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Expansion of Islamic Finance into Mainstream Global Commerce



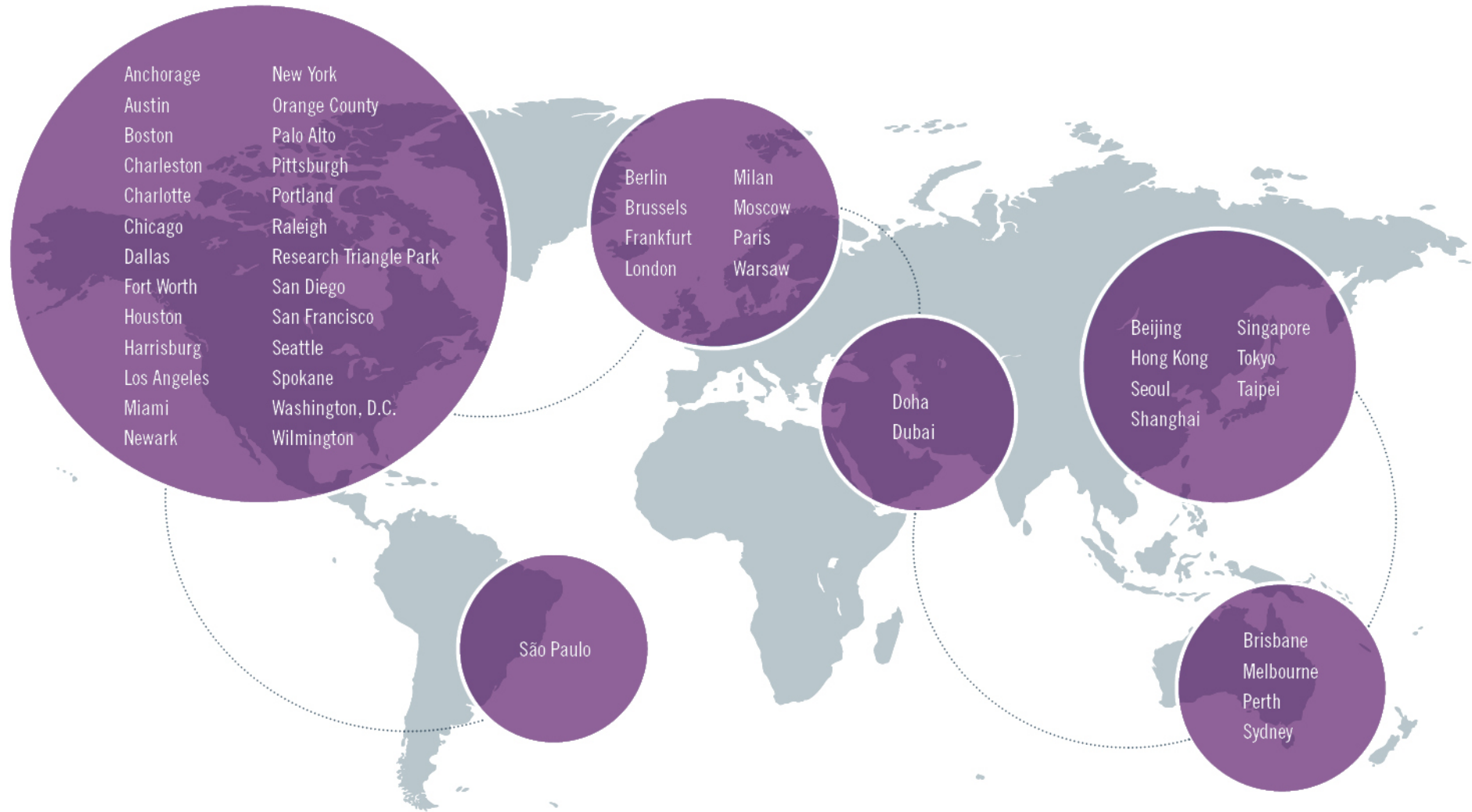
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GLOBAL LEGAL COUNSEL IN 48 FULLY INTEGRATED OFFICES ACROSS FIVE CONTINENTS



Expansion of Islamic Finance

- Introduction
- Sources of Islamic finance law
- Key principles and common terminology
- Islamic compliant structures
- Islamic compliant capital markets instruments
- Combining Islamic compliant investment and conventional financing

Introduction

- Statistics:
 - 2013 global Islamic banking assets ~\$1.8 trillion
Ernst & Young's World Islamic Banking Competitiveness Report 2013
 - Demographics: ~25% global population is Muslim
Deutsche Bank Global Islamic Banking Report, Nov 2011
 - Islamic financial institutions in at least 105 countries
Figure taken from Ibrahim Warde's article in *Islamic Finance: Law and Practice* (eds Nethercott and Eisenberg)

GLOBAL RISE OF ISLAMIC FINANCE

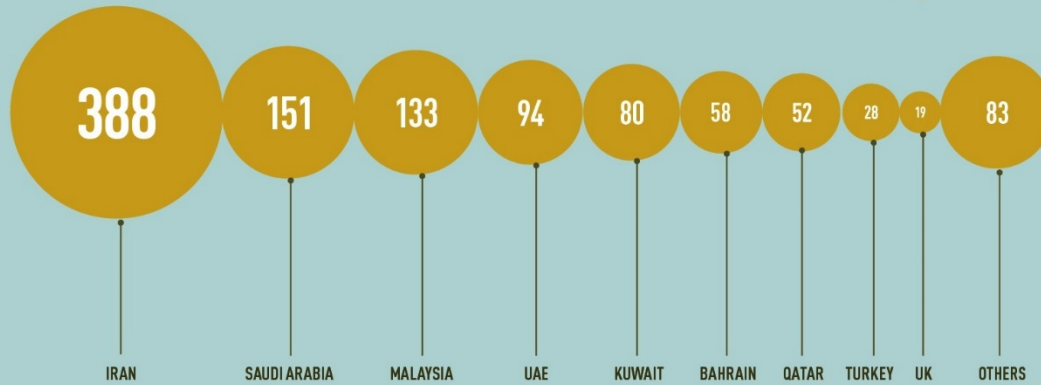
The Islamic finance industry is expanding beyond its core markets in the Middle East and Malaysia. Shaheen Pasha examines the trends and potential hot spots

- Sources:
 • The Banker
 • London Stock Exchange
 • EurekaHedge
 • MSCI, Barclays
 • Ernst & Young based on Zawya and EurekaHedge
 • The Banker, Ernst & Young
 • Ernst & Young

ISLAMIC FINANCE BY COUNTRY

BANKING, TAKAFUL (ISLAMIC INSURANCE) & FUND ASSETS, \$BN, END-2010

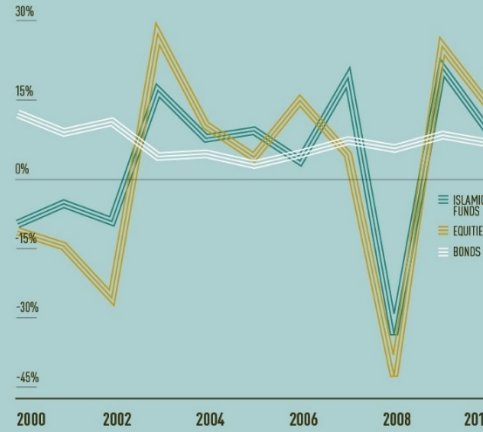
WORLD BANKING, TAKAFUL & FUND ASSETS END-2010 **\$1,086BN**



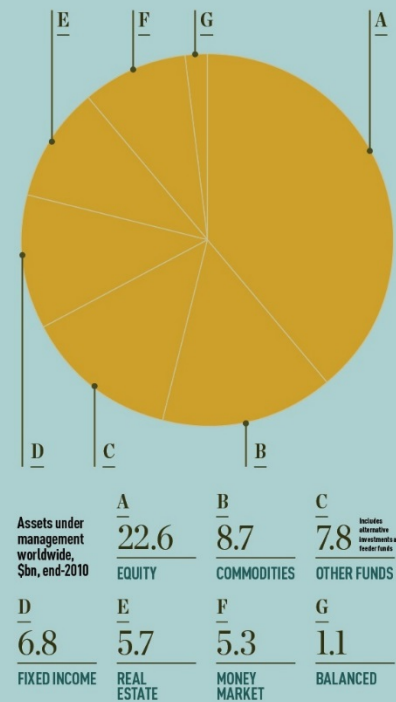
SUKUK LISTINGS ON LONDON STOCK EXCHANGE



RATE OF RETURN ON ASSETS WORLDWIDE



ASSETS MANAGED BY ISLAMIC FUNDS



GLOBAL ASSETS OF ISLAMIC FINANCE



ISLAMIC FUNDS WORLDWIDE



Introduction

- Common misconceptions:
 - Unscathed by the financial crisis
 - Islamic finance operates in rigid, immutable framework of strictly applied laws
 - Example: the spectrum between *halal* and *haram*

Sources of Islamic finance law

- *Qur'an*: first and foremost a work of holy scripture but also an important source of Islamic law
- *Sunna*: words and deeds of the Prophet
- *Ijma'*: scholarly consensus, for example:
 - Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI)
- Numerous other treatises and synopses

Key principles and common terminology

- Underlying principle of fairness
- *Halal* and *Haram*: respectively, that which is, and that which is not, permitted, for example:
 - Trade (*bayʿ*) is permitted whereas usury (*riba*) is not
- *Gharar* and *maysir*: uncertainty, chance, unreasonable risk
- Connection to underlying assets
- Sharing of profit and loss by all parties

Key principles - *Riba*

- The charging of sums for borrowed money (*i.e.* interest) is forbidden
- But the pledging of *Halal* assets, the guarantying of obligations and the leasing of property under what we might consider a finance lease (or *ijara*) is permissible
- *Murabaha* is the selling of a commodity at an agreed upon mark-up, and is used in Islamic finance as a fixed income investment substitute.

Key principles - *Riba*

Things to Watch Out For:

- Default Interest
- Administrative fees for late payments
- Consideration in respect of third party guarantees (see AAOIFI Shariah Standard No. 5)
- Preferred Shares are generally not permitted (AAOIFI Shariah Standard No. 21); but dividends distributed from profits are permitted.

Key principles - *Gharar*

- The act of taking on unreasonable uncertainty
- Examples of Gharar:
 - Gambling
 - Insurance
 - FX Trading
 - Credit default swaps
 - Options on stock (AAOIFI Shariah Standard No. 21, paragraph 16 of Appendix B)

Key principles and common terminology

- Prohibited industries:
 - Gambling
 - Pork production or consumption
 - Adult entertainment
 - Conventional banking and finance
 - Alcohol production or consumption
 - Weapons production
 - Tobacco production or use
- High correlation between Islamic compliant investing and socially responsible investing

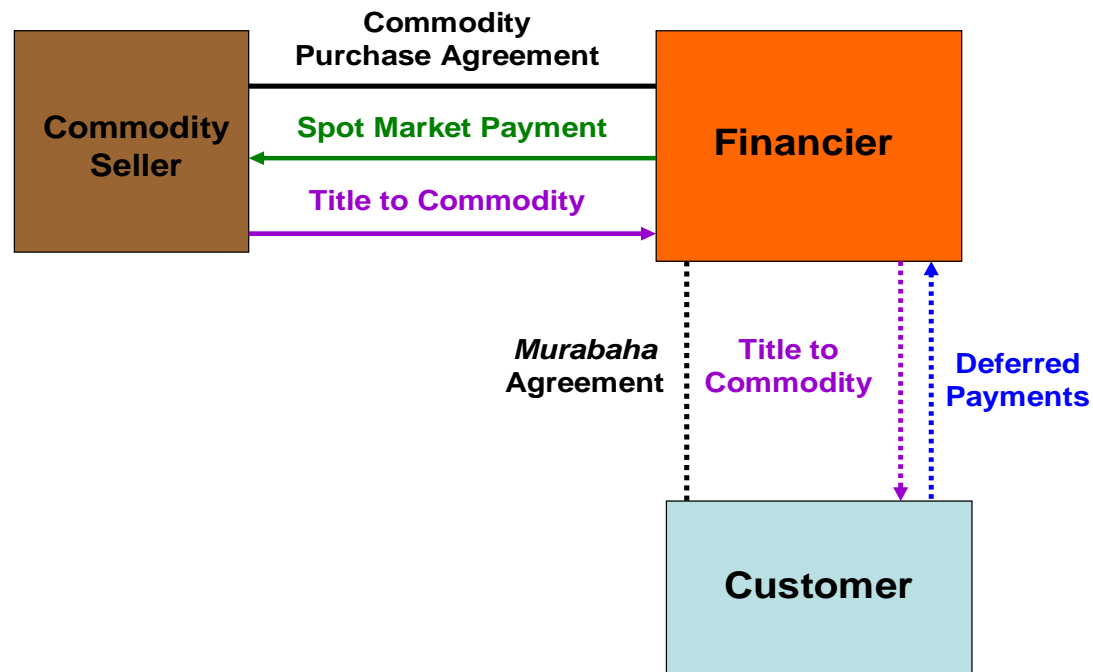
Key principles and common terminology

- *Shariah*: commonly used to mean ‘Islamic law’
- Terms describing compliant structures:
 - *Murabaha*: commodity sale with deferred payment at a mark-up, a fixed income substitute
 - *Ijara*: Islamic compliant lease structure
 - *Mudaraba/Musharaka*: partnership structures
 - *Takaful*: insurance
 - *Sukuk*: debt instruments
 - *Ta’Hawwut*: hedging

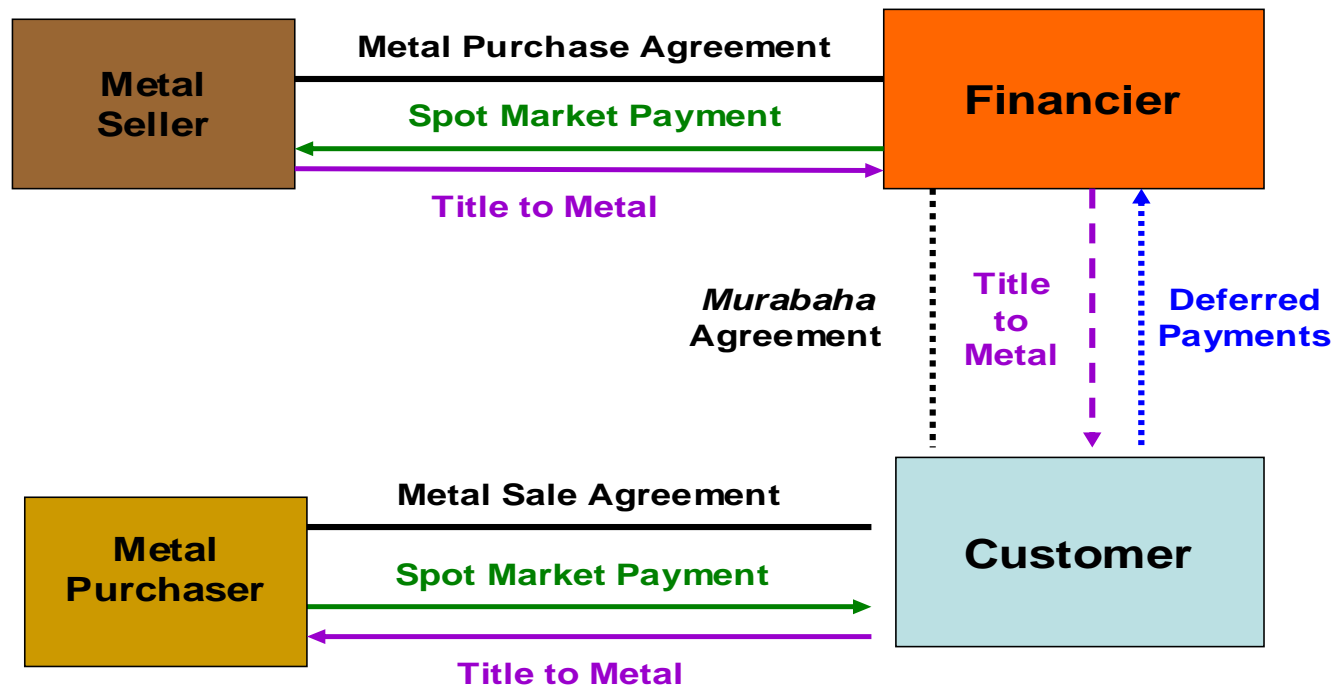
Islamic compliant structures - *Murabaha*

- Asset based
- Trade finance / Acquisition finance
- Unconditional contract of sale; goods, cost price, mark-up and payment date = defined and agreed
- Profit from marked-up sale price (not interest) paid in instalments
- Examples:
 - import-export finance
 - infrastructure project financing
 - leveraged acquisition
 - working capital facilities

Islamic compliant structures - *Murabaha*



Islamic compliant structures – *Tawarruq* (Reverse Murabaha)



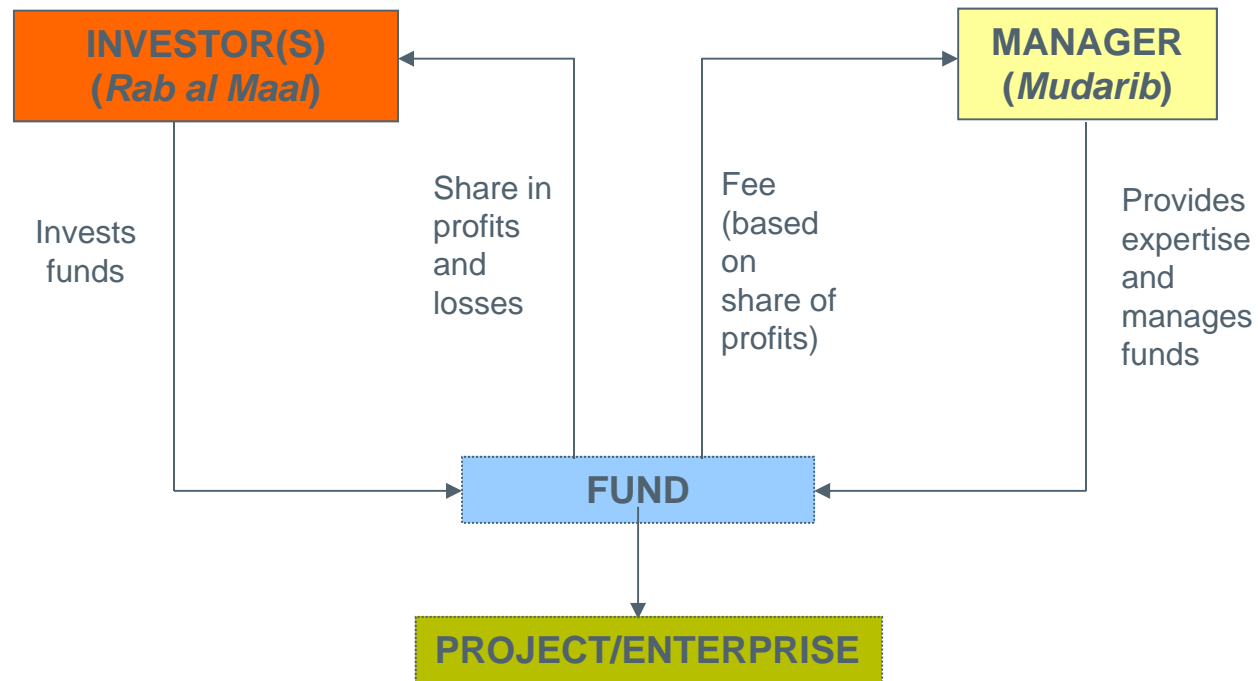
Islamic compliant structures - *Tawarruq* (Reverse Murabaha)

- Asset based
- Freely tradable commodities e.g. platinum, copper (silver and gold are considered currency and cannot be used)
- Provides customer with a cash sum
- Customer then has deferred payment obligation to financier

Islamic compliant structures - *Mudaraba*

- Risk sharing; profit and loss sharing
- Limited partnership: one partner provides capital; other partner provides expertise/effort and makes business decisions
- Restricted or unrestricted
- Examples:
 - funded participation arrangement
 - establishment of investment fund

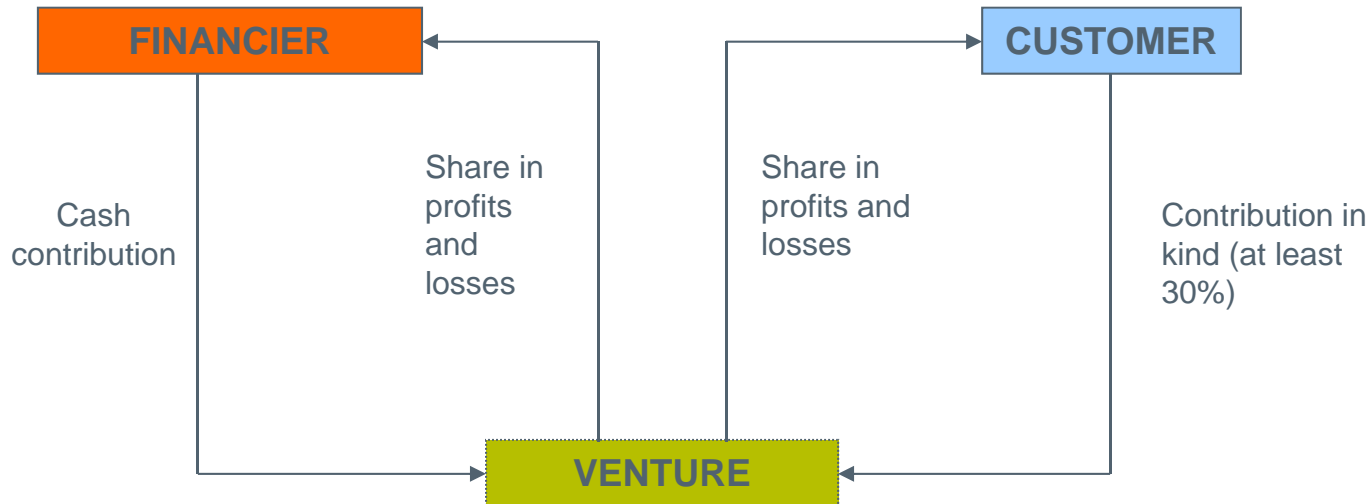
Islamic compliant structures - *Mudaraba*



Islamic compliant structures - *Musharaka*

- Risk sharing; profit and loss sharing in same proportions
- General partnership / joint venture arrangement between financier and investor
- Provides equity funding to a venture; greater risk-reward factors and greater investor say in project management

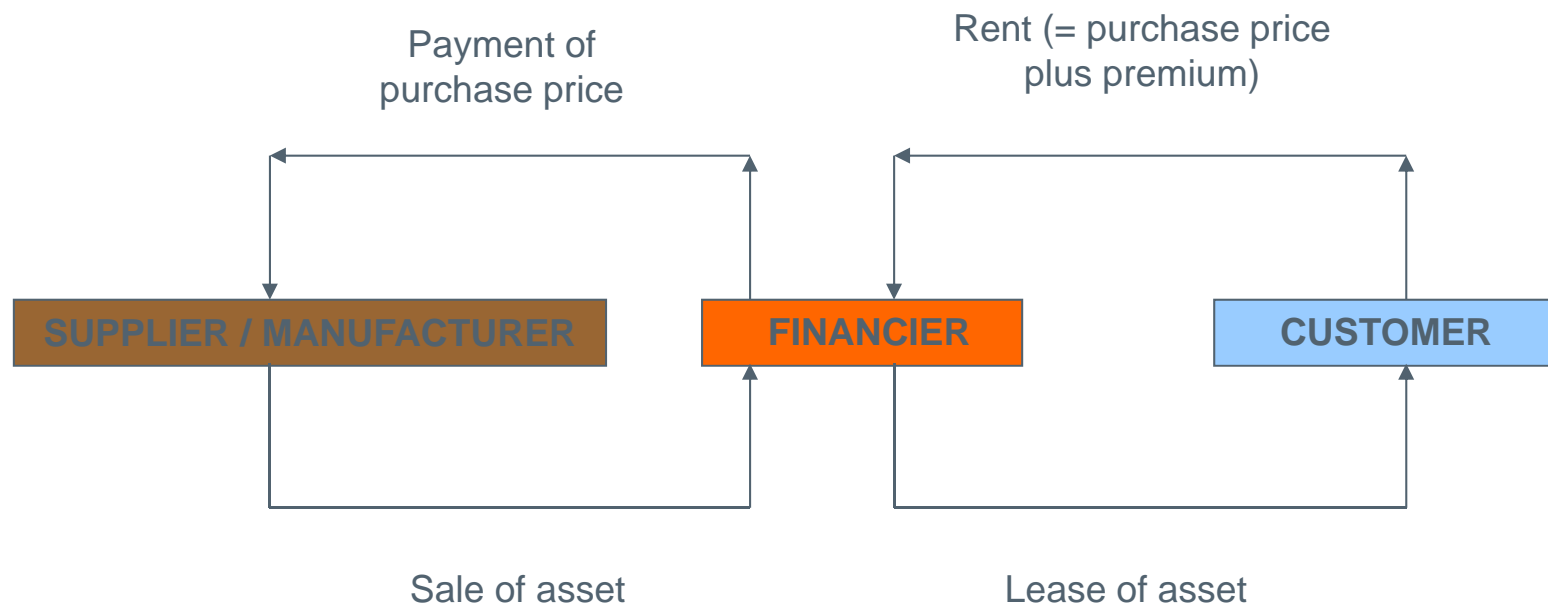
Islamic compliant structures - *Musharaka*



Islamic compliant structures - *Ijara*

- Asset based
- Hybrid between conventional operational and finance leases; a business process
- Analogous to secured loan
- Examples:
 - aircraft finance
 - ship finance
 - project finance

Islamic compliant structures - *Ijara*



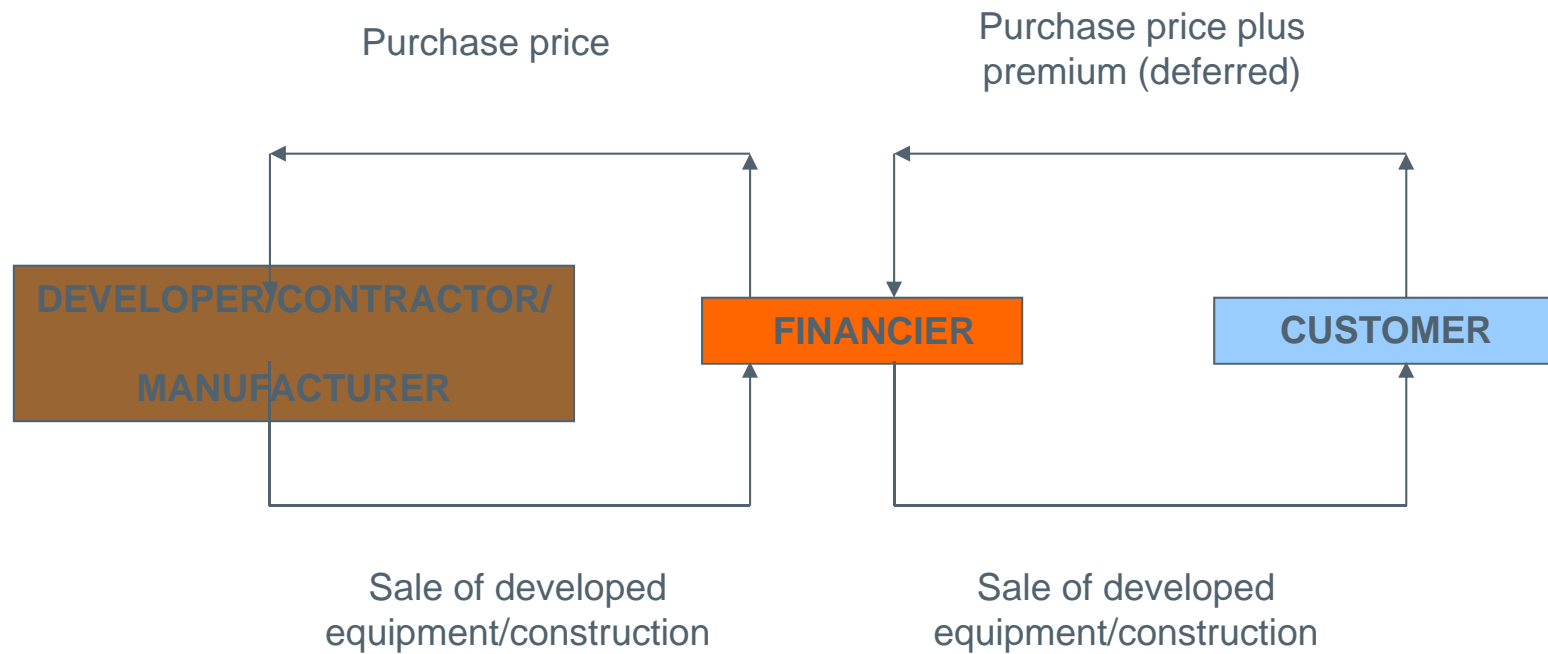
Islamic compliant structures - *Ijara wa-iktina*

- Asset based
- Lease with option for lessee to purchase leased asset
- Analogous to finance lease / hire purchase contract
- Examples:
 - medium term trade finance of equipment
 - refinancing under sale and leaseback

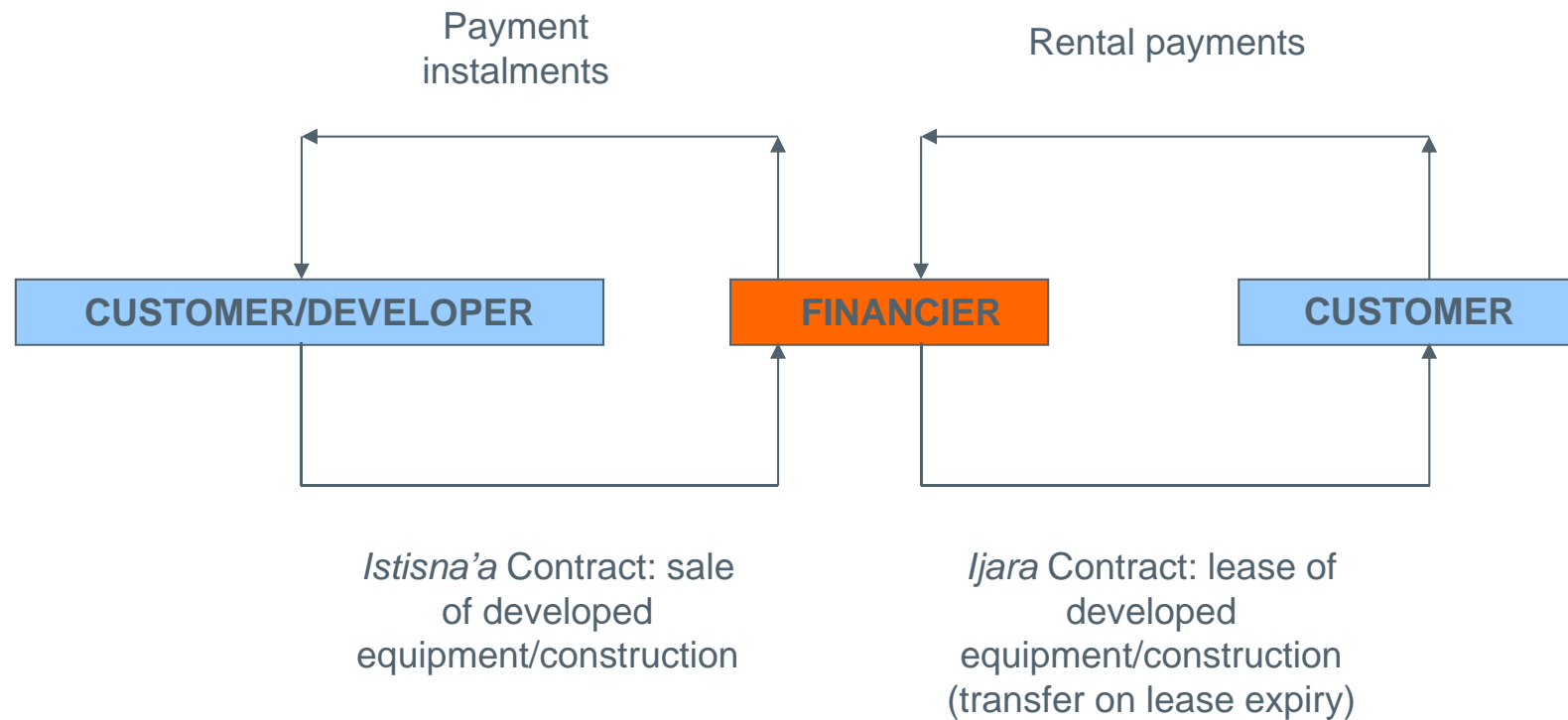
Islamic compliant structures - *Istisna'a*

- Asset based
- Funding agreement for production, manufacture or construction of asset to agreed specification: all specifications, delivery options, payment conditions and pricing must be agreed in contract
- No fixed delivery date and no payment in full at outset required
- Advance funding of:
 - major industrial, construction and real estate development
 - project finance
 - large equipment e.g. ships, aircraft

Islamic compliant structures - *Istisna'a*



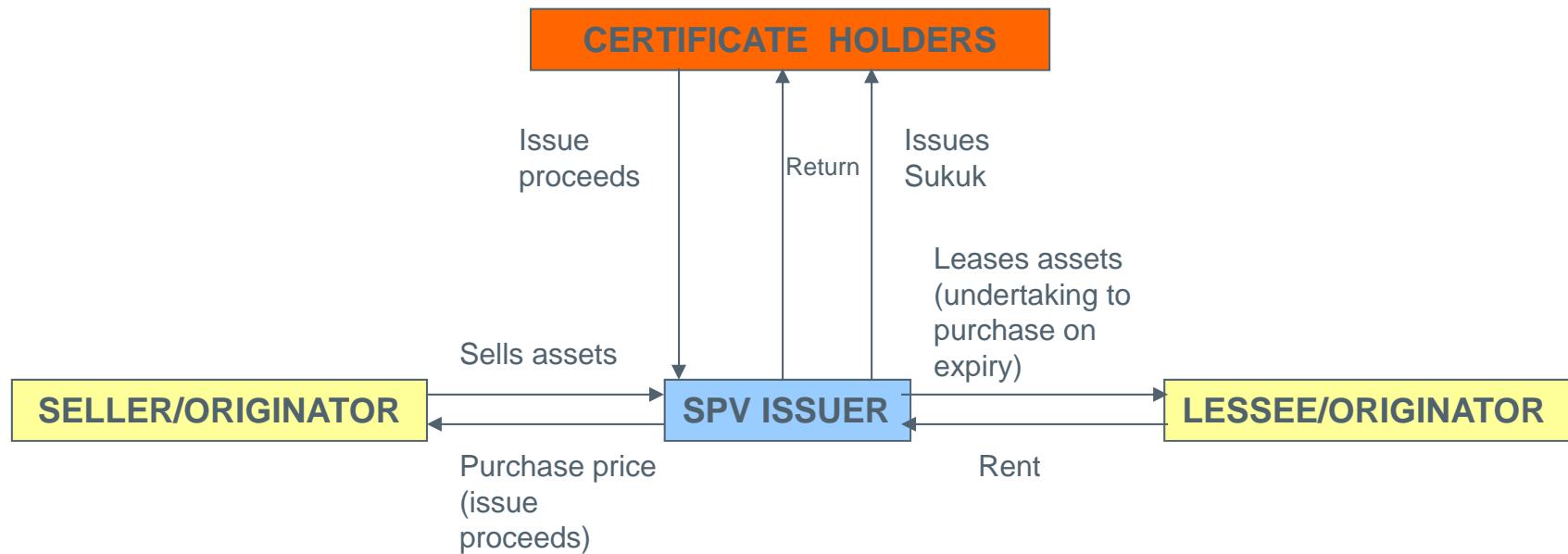
Islamic compliant structures - *Istisna'a/Ijara*



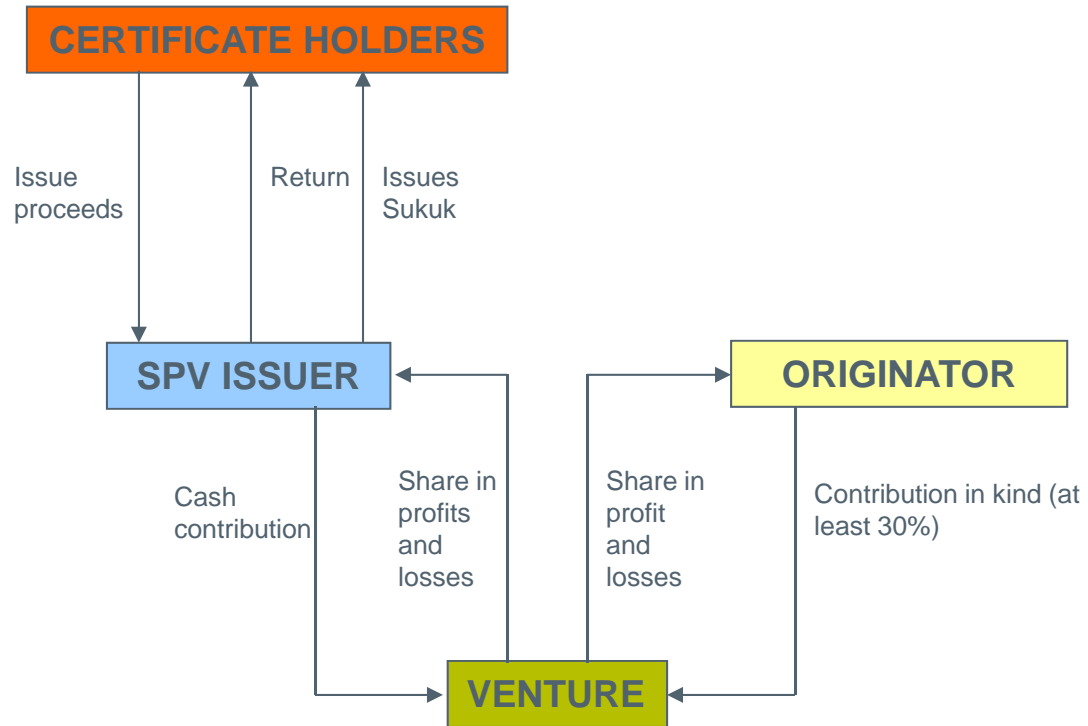
Islamic compliant structures - *Sukuk*

- Financial instruments / trust certificates representing undivided ownership share in underlying asset or interest held by issuer
- Right to share in profits and asset realisations
- Debt capital markets fundraising
- Bought and sold in secondary market
- Used in conjunction with other structures

Sukuk al Ijara



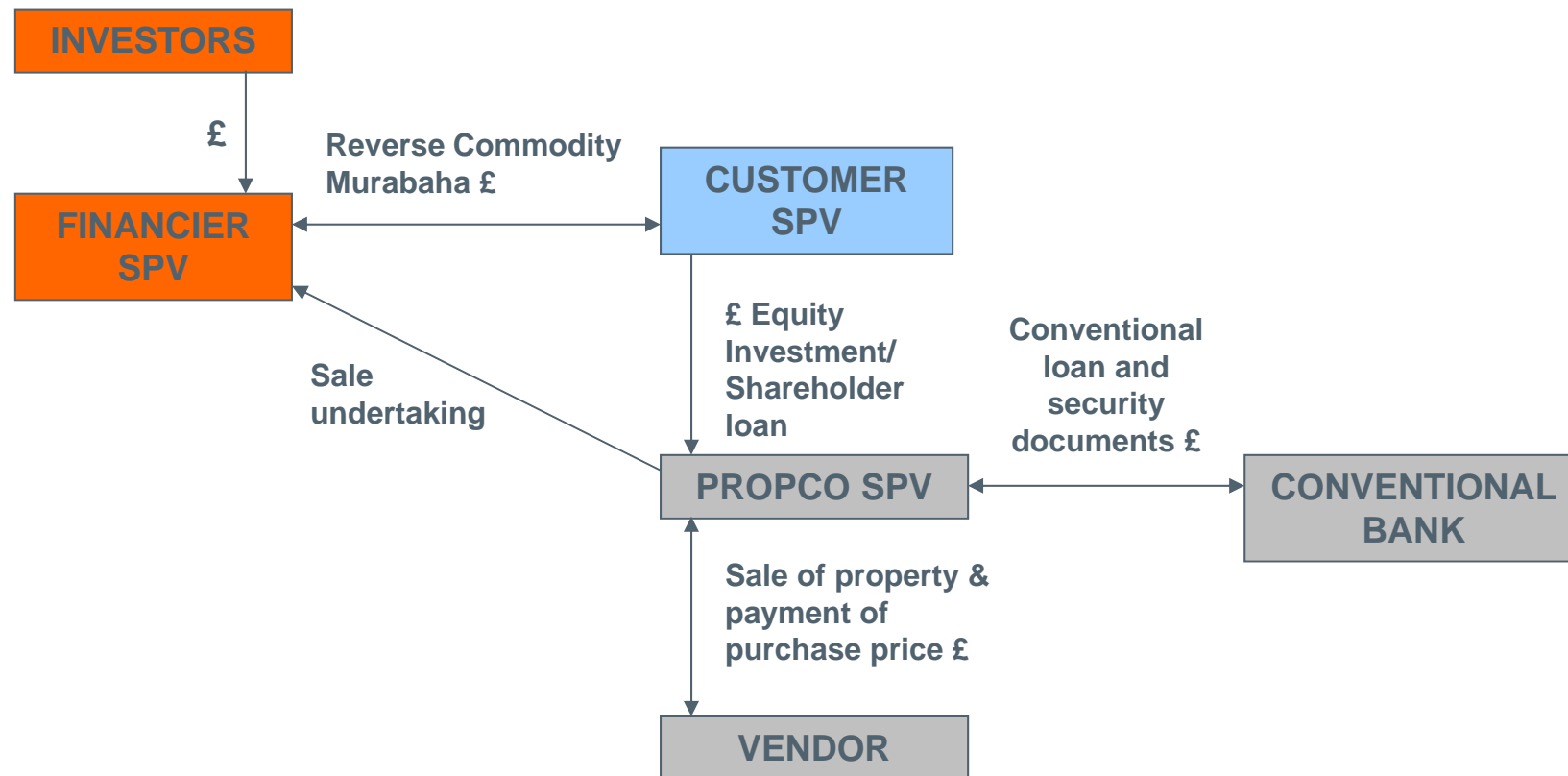
Sukuk al Musharaka



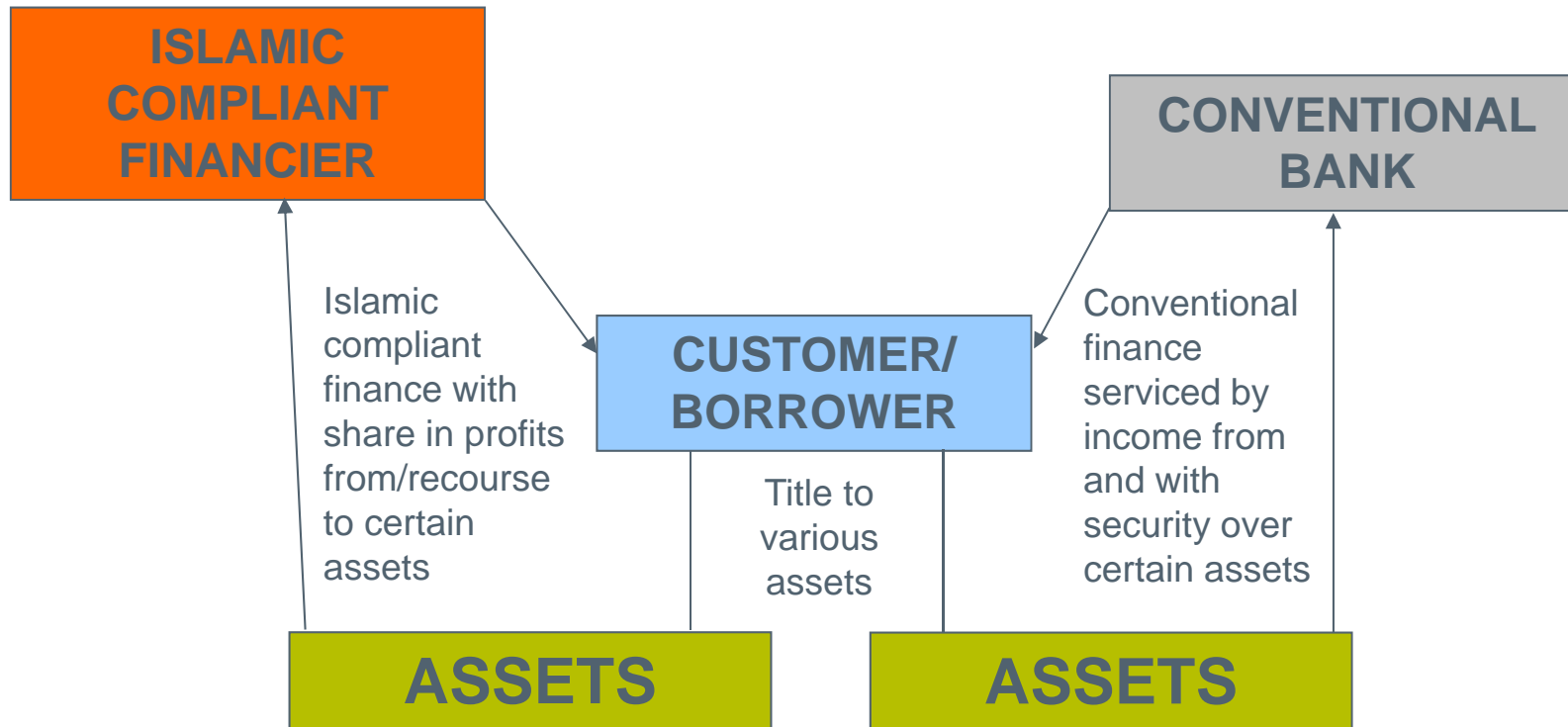
Islamic compliant structures – derivatives

- ISDA/IIFM *Tahawwut* (Hedging) Master Agreement
 - Eliminates provisions for payment of interest
 - Consequential amendments such as removal of certain definitions
 - Covers defined future transactions as well
 - Close-out mechanism differs
 - No reference to credit-worthiness of parties
- No guarantee of being Islamic compliant

Combining conventional and Islamic finance – structural separation



Combining conventional and Islamic finance – asset separation



Islamic finance challenges

- Scholars and schools of thought
- Lack of standardisation
- Transaction costs
- Asset ownership by financier involves potential liability e.g. environmental, warranty claims
- Insurance / *takaful*
- Tax treatment

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