asset purchase agreement. The issuer pays the debt obligation arising in the second asset sale agreement (comprising of the purchase price and the financiers’ mark-up) on an instalment basis over an agreed period, which is normally long-term in nature (beyond one year).

Table 3 shows that the issuance of BaIDS involved in the development of airport and highways via BOT financing. Many of the highway projects opted for the issuance of BaIDS due to its long-term financing and guaranteed fixed of income to the financier and the investors.

Murabahah Notes Issuance Facility (MUNIF)/ Islamic Medium Term Notes MTN

The Islamic Securities Guideline 2004 explained *murabahah* (sale with mark up) as a contract that refers to the sale and purchase transaction for the financing of an asset, whereby the cost and profit margin (mark-up) are made known and agreed

TABLE 3
Lists of BOT Projects and Issuance of BaIDS

Project	Amount
Kuala Lumpur International Airport (KLIA)	RM2.2 Billion BaIDS
Cheras–Kajang Highway	RM210.0 Million BaIDS
Shah Alam Expressway	RM800.0 Million BaIDS
KL-Putrajaya Highway	RM380.0 Million BBA Medium Term Notes (BBA MTN)
New Pantai Expressway	RM740.0 Million BaIDS
Western KL Traffic Dispersal Scheme	RM510.0 Million BaIDS

by all parties involved. The settlement for the purchase can be either on a deferred lump sum basis or on an instalment basis, which is specified in the agreement.

The above definition explains that *murabahah* is a kind of sale and purchase of an asset with profit and deferred in payment either lump sum or by instalments. The differences between *murabahah* and BBA are the cost and mark up price must be made known to the involved parties. This is because *murabahah* is a category of *bay' al amanah* (trust sale).

In terms of *modus operandi*, both BBA and *murabahah* securities share similar features. The only difference is in the term of tenor and mode of payment of financing. The industry applies BBA financing for long-term financing with instalments payments, while *murabahah* financing is used for medium- and short-term financing needs with short- or medium-term maturity with bullet or lump sum payment. The classification is purely based on industry driven and not due to any *Shariah* requirement. Both the products are popular due to their ability to contractually guarantee a fixed flow of return to the financier, by virtue of the debt obligation created by the deferred payment mode, plus the mark-up. The risks to the financiers are also practically low because of the immediate sequence of the purchase and sale contracts entered into by the parties. Since the financiers own the property very shortly during the transaction, the risks attributed to ownership of the property are practically almost non-existent.

The issuance process of MUNIF resembles BBA structure with a few modifications. The transaction begins with the issuer identifying an asset to be sold to the primary subscriber. The identified asset is then tendered by the issuer to a group of tender panel members (TPM). The aim of the tendering process is to allow for a best purchase price for the tendered asset. The tender sale is based on the *Shariah* principle of *bay' muzayadah*. According to the Resolutions of the Securities Commission *Shariah* Advisory Council, *bay' muzayadah* is the offering of goods in a market by a seller with a number of interested buyers who compete to offer the

highest price. The sale is permissible based on *athar* of the Companions of the Prophet and the opinions of the past jurists.

The tendering process is either with or without underwriting. If the tender is underwritten, the underwriter will buy the asset at the underwriting price, if there is no other higher bidder. The role of the underwriter is to secure a minimum price for the asset, particularly when the issuer is not confident of getting the targeted price during the tendering process.

The successful tender panel member will buy the asset from the issuer for the agreed purchase price. Immediately thereafter, the buyer will sell the asset back to the issuer for a sale price that is an informed mark up (*murabahah*) and on a deferred payment basis (*Bai Bithaman Ajil*, BBA) at an agreed maturity date. The issuer will then issue the *murabahah* notes (MUNIF) as an evidence of the marked up and deferred sale price. This creates a debt obligation (indebtedness) between the issuer and the successful tender panel cum primary subscriber. These notes are tradable at the secondary market based on debt trading.

Another type of *murabahah* security is the Islamic commercial paper (CP) and or Islamic medium term notes (MTN). The MCP includes short-term issuance with maturity ranging from 14 days to 12 months. It is structured with multiple draw-downs within the agreed 'ceiling' of financing amount that can be 'revolving'. For instance, the maximum financing amount for the MCP is RM200 million. The issuer may issue smaller amounts in a number of draw-downs as long as the total does not exceed the ceiling of RM200 million. The available financing amount will be adjusted accordingly upon the maturity and payment of the debts owed to offer the revolving feature to the MCP structure.

The tendering process is conducted at every draw-down in the MCP programme. The successful tender panel member (investor) will then buy the asset at the agreed purchase price. Cash payment shall be made to the issuer for the asset purchase price. Immediately thereafter, the underlying asset is resold to the issuer by the tender panel member cum investor at a mark-up

price. The MCPs are then issued to the investor to prove the obligation to pay the sale price based on the agreed tenure between 14 days to 12 months. The issuer will arrange payments for the asset sale price within the deferred period as stated in the MCPs.

The tender process and the issuance of the MCPs are completed through Fully Automated System for Tendering (FAST), which is electronically operated by Bank Negara Malaysia. The transactions are facilitated by Facility Agent with appointed trustee acting for the benefit of the MCP holders based on the terms of the Trust Deed of the MCPs.

Table 4 illustrates that there are two highways via BOT financing which have issued MUNIF. Both the projects have issued BaIDS for their long-term financing and MUNIF for short-term financing.

Sukuk Istisna' in BOT Project

Istisna' is defined in the Islamic Securities Guidelines 2004 as a purchase contract of an asset whereby a buyer will place an order to purchase the asset which will be delivered in the future. In other words, the buyer will require a seller or a contractor to deliver or construct the asset that will be completed in the future according to the specifications given in the sale and purchase contract. Both parties of the contract will decide on the sale and purchase prices as they wish and the settlement can be delayed or arranged based on the schedule of the work completed.

The definition describes that *istisna'* is a classification of purchase order contract. In this contract, the buyer ordered the seller to manufacture or to construct an asset according to the specification agreed in the sale and purchase

agreement. The price of the ordered asset will be decided by the parties to the contract. The payment can be made during the contract or delayed or arranged according to the schedule of the work progress.

Bay'al istisna' is a sale based on an order to construct or to manufacture an asset according to the specifications agreed on and the materials provided by the contractor/manufacturer (Nazih Hammad). *Bay'al istisna'* is an exception to the general *Shariah* principles that the subject matter of the contract must exist at the time of the formation of the contract. The majority of the jurists, such as the Hanafis, Shafis and Malikis, allowed the sale of non-existent assets due to the *hajat* (need) of the people for such forward and manufacture contracts.

In practice, *sukuk istisna'* represents two situations; namely, *sukuk* that represents the *istisna'* sale price and *sukuk* that represents the *istisna'* asset. The *sukuk istisna'* issued in Malaysia represents the deferred sale prices. In other words, they are debt-based *sukuk*. In term of the transaction structure, there is no basic transaction structure for the *sukuk istisna'*. This is due to the fact that *sukuk istisna'* in Malaysia has evolved from one model to the another based on the market familiarisation and experimentation with the concept and features of *istisna'* arrangement.

**LEBUHRAYA KAJANG-SEREMBAN
(LEKAS) RM1,453.0 MILLION
SUKUK ISTISNA'**

The LEKAS project has secured a tranche of RM1,453.0 million *sukuk istisna'*. In this transaction, the issuer is LEKAS Sdn. Bhd., while the primary subscribers are Am investment Bank for Senior *istisna'* and Bank Pembangunan

TABLE 4
Lists of the BOT projects and Issuance of MUNIF

Project	Amount
Shah Alam Expressway	RM100.0 Million MUNIF/IMTNs
KL-Putrajaya Highway	RM80.0 Million <i>Murabahah</i> Commercial Paper (MCP)

Malaysia Berhad (BPMB) for Junior *istisna'* that entered into parallel *istisna'* arrangement. Firstly, the issuer enters into a Sale Agreement with the primary subscribers, whereby the latter agreed to construct and deliver the identified assets to the former, in consideration of the *istisna'* sale price. The *istisna'* sale price was inclusive of profits to the primary subscribers, cum seller, and would be paid on deferred payment terms according to an agreed payment schedule. The *sukuk istisna'* was issued to the primary subscribers so as to prove the issuer's obligation for the deferred *istisna'* sale price. The *suku istisna'* structure consisted of senior and junior *sukuk*.

Then, the issuer entered into *istisna'* Purchase Agreement with the primary subscribers, where the former agreed to construct and to deliver the identified assets to the latter in consideration of the *istisna'* purchase price. The *istisna'* purchase price would form the *sukuk* issuance proceeds. The identified assets in both of the *istisna'* agreements were the Kajang-Seremban Highway to be construed pursuant to the relevant concession agreements.

THE PARTNERSHIP-BASED FINANCING OF BOT PROJECTS

The partnership-based financing of the BOT projects utilized two main contracts, namely, the *murabahah* (profit sharing contract) and the *musharakah* (partnership contract).

Sukuk Mudarabah

The Islamic Securities Guidelines 2004 considered *mudarabah* as a contract which is made between two parties to finance a business venture. The parties are a *rabb al mal* or an investor who solely provides the capital and a *mudarib* or an entrepreneur who solely manages the project. If the venture is profitable, the profit will be distributed based on pre-agreed ratio. In the event of a business loss, the loss shall be borne solely by the provider of the capital.

The Islamic Securities Guideline provides a detailed explanation on the issuance process of

sukuk mudarabah. The contract of *mudarabah* is a joint venture which involves *rabb al mal* (investor) and *mudarib* (an entrepreneur) who will manage the project. The profit of the business venture will be distributed according to the pre-agreed ratio. The loss shall be borne solely by the capital provider. Nevertheless, if the loss is due to the *mudarib's* negligence, the *mudarib* shall be liable for the amount of the *mudrabah* capital.

In the transaction structure, the issuer will first call for the investors to participate in the *mudarabah* contract. The issuer will act as the manager or *mudarib*, and the investors will be the capital provider or the *rabb al mal*. The *mudrabah sukuk* is issued by the issuer to prove the proportionate capital contribution by the investors (*rabb al mal*) to the *mudrabah* and their subsequent rights in the *mudarabah* project or the investment activities.

The issuer, as a *mudarib*, will then invest the *mudarabah* capital into an agreed project. Normally, the *mudarabah* project has already identified project cash flow, and this allows the issuer to indicate an expected rate of profit to the investors upon initial issuance of the *sukuk mudarabah*. The expected rate of profit should be calculated based on a pre-agreed profit sharing ratio that is tentatively applied to the projected return of the project.

Once the project starts to generate profit, the issuer will apply the profit sharing ratio and pay the profit share of the investors as a periodic coupon distribution, which is normally at the expected profit rate. However, if the project suffers a loss, it will be borne by the investors, except when the loss is caused by the negligence of the mismanagement of the *mudarib*.

Sukuk mudarabah are conceptually equity-based and not debt instruments. The *mudarabah sukuk* represents the *sukuk* holder's proportionate rights over the *mudarabah* project and the revenue. Accordingly, the secondary trading of the *mudarabah sukuk* on the secondary market is not generally a sale of debt (unless it can be shown that the *mudarabah* project has been liquidated and its entire assets are in the form of cash or receivables).

It is important to note that guarantee is not permissible to the capital or the profit in a *sukuk mudarabah* transaction. This is due to the fact that the *mudarib* is considered as the manager and *amin* (trustee) of the *mudarabah* fund and its project. Therefore, the *mudarib* is not to be made responsible for losses, unless it is due to negligence, mismanagement and dishonesty that have led to losses. However, an independent third party is permissible to give guarantee to preserve the *mudarabah* capital. The Lebuhraya Kemuning–Shah Alam (LKSA) has secured a tranche of RM 415.0 Million *sukuk Mudarabah*. LKSA links the existing Shah Alam Expressway's (KESAS) Kemuning interchange to Shah Alam in the State of Selangor. This is pursuant to a 40 year Concession Agreement (CA) between PLSA and the Government of Malaysia, dated 27 November 2006. Projek Lintasan Shah Alam Sdn. Bhd. (PLSA) is a company that was incorporated to undertake the design, construction management, operation, and maintenance of the PLSA.

Sukuk Musharakah

The Islamic Securities Guidelines 2004 defined *musharakah* as a partnership arrangement between two or more parties to finance a business venture, whereby all parties contribute capital that can be either in the form of cash or in kind for the purpose of financing the business venture. Any profit that is derived from the venture will be distributed based on a pre-agreed profit-sharing ratio but a loss will be shared on the basis of equity participation.

The definition clearly shows that *musharakah* is a kind of partnership between two or more parties. It is a business venture which requires all the parties to contribute their capital, which is either in cash or in kind. The profit that derived from the business partnership is divided based on a pre-agreed profit sharing ratio. However, the loss will be divided based on equity contribution of the parties.

Maju Expressway Sdn. Bhd. (MESB) has issued Islamic medium term notes (IMTNs) issuance programme under the principle of

Musharakah. The *Sukuk Musharakah* financing is RM550 million. Under the *Musharakah* structure, the investors shall form a *Musharakah* among themselves to invest in a venture, which is the *Musharakah* Asset, under the Concession Agreement granted by the Government of Malaysia to MESB pursuant to the Concession Agreement (collectively, the Trust Asset). The rights of the *Musharakah* Assets under the venture are subject to the assignment of the Concession as security for the existing financing facilities of MESB. MESB shall make a declaration of trust over the *Musharakah* Assets for the benefit of the Investors. MESB will then issue trust certificates (the IMTNs) to the investors. The IMTNs shall entitle the investors to the undivided proportionate share of beneficial ownership in the venture. In addition, the investors will also be entitled to the income that will be generated from the Trust Asset throughout the tenure of the *Musharakah* and/or proceeds from the sale of the Trust Assets in proportion to the nominal value in the venture and the rights of the investors against the issuer under the Purchase Undertaking.

The strengths of the project are satisfactory traffic growth since operation commencement supported by improved public awareness on highway, back-loaded debt service structure, and available cash that provides cushion for revenue shortfalls in the early years, moderate reliance on traffic growth to maintain future compliance with minimum FSCR, as well as moderate government support for the concession evidenced by grants and termination payments payable by the government in the event of termination of concession. The challenges faced by the project are optimistic bias in toll road traffic forecast, and event risk arising from renegotiation of the concession agreement (MARCB, 2010).

Accordingly, Konsortium Lebuhraya Utara–Timur (KL) (KESTURI) has issued RM820 Million IMTNs in nominal value under the Shariah principle of *Musharakah*. The investors of each tranche of IMTN (*Musharakah* Partners) shall form a *Musharakah* amongst themselves,

and shall enter into a venture (Venture) as a part of the financing arrangement.

The strengths of the project are the high proportion of commuter traffic on expressway which is less sensitive to economic conditions, strategically linked to a network of major roadways, and back-ended amortisation schedule of the notes that accommodates slower traffic ramp-up. Meanwhile, the challenges of the project are lower than the forecast traffic flow and public resistance to toll hikes (MARCB, 2010).

Majlis Ugama Islam Singapura (MUIS) SD35m Sukuk Musharakah is another interesting instance of *sukuk musharakah*. In this transaction, MUIS acted as the issuer. MUIS wanted to raise money to invest in a prime property (office and shopping complex) as parts of its *waqf* development project. Most of the capital was contributed by the investors. MUIS's capital contribution came from the *waqf* fund that it was administering. MUIS issued the *musharakah sukuk* to the investors to evidence their proportionate capital contributions to the *musharakah* and any subsequent asset/s acquired by it. The *musharakah* capital was used to acquire a prime property in Singapore. The property was then leased out for 5 years. To enhance the structure, the lease rental was guaranteed by a third party. The lease rental payments would be shared between MUIS and the investors at the ratio of 26.5:73.5 that was translated into 3.5% rate of return to the investors. MUIS, on behalf of the *waqf*, would gradually buy out the investor's share in the *musharakah* by redeeming the *sukuk* according to the agreed schedule. The source of the payment for the redemption came from the *waqf* income which was from the share of the rental as well as other sources. At the end of the *sukuk* tenure, the *waqf* would own the property in the name of MUIS as the *waqf* administrator. In the MUIS transaction, the *musharakah* venture was backed by acquisition of real estate that generated lease rental income for the investors. The real estate was later fully acquired by the issuer through the *sukuk* redemption.

THE LEASE-BASED FINANCING OF BOT PROJECT

Ijarah is defined in the Islamic Securities Guidelines 2004 as a *manfa'ah* (usufruct) type of contract, whereby a lessor (owner) leases out an asset or an equipment to its client at an agreed rental fee and a pre-determined lease period upon the *aqad* (contract). The ownership of the leased equipment remains in the hands of the lessor.

Leased-based financing features contract of usufruct between the lessor (the owners) and the lessee (the client). The owner leased out an asset or an equipment to its client based on an agreed rental fee. The period of lease was pre-determined upon the contract signed. However, the ownership of the leased asset remains with the owner.

Lebuhraya Kemuning-Shah Alam RM 330 million *Sukuk Ijarah* is a good example of the BOT project which utilises the Islamic financing principles from the formation of the partnership until the operation of the completed project. In operating the toll-road business, Projek Lintasan Shah Alam Sdn. Bhd. (PLSA) as the *mudarib* has invited other investors, namely the *Sukuk Ijarah* holders (the lessors) to participate in the construction and development of the LKSA (the Project).

Due to its significance as point of reference, the BOT and privatization case of Zam Zam Tower in Mecca is cited here in addition to the preceding Malaysian cases. *Sukuk Intifa'* is a certificate or a deed that entitles its holder the right to utilize a specific real estate property for a specific duration of time per year over a determined number of years. This right is wholly owned by the *Sukuk* holder who is entitled to sell, grant, inherit or invest the *sukuk*.

Zam Zam Tower *Sukuk Intifa'* involved the development of one of the apartment towers near the Grand Mosque in Makkah. In this transaction, a construction and real estate company by the name of Munshaat had been awarded with a 24 year lease to construct one of the six towers (Zam Zam Tower) on the *waqf* land adjacent to the Grand Mosque in Makkah. The *sukuk* issuance was for the purpose of financing the construction cost of the said tower.

In this transaction, the developer, Munshaat, was granted with a 24 year lease over the *waqf* land. The sukuk issuance was to finance the construction which was achieved via the '*ijarah mawsufah fi dhimmah*' (forward lease' contract). Under the forward lease, Munshaat leased the asset under the construction to the *sukuk* holders for 22 years, who paid the lease rental in advance in one lump sum. The *sukuk* holders would enjoy the *intifa'* (usufruct) of the asset after its construction based on time-sharing slots due to the restriction on the ownership of non-Saudis of real property rights in Makkah. The time sharing rights under the forward lease were evidenced by the issuance of *sukuk intifa'*. The advance lease rental (*sukuk* proceed) was used by Munshaat to pay for the 24 year lease rental on the *waqf*, as well as the construction costs of the Zam Zam Tower.

The interesting part of *sukuk intifa'* is the recognition of a new asset class upon which the *sukuk* are based. This new asset class is in the category of *manfa'ah* (usufruct). The *sukuk* holder holds the right to benefit or *haq al intifa'* (enjoyment) in the form of time-sharing in the use of a common property. These *sukuk* are fully negotiable, which means they can be sold, leased, lent, given, bequeathed, exchanged, and delayed subject to certain conditions. The investors participate by purchasing the *sukuk* and paying their value in advance, plus the payment of annual charges for maintenance and managerial services.

THE STRENGTHS AND WEAKNESSES OF THE ISLAMIC BOT FINANCING CONTRACTS

The Sale-based Financing Has a Fixed Return with a Deferred Payment Mechanism

The sale-based financing in the BOT project has utilised the Islamic principles of *bay' bithaman ajil*, *murabahah* and *istisna'*. The BaIDs, MUNIF/CP and Sukuk *istisna'* share the financing structure of *bay' al inah* (sales of buy back) with the features of sale price with a mark up and a deferred payment. Sale-based *sukuk* is more popular to the Project Company

of BOT due to its fixed return and deferred payment mechanism. BaIDs are issued to meet the long-term nature of the BOT projects which last from 20 to 60 years of concession. In contrast, MUNIF/CP is issued to meet the short-term financing which is between 12 months to 15 years.

The preceding instances showed that all the sale-based *sukuk* are issued to finance public facilities like airport and highways. At the same time, BOT projects depend on the revenue stream for the repayment of its expenditure during the construction and other commitments. The fixed return feature of the sale-based *sukuk* influences the toll collection mechanism which will indirectly burden the end users. It is submitted that partnership mechanism is encouraged to overcome the said constraints.

Although sale-based financing has benefited the BOT projects and the Malaysian Islamic capital market, it faces many constraints like the use of controversial principles. The adoption of *Bay' Inah* structures in the sale-based *sukuk* and the application of *bay' al dayn* in trading the *sukuk* in the secondary market are unacceptable to the global market. As a result, the *sukuk* is not competitive in the global world.

The Partnership-based Financing Are Equity Financing and Business Venture Between Parties

Sukuk Mudarabah and *Musharakah* are equity based. Both *sukuk* involve business venture between the parties. The *Mudarabah* Venture involves a business venture between the *rabb al mal* (investors) and *mudarib* (entrepreneur). Accordingly, *Mudarakah* Venture is a business venture among the investors and may include more than two parties. The LKSA has utilised the *Mudarabah* Venture to finance the construction of its highway. It is submitted that the *Mudarabah* structure is suitable for BOT projects. PLSA as the Project Company cum *Mudarib* contribute their expertise in completing the project. The investors cum *rabb al mal* cum *sukuk* holders provide the capital for the construction of the project. The profits are distributed according to

the agreed profit ratio between the parties. The investors in the *Mudarabah* Venture will bear the loss in the event of a business loss. Nevertheless, the *mudarib* shall be liable if the loss is due to the *mudarib* negligence.

As indicated the *Musharakah* Venture involves the partnership among the investors. The advantage of the *Musharakah* Venture is that the loss of the Venture shall be borne among the investors in proportion of their respective interests in the *sukuk* and limited to each holder's respective capital contribution under the *Musharakah* capital.

It is submitted that both the structures are suitable to finance the BOT projects due to their nature of business venture. Accordingly, their profit sharing and distribution of loss mechanism ensure the smooth running of a particular project.

The Lease-based Sukuk Utilized the Beneficial Interest of an Asset

The lease-based *sukuk* is essentially unique due to the nature of the lease that exploits the beneficial interest of an asset. Hence, even if the project is still under construction, the beneficial right is utilised using the forward lease principle. In the LKSA project, for instance, PLSA as the *Mudarib* in LKSA project has invited investors, namely the *Sukuk Ijarah* holders (the Lessors), to participate in the construction and development of the LKSA project. The periodic rental is paid to the Lessors beginning from the construction stage based on the principle of *Ijarah Mawsufah fi Zimmah* (Forward Lease) and is considered as a partial payment/forward lease on the aggregate rental under the *Ijarah* Agreement. Accordingly, future rental payments under the agreed rental schedule will be reduced. It is observed that the principle of forward lease should be adopted in the BOT project. The mechanism can avoid the increase of toll fees to the end users and accordingly reduce the fees until it reaches a nominal value. The second interesting *sukuk ijarah* is *sukuk intifa'*, which is based on time sharing. The issuance of the *sukuk* has benefited from the principle of forward lease. The *sukuk*

has also identified a new class of asset, namely time-sharing, in the use of a common property.

CONCLUSION

It has been demonstrated that financing BOT projects using Islamic principle is quite widely in practiced albeit in its various forms. The purpose of using the Islamic principles is that the Islamic financing structure is certain and transparent. The analysis on the Islamic BOT financing contracts revealed that sale-based financing is more popular to the Project Company of BOT in Malaysia due to its fixed return and deferred payment mechanism. Nevertheless, the sale-based financing still faces various constraints like using controversial principles of *Bay' Inah* structures in the sale-based *sukuk* and the application of *bay' al dayn* in trading the *sukuk* in the secondary market. Both the principles are not acceptable in the global market. As a result, the *sukuk* are not competitive in the global world. On the other hand, the *mudarabah* and *musharakah* contracts provide alternatives to the project Company since both the structures are in the form of business venture. Accordingly, their profit sharing and distribution of loss mechanism ensure the smooth running of a particular project. Finally, the lease-based financing exploits the beneficial interest of an asset. Hence, even if the project is still under construction, the beneficial right is utilised using the forward lease principle.

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