Offshore centers: Accommodating Islamic finance transactions

AMJAD HUSSAIN and KATHLEEN BRADLEY look at how some offshore financial centers have adapted to attract the Islamic finance industry and accommodate Shariah compliant transactions.

The growth of the Islamic finance industry has been remarkable in the last decade and, in certain parts of the world, Islamic finance is now the mode of choice for corporates looking to raise funds.

As with conventional finance, borrowers (or the recipients of funds) look to raise funds in the most efficient and expedient manner. This involves looking at structures that, amongst other things, minimize tax liability, provide ease of executing business transactions and give comfort to contracting parties in terms of enforcing their rights.

There are a number of offshore financial centers (OFCs) that have come into existence over the last 30 years or so. One of the main catalysts behind the growth of OFCs has been the growth in financial engineering (especially securitization) to structure products that facilitate easy and quick flow of funds to a global investor and borrower base.

OFCs
An OFC is usually characterised as a low-tax and regulation-light jurisdiction that provides financial services to individuals and corporate who are non-resident.

Historically, OFCs were often found in geographical locations that were away from the usual major financial hubs and, as such, they focused upon providing competitive services which would attract investors away from the more traditional financial centers.

However, this is not the case now. A number of OFCs have been created alongside on-shore trading hubs to encourage foreign investments. Two Gulf-based examples of this are the Qatar Financial Center and the Dubai International Financial Center.

These have been established alongside the existing regimes but aim to provide a regulatory framework that is akin to the leading global financial centers and offer incentives (such as no restriction on foreign ownership and repatriation of profits) aimed at attracting investors.

Clearly a major factor in selecting an OFC is the tax benefits that would be achieved by using a structure which involves that OFC. As such, many of the successful OFCs have a network of international tax treaties which will provide investors with significant tax savings as well as relief from other fees and charges that may be payable onshore to authorities.

Another key feature of OFCs has been the secrecy and anonymity they have provided.

However this aspect is not as robust as it used to be due to the tightening up of anti-money laundering regulations, greater collaboration imposed upon OFCs by cross-border bodies such as the Organization of Economic Cooperation and Development and the existence of Tax Information Exchange Agreements.

The existence of a light but yet clear regulatory framework has continued to be a key consideration that influences investors in deciding which OFC to select. Many of the OFCs have laws that are based upon the legal framework of established and tested legal jurisdictions. These laws are often supplemented by additional specific laws to clarify any ambiguity so as to provide a greatest amount of clarity to potential investors. There are also international rules concerning money laundering which are usually adopted by OFCs and these help provide additional comfort to investors.

In terms of enforcement of rights, many of the popular OFCs are former colonies of the UK and, as
such, their laws are based upon English common law. Also, a number of OFCs still refer to the Privy Council of the House of Lords for final decisions on areas of law where their own statutes and court decisions are silent. This adds to investor comfort.

In the context of Islamic finance, English law is seen by many as the law of choice for many of the core transaction documents.

Therefore, using a structure which involves an OFC that is based loosely on English law makes sense and allows for advisors and investors to appreciate the wider legal issues for a transaction more readily.

All of the above considerations apply as much to transactions that comply with Shariah law as those that do not. So, what are the favourite OFCs for the Islamic finance industry?

Islamic finance OFCs?
As the Islamic finance industry has continued to grow exponentially and make the headlines, OFCs have looked to see how they can capitalize on this emerging and fast-growing market.

Most OFCs claim that they provide the best platform for Shariah compliant investors. However, in reality there are a relatively few OFCs that have succeeded in attracting bulk of the Islamic finance business. These include the British Virgin Islands (BVI), Cayman Islands, Bermuda and Labuan (mainly for Asian transactions).

These OFCs have proven to provide the best environment and vehicles that allow Shariah compliant investors to structure products that are globally accepted and are also flexible enough to accommodate Islamic principles. Indeed, each of these OFCs has taken specific steps to introduce laws and regulations which are directed towards encouraging the Islamic finance industry to transact business there.

Cayman Islands
The Cayman Islands are seen as the OFC of choice for many Gulf-led Islamic finance transactions. Some of the largest Sukuk transactions have been structured through the Cayman Islands: including the US$1.45 billion TDIC Sukuk of 2009 (for which the Government of Abu Dhabi used a Cayman Island SPV) and the AED7.5 billion (US$2.04 billion) JAFZ sukuk of 2007.

More recently, HSBC’s US$5 billion Sukuk program was put into place using a Cayman Islands structure as was the controversial Goldman Sachs US$2 billion Sukuk issuance program.

In March 2007 the General Registry of the Cayman Islands introduced the Arabic language facility to allow companies to receive their incorporation documents with Arabic language as well as English. This was seen as a move to welcome Middle Eastern investors and make it clear that the Cayman Islands were keen to develop further links with the Arabic speaking world.

The regulatory authorities in Cayman Islands were also quick to address concerns regarding treatment of Islamic finance structures by passing legislative amendments in 2008 clarifying that, for example, Sukuk would not fall within the remit of the Mutual Funds Law and the Banks and Trust Companies Law.

The Cayman Islands have been popular with Islamic fund managers and Gulf-based sovereign wealth funds for a number of years. This stems from the popularity of the Cayman Islands in structuring and managing the wealth of a number of high net worth families and individuals from the Gulf. This has meant that there is a now a level familiarity with the Cayman Islands and a view that they are a safe and trusted OFC.

British Virgin Islands
The BVI Business Companies Act 2004 is seen by many practitioners as a good example of a law that has been enacted with a view to ensuring the flexibility required to accommodate future innovation and development of Shariah compliant structures. In particular the rules concerning the ability of a director to act in the best interests of shareholders (as opposed to just the SPV) are particularly useful in the context of Musharakah-based instruments.

In 2008 the Saudi Binladin Group (through Purple Island Corporation) issued a US$267 million Mudarabah Sukuk using a BVI SPV. Although the BVI have not been as popular as Cayman Islands or Bermuda for Sukuk issuances, the mutual funds regulatory framework has been popular with Islamic asset managers and for other Shariah compliant transactions.

Bermuda
Bermuda is seen as one of the leading OFCs for Islamic finance and has made considerable efforts to attract Islamic finance business. The Bermuda Monetary Authority, which was established in 1969, has
been careful to ensure that the regulatory regime in Bermuda is sufficiently accommodating to a number of asset classes and investors, including Islamic investors.

A number of changes were made to the corporate laws in 2009 to attract foreign investors. These included permitting delivery of official documents through the internet and allowing companies the ability to select a wider range of corporate objectives.

The US$500 million Sukuk issued by GE Capital in 2009 was seen as an endorsement of the jurisdiction in the eyes of many commentators.

Bermuda has been favoured as a jurisdiction by Islamic fund managers for a number of years. The regulatory environment is seen as flexible and allows for specific reference to Shariah standards into the constitution and offering documents.

Although Bermuda is not unique in this, many commentators have suggested that the Bermudan authorities have been more proactive than others in accommodating non-conventional structures. The Bermuda Monetary Authority has issued a number of guidance notes directed at giving further comfort to the Islamic finance industry.

The long tested experience of Bermuda in insurance and reinsurance fields has meant that it has been able to take a key role in attracting Takaful and re-Takaful providers targeting the US and European markets.

Bermuda has commonly been used for the structuring of complicated asset finance deals, especially in the aviation and shipping sectors. This therefore makes it a popular choice of law for Shariah compliant transactions.

Labuan

Another OFC that has grown in prominence in recent years for is the Labuan International Offshore Financial Center (LIOFC), which is based on a small island located off the coast of Borneo.

With the lead that Malaysia has taken in the growth of the Islamic finance industry, it is not surprising that the LIOFC has grown in prominence.

The Labuan Financial Services Authority has been active in putting into place a regulatory environment that is aimed at the attracting the Islamic finance industry. In 2004 it signed an MoU with the Islamic International Financial Market in Bahrain to encourage Gulf business. In 2010 it introduced the Labuan Islamic Financial Services and Securities Act which, amongst other things, has strengthened the supervisory role of the Shariah board and allows for the board to be referred to for dispute resolution. The LIOFC has been successful in attracting a number of Islamic banks and Islamic banking windows. In 2010, the total deposits with these institutions grew by 63% to US$1.3 billion.

Conclusion

It is clear that investors who choose to invest using Shariah compliant instruments share many of the same concerns that conventional investors have. These include ensuring that the structures used provide tax efficiency, privacy and clarity around the legal and regulatory frameworks; and allow for effective enforcement of rights. Additionally, Islamic investors look at issues around neutrality of treatment of investments (to ensure that they are not at any disadvantage) and also the flexibility to structure instruments in a manner consistent with their religious beliefs.

Most OFCs have welcomed the Islamic finance industry through tacit approval and issuing guidance to clarify the suitability of their framework for Shariah compliant investors. Some OFCs have taken specific steps to encourage and invite Islamic investors to use their services and jurisdiction for investments. However, there does not seem to be any OFC jurisdiction which is head and shoulders ahead of another in terms of its attractiveness to the Islamic finance industry and for that reason Islamic investors will have to look at a number of issues to decide which OFC is most suitable for their specific transaction and product.

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