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The year in Islamic finance

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Banking & Finance analysis: As we head towards the start of the new Islamic year, we ask a panel of experts to consider the development of Islamic finance and the future of this growing sector.

The experts

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What do you think has been the most important development within Islamic finance during the past year?

Farmida Bi (FB): I think probably the UK government sukuk because that galvanized a lot of interest from non-traditional jurisdictions. The UK sukuk led to the Hong Kong deal and the Goldman Sachs issue. These developments have been very favourably received. There was some concern raised at the announcement of the UK government sukuk that traditional Islamic investors would have little interest in sukuk issued by a non-Islamic issuer, but instead we have seen a real appetite for these kinds of deals. I think this will mean that Islamic finance will no longer be seen as niche but part of the mainstream, and become a real alternative source of finance for many types of issuers.

Mohammed Paracha (MP): As it has found its feet after the financial crisis, I think the last few years have been rather 'light' for the industry in terms of development of cutting edge products and new markets. However, a couple of things that I think stand out over the last 12 months are:

- the standardisation by the International Islamic Financial Market (IIFM) of the Interbank wakalah product--the third product it has brought out and which is designed to be the standard for Interbank deposits
- the regulatory capital/hybrid sukuk issuing in various markets

Sara Carmody (SC): I am excited by the fact that several countries are competing to become the Islamic finance capital. The UK has become the first country outside the Islamic world to issue sovereign sukuk, with London having ambitions to be an Islamic finance capital. Dubai has set its sights to be the hub of the Islamic economy. Islamic finance is developing global momentum--this is quite a significant development from when the industry started and a very different state of affairs from when I first began working in London in 2002.

Sajjad Khoshroo (SK): I would say it's the prevalence of sukuk issuances, building on what we have seen over the last few years--especially 2012/13 where we saw sukuk issued as part of the initial funding package of a project finance transaction. In my line of work, project finance (especially in the oil and gas sector in the Middle East), sukuk and other Islamic finance structures have become an important part of the overall funding package of mega-projects (frequently worth in excess of $10bn). Historically, Islamic financing structures were not widely utilised in large-scale long-term project financings. This change was helped by:

- the capital-intensive nature of the mega-projects, requiring project sponsors to draw on all available funding sources
- growth in dedicated Islamic finance institutions (IFIs) offering a full range of Shari'ah-compliant products capable of utilising a project's underlying tangible and intangible assets
- an increase in the liquidity of the IFIs allowing them to participate in project financings with longer tenors
- political and cultural desire in certain projects (especially mega-projects with national significance) to promote Islamic finance, and
- broader consumer demand for Shari'ah-compliant financial services and products

Sukuk has also become the product of choice for non-Islamic centres like the UK, Hong Kong and South Africa, to all issue sovereign sukuk in 2014. Big banking names such as Goldman Sachs are entering the market, following the likes of HSBC, so Islamic financing is firmly entering the mainstream and is no longer considered to be niche.

Amjad Hussain (AH): I think the Islamic finance industry has seen a number of interesting developments over the last year. However, the one that is the most important for me has been the manner in which sovereign issuers have expressed an interest in the sukuk market. The UK sovereign sukuk in June 2014 demonstrated the growing appeal of Islamic finance as an alternative source of financing, even for non-Muslim countries. Given how long this has been in the pipeline, the Islamic finance industry welcomed this development with a huge degree of hope and optimism for the future. Indeed, it was expected that further non-Muslim countries would follow the UK's lead and enter the sukuk market and this happened in September 2014, when Hong Kong also made its debut by tapping the Islamic capital markets. South Africa is expected to issue in the next few months while a number of other non-Muslim (and Muslim) countries have been expressing an interest in following suit.

The use of Islamic financing by more major economies shows acceptance of Shari'ah-compliant sources of funding by a wider audience, and this will assist in raising awareness and moving these structures further into the mainstream.

Jonathan Lawrence (JL): In the UK generally, it has been the issuance of a £200m government sukuk on 25 June 2014, backed by UK government real estate assets. It is understood that orders were around £2bn, clearly showing the market appetite. This was the first sukuk to be issued by the national government of a G8 member country. This has yet to translate to more corporate level Islamic financing in the UK, but this is the hope in the industry.

The important trend I am seeing within our own firm's Islamic finance practice is the increase in the cross-border nature of our Islamic finance work. Whether it is London lawyers working with US lawyers to set up Islamic-compliant funds, or Doha lawyers working with New York lawyers on bankruptcy issues surrounding the restructuring of an Islamic finance institution, Islamic finance is becoming an increasingly international skill.

Tom Bartlett (TB): From my perspective as a project finance lawyer--and I would say this having advised on it--the most important development in my view was the Sadara project financing which included a project sukuk as part of its debt mix. It is the largest ever chemicals project built in a single phase and it utilised $12.5bn of debt. Unique to that project, among other things, was a project sukuk issued as initial debt for the first time. There had only ever been one sukuk issued previously in respect of a project financing before, on the Saudi Aramco and TOTAL-sponsored SATORP refinery financing. That sukuk was a lot simpler, because the main project financing had already been funded, and then a year or so later the project sukuk came in and took out part of the initial debt by way of replacement debt. In the case of Sadara, the project sukuk was issued first--$2.5bn-worth of project sukuk issued into Saudi Arabia--and six months later the other $10bn-worth of debt from export credit agencies and commercial banks including Islamic financing (including on an istisna-ijara [procurement-leasing] and wakala-ijara [agency-leasing] basis) came in. This was all unique in that a structure had to be created to allow the sukuk to be issued first, prior to the incurrence of the remaining debt.

In terms of Islamic finance being used for project financing it's becoming a fairly well-established structure. Typically in project financings over the last 10-15 years, they have implemented leasing structures on an istisna-ijara or wakala-ijara basis. This was the first significant project financing to utilise project sukuk from the beginning. Going forward, project sukuk could now be available to other sponsors--ie high-level, capital-intensive projects to utilise another form of Islamic financing and also for other countries within the Middle East to develop their internal capital markets by developing sukuk.

Which Shari'ah-compliant structures are being most commonly used in financing at the moment?

FB: The ijarah structure is still the most common and widely accepted structure for sukuk issues--it requires the sukuk issuer to use the proceeds of the sukuk issue to buy or lease an asset and to then lease this asset to generate a rent which is paid pro rata to investors as their share of the profits generated by that asset. At the end of the lease period there is a put and call option to sell the asset at a pre-agreed price which is sufficient to repay the principal to the sukuk investors. The ijarah creates a certain limit as to how many deals can be done, especially for Western investors who often do not have available assets that can be tied up in tax or regulatory arrangements.

Outside the capital markets, the commodity murabaha is still the most widely used structure to raise finance although some Islamic parties choose not to use it. It's comparable to the way a traditional Loan Market Association loan works and is easily understood. What is becoming interesting, though, is the amount of hybrid deals happening in the market. For example, the Goldman Sachs deal is a wakala sukuk where the proceeds are invested in a 51% wakala investment arrangement, and the remaining 49% in a murabaha that creates a debt obligation through the commodity trade that is sufficient to repay the principal. That sort of hybrid structure is attractive because it doesn't require the sukuk issuer to acquire assets such as property or equipment that may not be available.

MP: It's still predominantly the commodity murahaba. However, there have been further steps taken over the past 18 months in the industry to move to other structures such as the ijarah and asset murabaha structures. We have also seen hybrid sukuk being issued for regulatory capital purposes, as well as straight secured sukuk--there are also now a combination of wakalah and commodity murahaba instruments in vogue in the market.

There are, however, some inherent problems in using a 'pure' Islamic structure, in that it doesn't always lend itself to local laws in some jurisdictions, so you end up having to fall back on the commodity murahaba. Part of our practice is UK property acquisition/development financing, and while there are laws in the UK that support ijarah, musharakah [partnership] and murahaba structures, we have Shari'ah difficulties when using them if the property is already let. This results in having to go back to the default commodity murabaha structure.

SC: At the moment, it's definitely the commodity murabaha. I don't think this is going to change any time soon, because the murabaha is a structure which people are comfortable with in terms of structuring.

SK: We have mentioned the sukuk structure, but it also worth considering that the sukuk has a kind of umbrella structure that covers other Shari'ah-compliant structures underneath it. It often sits on top of an istisna-Ijara structure, with some musharakah elements--as was the case in the sukuk issued for our oil and gas transaction.

The wakala-Ijara structure is also often used in the Saudi market, while murabaha and tawarruq (cost-plus financing) structures are often used for working capital facilities.

AH: Sukuk al ijarah remains a popular form of sukuk structure that is capable of harnessing the relatively safe returns of real estate investments, both in the domestic market and internationally. This is particularly relevant, as the real estate sector continues to perform well in the Gulf Cooperation Council (GCC) as well as in traditional target real estate markets for GCC investors such as London and Paris.

Murabaha structures are also very popular in bilateral or syndicated lending for private sector borrowers to raise finance--particularly in the GCC where borrowing has been quite cheap amid the drive to increase loan growth of the domestic banking sector. This has allowed banks to lend on attractive borrowing terms.

TB: In terms of project financing, you are looking more in the longer-term for debt tenors--ie between 10-12 years. Initially, when Islamic financing was used, one of the doubts raised was whether you could push out the tenors of Islamic financings to match other project financing sources such as export credit agencies (ECAs) and commercial banks. It has now been established that Islamic financing can sit alongside other funding sources in project financing structures and substantially match the other tenors of ECAs and commercial banks.

How do you see the Islamic finance sector developing in the next 12 months?

FB: There have been a number of issues in the last three to four months and we expect to continue to see deals coming from non-traditional sources. This is a deep and liquid market and investors will continue to find it attractive. I don't think there is any reason to think that that speed of growth won't carry on, as investors are keenly looking to this market for putting structures together.

The point to make here is that we are seeing governments from non-traditional countries now entering the Islamic capital markets sector, followed by financial institutions. We would expect corporates to follow this trend.

MP: Foreign governments are again raising debt using Islamic finance. Jurisdictions are issuing benchmark sukuk to support the development of the Islamic finance industry in their countries. Hong Kong is a good example of this.

Corporates also want to exploit their business model by expanding into the Middle East, which as a market has seen growth that outstrips the traditional 'home [European]' market of many corporates. When such corporates expand into the Middle East, they have to understand Islamic finance. Recent examples include one of the leading German luxury car manufacturers which has been selling its cars in the Middle East for a while, creating Islamic finance solutions for its retail customers.

I think this is one way we'll see the industry develop--Western companies with a strong business model that may not be growing at the rate they desire, looking to the Middle East for additional growth. These businesses will have to learn about Islamic finance if they wish to tap into local liquidity. Coupled with further issuance of sovereign sukuk, these will be the two main trends continuing in the next 12 months.

SK: I would suspect that we will continue to see similar Shari'ah-compliant structures used in the next 12 months.

What hasn't caught on as much is Tahawwut, a form of Islamic hedging. But I would expect such structures to gradually become more commonly used going forward.

Another Shari'ah-compliant structure that is developing and becoming more popular is the takaful (Islamic insurance). Takaful has not been used for big oil and gas deals that I have worked on, as the Islamic insurance market wasn't big enough to be able to cover such large-scale risks. However, I have seen takaful used for smaller Shari'ah-compliant deals involving ships and aircraft. I would suspect that the Islamic insurance market will continue to develop and eventually be able to take on larger deals and play a bigger role in the industry.

Have there been any cases from the last year that have been particularly significant?

FB: It's not strictly a 'case', but the chapter 11 restructuring of Arcapita, a Bahranian-Islamic bank, proved to be very interesting and instructive. The US court had to grapple with Islamic instruments and the demands of different investors to come up with a solution that was acceptable to everyone and it was able to apply general principles under chapter 11 in order to achieve this.

SC: In my jurisdiction (working in DIFC), a high profile case was heard in August 2014 in which Bank Sarasin-Alpen was successfully sued by a Kuwaiti family for giving them apparently bad investment advice. This case has turned a spotlight on the advice given by different types of financial advisers in the financial services sector in this region and also globally. Until now, the regulation of the financial services industry within the UAE has been at a relatively unsophisticated level in terms of court proceedings in particular. We could see more claims brought against financial institutions for mis-selling, for example, of which there are very few examples in the region.

SK: Not that I am aware of, as my work as a lawyer deals with project finance rather than the litigation or the dispute resolution side of things. Having said that, Islamic finance transactions don't tend to go to litigation or dispute settlement often.

AH: There is growing recognition that traditional litigation is rarely the appropriate form of dispute resolution in the context of Islamic finance, particularly as Islamic finance becomes more global and cross-jurisdictional. The reason for this is the lack of expertise and know-how of most local courts in dealing with the complex issues and principles of Islamic finance whose interpretation varies between different schools of thought. As such, arbitration or other forms of alternative dispute resolution are seen as more specialised and capable of understanding and resolving Islamic finance disputes.

One of the most interesting on-going matters that has concerned Islamic finance is the bankruptcy of Arcapita. This has raised a number of issues surrounding the jurisdiction of US bankruptcy courts and shows the importance of ensuring that Islamic banking transactions are carefully structured, especially where there are cross border elements involved. The use of foreign law combined with the focus on Islamic principles can sometimes raise issues of priority of laws, which the courts will have to grapple with over time. In that, if a GCC borrower lends money from a US bank under a Shari'ah-complaint structure which is subject to English law, and where Shari'ah law is stated to prevail in the event of a dispute between English and Shari'ah law, then this can lead to some interesting issues arising.

Can you see significant divergence in the Shari'ah principles being applied by the Accounting and Auditing Organisation for Islamic Financial Institutions in Bahrain and the Islamic Financial Services Board in Malaysia?

MP: The convergence between Malaysia and the GCC now is pretty strong. There can be slight differences in terms of the Malaysian domestic market and its domestic debt capital market (DCM) issuances structures v GCC DCM structures. However, when Malaysian entities are involved in cross-border Islamic finance there is no divergence--that is just the reality. We work with several Malaysian entities on cross border banking and sukuk transactions, and we don't really encounter any issues. It's something the industry talks about a lot, but doesn't really affect us as much as the 'talk' would indicate.

How significant do you think the UK issuing a sovereign sukuk will be and do you think this will lead to other Western nations following suit?

MP: Well, they weren't the first Western nation to do so--the German state of Saxony-Anhalt issued a sukuk some years ago. I think the industry was hoping the UK government would launch with a higher amount than it did as there continues to be a severe lack of GBP denominated investment products. However, and this might be a politically incorrect statement to make, due to the current political climate in some parts of Europe, I think it may be difficult for some aspiring new entrants in Europe to support Islamic finance in the way the industry had hoped (I am not including offshore centres such as Luxembourg that continue to push their own interests as an offshore centre for Islamic finance). The UK is a very specific case because it had started its sukuk journey a long time ago, but I believe it may unfortunately be the wrong time politically for others in Europe to enter into Islamic finance.

JL: We have already seen South Africa and Luxembourg following suit. The next question is how this will filter down to other areas of Islamic finance work and how many non-Muslim majority country governments will become regular issuers of sukuk. For example, there appears to be no indication that a second UK sukuk is imminent.

What are the current hot topics for lawyers working within Islamic finance?

FB: I think, going forward, that the industry is excited about the potential of project sukuk. There's a huge interest in developing infrastructure in places such as Turkey, for example, and to use sukuk where there is an actual risk taken on the project rather than on the corporate creditor at the end of the day.

It would also be good to see Islamic securitisation being used more.

SC: I would identify the hot topics as:

Conformity in respect of the types of documentation

Each financial institution has its own Shari'ah board and there can be a lack of conformity between those boards in respect of the interpretation of the documentation and structural preferences. There is no independent standard with respect to the way in which the interpretation of the Shari'ah boards is applied--this is an important issue, especially for syndicated cross-border transactions.

Growth in Islamic finance in new jurisdictions

For example, one of the markets I am watching closely at the moment is Oman--until recently, it wasn't even in the market for Islamic financing. There is a definite trend in terms of Islamic financing becoming an accepted normal financing mode instead of being seen as a niche market.

SK: I would say it's the interaction between Islamic finance and conventional finance--you have to incorporate the Islamic finance piece into a larger financing puzzle, and ensure that the risk reward profile of the Islamic financing piece fits with the risk reward profile of the conventional financing piece. You must make sure that the financers and all the other parties involved on both sides of the transaction get a similar package--this is a crucial area for finance lawyers in ensuring that all documentation is captured.

There is also an ongoing debate--perhaps more on the academic, rather than the practical side of things--around the substance of Islamic finance. If it in effect is mimicking conventional finance, does it really bring anything to the table, or is it just a marketing ploy? Do bankers, scholars or financiers really add value to a transaction or are they simply adding transaction costs?

AH: In my opinion, the hot topics are:

- the improvement of regulatory clarity (consumer protection, Shari'ah governance, the changing landscape of the regulation of financial services)
- the pressure of regulatory compliance (eg Basel III and Central Bank directives)
- the growing recognition of the value of Islamic finance as an alternative source of finance outside the Islamic world and the challenge of co-financing of investments with conventional financing (ie priority of security)
- the global financial concerns of shrinking investment in emerging markets (ie in China, Turkey and Latin America)
- the continuing political instability in the Middle East and internationally (eg the impact of Russian sanctions)

TB: I'm not sure there are any, for the reason that Islamic finance is now a fairly widely accepted structure. Yes, you will get individual problems in dealing with certain characteristics of the project to make it fit with your structure. But what we have seen in the last three or four years is a fairly established structure that Shari'ah committees are now likely to accept across the board. The picture is a lot more straightforward now--one of the issues with Islamic financing initially was that it was burdensome, because of the increase in documentation, which in turn increased costs. I think in the last few years the situation has reversed and people are entering into Islamic financing deals with a higher sense of certainty because Islamic financing structures don't allow much space for negotiation or 'wriggle room'. One of the good things about employing

Islamic financing now is that you have that certainty and it is seemingly relatively straightforward to implement these structures.

How do you see the Islamic finance sector developing in the next 12 months?

FB: The sector as a whole seems very buoyant at the moment and there seems no reason why that will come to an end. We expect continued growth, not just in the core Islamic finance markets in the Gulf and in Malaysia but also in the non-traditional Muslim majority countries, either by financial institutions or corporates. The byword is continued growth and perhaps continued innovation.

SC: I think there is a potential in this region for more Shari'ah-compliant project financings, particularly in respect of large infrastructure projects, with tranches of the funding coming by way of several different Islamic instruments, including by way of sukuk. There has been a huge growth in terms of infrastructure within the region and airplanes, railways and large scale infrastructure development projects are an obvious target for funding by way of Islamic structures.

SK: I would expect more of the same. I think we will have incremental developments on the existing structures but I would not expect radically new or different structures to enter the market. There will be more and more deals made on the same basis, but maybe by players that we haven't seen much of in the industry up until now--for example, the sovereign sukuk issued by the UK, South Africa and Hong Kong. Alongside this, other participants will enter the market--for example, new banks that haven't traditionally been identified as Islamic finance players. The industry will continue to grow and will probably exceed the $2trn mark next year.

AH: The sovereign sukuk market is on a dynamic upward trend, buoyed by increasing interest and participation from traditionally Muslim and non-Muslim governments. For example, industry reports (ie Moody's) project an additional $30bn-worth of government Islamic securities this year, bringing the estimated overall outstanding amount of sovereign sukuk to reach $115bn by the end of 2014.

TB: The sukuk issued by the UK finance industry will obviously be developed a lot further.

In terms of the Middle East, the industry is as strong as ever, the liquidity is there, and increasingly sponsors are focusing on European banks for funding.

The main trend I would expect is that there will be continued availability of funds over the next 12 months.

In your jurisdiction, at what stage is the Islamic finance market?

MP: It has grown significantly in the last year. The growth has shown itself in terms of who the liquidity providers are. Where previously, large international banks were the dominant force in transactions, now where those same transactions are coming forward for refinancing they have been backed by local banks entirely. This has been noticeable on some very big transactions. A recent example is the refinancing of the Dubai Mall--a $1.5bn transaction--in which no international banks took part. We have seen the same in Saudi and other regions--there is strong liquidity within the region.

JL: In the UK, there is an increase in appetite for more varied types of Islamic finance alongside the traditional murabaha financing of real estate. For example, we recently advised a newly established leasing company on a £35m ($58.5m) financing line from a Shari'ah-compliant UK bank. The company was established to provide asset financing services--including hire purchase, lease purchase, finance lease, sale, and lease back--to small and medium-sized enterprises and high-net worth individuals. Despite financing pressures on the SME market having eased a little over the last 12-18 months, businesses continue to struggle to access finance. This new solution is entering a new market for Islamic finance and is ideally suited to its principles.

Interviewed by Duncan Wood.

The views expressed by our Legal Analysis interviewees are not necessarily those of the proprietor.