

ABSTRACT – KYOTO CDM PROJECT COMPLIANCE WITH ISLAMIC FINANCE

The UN Framework Convention on Climate Change (UNFCCC) estimates that the “amount of wealth” that developing economies can achieve from financing mechanisms associated with Greenhouse gas (GHG) reduction treaties and initiatives amounts to approximately \$3.64 trillion.

Of the three mechanisms set out by the Kyoto Protocol (ratified by eight of the fifty-six IDB member countries), the Clean Development Mechanism (CDM) is highly relevant to projects undertaken in developing countries. However Kyoto financed CDM projects, including Emission reduction purchase Agreements (ERPAs) remain a novelty worldwide, as well as for the Islamic financial community, and for the Middle East and GCC areas. This results in numerous foregone opportunities.

Kyoto finance offers high potential returns for investors, financial institutions and governments through the potential future appreciation of Kyoto instruments and the returns generated to the projects themselves by the sale of Certified Emission Reduction Certificates (CERs.) Moreover, developing countries benefit a great deal from the free capital generated by CDM projects, the associated technology transfer, and the reduction in poverty resulting from the higher economic efficiency achieved by Kyoto-compliant economic development projects.

In order for Islamic financial institutions and project developers and governments to accept Kyoto finance in developing countries, CDM compliant project-finance and associated contracts must be compliant with basic Islamic techniques (*Istisna'*, *Salam*, *Ijara* and so forth) and fundamental *Sharia'* principles.

We shall address the compliance of the provisions usually included in CDM project agreements, particularly the ERPA, with the *Sharia'* principles. We shall also address issues such as (i) options granted to buyers in ERPAs to buy additional Emission Reductions (ER), (ii) condition precedents, (iii) deficient delivery (iv) events of default (v) the possibility for the financier to dispose of the CERs prior to receipt thereof (vi) termination of the agreement, and (vii) legal and judicial competence. We shall also suggest structures and solutions that may render such provisions to comply with the *Sharia'*. Indeed, we shall set out the solutions acceptable to the *Sharia'* to cover some of the risks related to Islamic techniques that would otherwise be borne by the financiers (non-compensation in case of damages not caused by the borrower, non-reimbursement of the principal paid by the financier, ownership risks, tax issues and so forth).

The analysis of Kyoto finance that is compliant with the *Sharia'*, and the determination of appropriate solutions, will enhance the Islamic community's participation and involvement in Kyoto finance, while ensuring that the characteristics of Kyoto finance are preserved.

Determination of compatibility between Kyoto financial instruments and the *Sharia'* will enable Kyoto compliant projects undertaken in Islamic countries to benefit fully from this powerful financial methodology. At the same time, we anticipate that the opinions on compliance of Kyoto finance with Islamic finance will evolve as *Sharia'* advisory committees and scholars, whose opinion will be sought by - concerned parties, will become more familiar with such Kyoto compliant financing methods and project-finance models.

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