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Legal Challenges & Considerations in Islamic Finance
K&L GATES

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.

ISLAMIC FINANCE BY COUNTRY

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

ASSETS MANAGED BY ISLAMIC FUNDS

SUKUK LISTINGS ON LONDON STOCK EXCHANGE

RATE OF RETURN ON ASSETS WORLDWIDE

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 (*bay‘*) 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*

- **Commodity Seller**
  - Commodity Purchase Agreement
  - Spot Market Payment
  - Title to Commodity

- **Financier**
  - Murabaha Agreement
  - Title to Commodity
  - Deferred Payments

- **Customer**
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*

**INVESTOR(S) (Rab al Maal)**
- Invests funds
- Share in profits and losses

**FUND**

**MANAGER (Mudarib)**
- Fee (based on share of profits)
- Provides expertise and manages funds

**PROJECT/ENTERPRISE**
- Share in profits and losses
- Fee (based on share of profits)
- Provides expertise and manages funds
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*

- **FINANCIER**
  - Cash contribution
  - Share in profits and losses

- **CUSTOMER**
  - Share in profits and losses
  - Contribution in kind (at least 30%)

- **VENTURE**
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*

- Payment of purchase price
- Rent (= purchase price plus premium)
- Sale of asset
- Lease of asset

**SUPPLIER / MANUFACTURER** → **FINANCIER** → **CUSTOMER**
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’ā*

- Purchase price
- Sale of developed equipment/construction
- Purchase price plus premium (deferred)
- Sale of developed equipment/construction

**DEVELOPER/CONTRACTOR/MANUFACTURER** → **FINANCIER** → **CUSTOMER**
Islamic compliant structures - *Istisna’a/Ijara*

- **Customer/Developer**
  - *Istisna’a* Contract: sale of developed equipment/construction
  - Payment instalments

- **Financier**
  - *Ijara* Contract: lease of developed equipment/construction (transfer on lease expiry)
  - Rental payments

- **Customer**
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**

**Certificate Holders**

**Seller/Originator**

**SPV Issuer**

**Lessee/Originator**

- **Issue proceeds** to **Certificate Holders**
- **Return** the Sukuk to **Certificate Holders**
- **Sells assets (undertaking to purchase on expiry)** to **Lessee/Originator**
- **Leases assets** from **Lessee/Originator**

**Purchase price (issue proceeds)**

**Rent**
Sukuk al Musharaka

- Certificate Holders
  - Issue proceeds
  - Return
    - Issues Sukuk

- SPV Issuer
  - Cash contribution
  - Share in profits and losses

- Originator
  - Share in profit and losses
  - Contribution in kind (at least 30%)

- Venture
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

INVESTORS

FINANCIER SPV

£ Reverse Commodity Murabaha £

CUSTOMER SPV

£ Equity Investment/Shareholder loan

£ Equity Investment/Shareholder loan

Conventional loan and security documents £

PROPCO SPV

Sale of property & payment of purchase price £

CONVENTIONAL BANK

VENDOR

Sale undertaking
Combining conventional and Islamic finance – asset separation

ISLAMIC COMPLIANT FINANCIER

Islamic compliant finance with share in profits from/recourse to certain assets

CUSTOMER/BORROWER

Title to various assets

CONVENTIONAL BANK

Conventional finance serviced by income from and with security over certain assets

ASSETS
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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