Practical Lending and Security Precedents

Islamic Finance

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General Introduction

1 Background to the development of Islamic finance

O–001 Islamic-compliant financing is on a growth trajectory based on demographic trends, rising investible income levels and progress towards harmonisation with global regulation. Whilst the economies of developed economies are under strain, real estate market participants are looking to funding alternatives such as Islamic debt. Islamic banks originating in the countries of the Gulf Cooperation Council (GCC) could emerge as forces to be reckoned with in the new global order of finance.

On current estimates, 26.4 per cent of the global population will likely be Muslim by 2030 against 23 per cent in 2012. The proportion of Muslims in Europe is around 5 per cent of the population. This creates a large market and investor base to consider. The level of harmonisation is increasing between conventional and Islamic banking regulation, thus eroding barriers to entry. Islamic banking services are available in 39 countries on four continents. There are also significant growth opportunities given that the global penetration of Islamic banking is currently below 2 per cent in real estate finance and the Islamic debt market or *sukuk* accounts for only approximately 1 per cent of global debt issuance.

The United Kingdom has enjoyed an in-built advantage in its attempt to become the hub of Islamic finance in Europe. This is due to English law often being the governing law of international Islamic finance transactions. An Islamic finance transaction might involve a Swiss bank and a Middle Eastern counterparty, but they may well choose to use English law to structure their documentation in order to give flexibility and certainty to both sides. The UK government has announced plans to issue a £200 million government *sukuk* prior to April 2015. A *sukuk* is a bond-type instrument that is compliant with Islamic principles and is therefore attractive to investors that wish to invest in accordance with their religious beliefs. This would be the first *sukuk* to be issued by the national government of a G8 member country.

With Islamic finance growing 50 per cent faster than conventional finance, and with global Islamic investments set to reach $2.1 trillion in 2014, the proposed *sukuk* is symbolic of wider efforts by the UK government to foster growth in the Islamic finance sector in the country. This move could lead to more national governments outside the Islamic world looking to tap the *sukuk* market.

Sukuk are certificates that are compliant with Islamic (or *Shari'ah*) principles and represent an undivided ownership interest in an underlying tangible asset proportionate to the value of the holder's investment. The certificates entitle the holders to receive a pro rata share of the cash flows or revenues generated from the underlying tangible asset.

Sukuk are often compared to bonds; however, there are differences:

- *Sukuk* are not debt obligations as bonds are; rather, they represent the *sukuk* holders' ownership interests in a particular pool of assets.
- In compliance with *Shari'ah* principles, *sukuk* holders are not entitled to receive interest. Instead, they receive a portion of the revenues generated by the assets they own. If no revenues are generated, the *sukuk* holders are not entitled to any returns.

In the case of the UK sovereign *sukuk*, the underlying assets are likely to be rental streams on central government-owned real estate. Previous plans to issue such an instrument date back to 2006. However, partly owing to the exigencies of managing the financial crisis, and partly owing to value-for-money concerns, these plans failed to materialise. While the financial crisis has receded, for some market participants, the value-for-money concerns remain based on the additional expense of arranging Islamic-compliant structuring and the fact that the UK government has a vibrant gilt market from which it can borrow relatively cheaply. However, the collateral benefits of the issuance appear to have pushed the UK government to act.

Certain emergent factors indicate a high likelihood of these plans at last reaching fruition:

1. Since 2006, awareness and support of Islamic finance has grown among investors from Muslim countries including Malaysia, Indonesia and GCC countries including Qatar, the United Arab Emirates and Saudi Arabia. The *sukuk* market in 2012 was worth nearly $50 billion with more than 120 deals being entered into. This growth provides clear justification for capitalizing on the sector's growth in order to support constrained government finances.

2. The reputation of Islamic finance was ultimately burnished by the financial crisis, as Islamic institutions appeared to weather the crisis better than others that suffered from exposure to more opaque and synthetic securities. Islamic financial institutions must invest in products based on concrete underlying assets.
3. The issuance serves to mitigate the absence of risk-free sterling Islamic-compliant paper, which has resulted in treasury management challenges for the UK's five stand-alone Islamic banks. The lack of highly rated sterling *sukuk* constrains Islamic lenders because the Bank of England requires them to hold easy-to-sell assets as protection against a short-term funding shock. As such, they can only fulfil their regulatory capital requirements by purchasing US dollar-denominated instruments issued by the Islamic Development Bank.
   UK government instruments issued in sterling would enable these institutions to manage capital constraints more effectively. Furthermore, capital market *sukuk* instruments will, in the longer term, enable the sector to create pension and investment products attractive to Muslim investors.
4. Competition from other Western centres of finance, including Luxembourg and Ireland, has added impetus to the UK government's decision to act swiftly to secure the centre ground in this sector. While £200 million is a relatively small sum compared to the broader gilt market, the issuance in itself will establish protocols and procedures for future, possibly larger scale, issuing activity.

Further to this goal, Mr Cameron's announcement came alongside an announcement that the London Stock Exchange would be creating an Islamic market index, allowing investors to discover Islamic-compliant investment opportunities in the UK with greater ease.

The announcement of the UK Islamic government *sukuk* ultimately provides for three key outcomes relevant to other governments:

- encouraging investment in the domestic economy from Islamic-compliant investors through cementing knowledge and acceptability of the sector;
- stimulating regulatory reform in finance, tax and other areas by national governments competing to attract Islamic investors; and
- persuading major corporate institutions into further private *sukuk* issuances, given the normalizing effect of national governments being seen to use Islamic finance as a means of raising funds.

Investor demand for *sukuk* product has outstripped supply in recent years. The entry of global governments into this space will go some way to meet this demand. The UK's plans may be a pathfinder for other countries.

Nonetheless, other European jurisdictions have sought to attract Islamic finance transactions. For example, in 2010, Ireland introduced a tax neutrality regime for Islamic finance. Ireland has signed over 60 double tax treaties ensuring there is no double taxation for such structures (for example, treaties with Malaysia, Saudi Arabia and the United Arab Emirates). The Irish government has called an Irish government *sukuk* "an option" and Dublin is already well developed as a financial centre, the Irish Stock Exchange having listed its first corporate *sukuk* in 2005. However, Ireland only has a Muslim population of approximately 30,000, and this may hamper the development of the industry. Nonetheless in 2008, the Irish Financial Regulator introduced a dedicated team to help Islamic-compliant funds set up in Ireland.

Luxembourg is planning a government *sukuk* and is aiming to do so before the UK. The country has attracted over 40 Islamic funds.

France has a Muslim population of over 3.5 million. However, the political climate has not been conducive to the development of the industry over the past few years. The UK has had a first-mover advantage over France and the London property market attraction for Middle Eastern investors has also put the UK ahead.

Turkey is a country to watch. Straddling Europe and Asia, its 70 million-plus population is 99 per cent Muslim. Companies are allowed to issue Islamic-compliant debt and the first corporate *sukuk* has been undertaken by a leading Turkish bank.

2 Real estate as an asset class

O–002 Real estate has been an increasingly important asset class for Islamic-compliant transactions and banks, especially in the UK. Therefore, the remainder of this section will have a heavy emphasis on Islamic- compliant real estate financing. Islamic-compliant finance has proved to be an alternative source of funds entering the European real estate market as witnessed by such high-profile London real estate deals as the Chelsea Barracks and the Shard of Glass, the tallest building in Europe.

Islamic finance has used real estate as an investible, tangible asset class on which to base its financial structures. The focus has tended to be on prime or trophy assets; for example, hotels or large office headquarter buildings. However, since 2010, Islamic funds and Islamic banks providing mezzanine finance have multiplied. In such structures, a conventional senior bank lends the majority of the debt on an interest payment basis, the investors inject their equity and the mezzanine finance tranche is put into the structure in an Islamic-compliant way. This is a feasible way of ensuring that deals get done. The senior conventional bank and the Islamic-compliant mezzanine lender enter into an

intercreditor agreement which governs the way each loan is treated and takes account of the Islamic sensibilities of the mezzanine lender.

Student accommodation has been a major target for Islamic funds given the existence of rental guarantees, steady demand and upward-only rental payments. Further developments may be seen in this sector due to a broadening view of social infrastructure to include healthcare, education and social housing sectors. Prime residential properties are still a focus, with an Islamic-compliant fund launching in the UK in September 2011 to offer Islamic investors exposure to this market.

Real estate has been a primary focus of the Islamic finance industry since the 1990s. Islamic property investments began in the residential housing sector, but quickly moved to commercial real estate, and commercial property investments now play a large role in this sector throughout the world. Initial investments were, and continue to be, effected through investment fund structures. However, the emergence of the *sukuk* in 2003 saw significant changes in Islamic-compliant real estate finance. The *sukuk* structures are described further below.

3 What is Islamic-compliant finance?

O–003 Islamic-compliant finance is the conduct of commercial and financial activities in accordance with the *Shari'ah.* The *Shari'ah* is a set of rules constituting a guide to how a Muslim leads his or her life (it means, literally, "the Way" or "the Right Path") and is the divine law to Muslims as revealed in the *Qur'an* and the *sunna*.

Fiqh is the human understanding of that divine law; the practical rules of *Shari'ah* as determined by the *Shari'ah* scholars. The primary methodology used in this interpretation is *ijtihad* (literally, "effort"), or legal reasoning, using the "roots of the law" (*usul al-fiqh*). The roots (*usul*) upon which Islamic jurisprudence are based are the:

i. *Qur'an*, being the holy book of Islam and the word of Allah (a word for God used in the context of Islam);
ii. *sunna* of the Prophet Mohammed, which are the binding authority of his sayings and decisions;
iii. *ijma*, or "consensus" of the community of scholars; and
iv. *qiyas*, or deductions and reasoning by analogy.

The *Shari'ah* is comprised of principles and rules and, historically, its explanation and application has been largely oral. There are also a number of schools of Islamic jurisprudence (the four main schools of the largest branch of Islam (*Sunni*) are Hanafi, Hanbali, Maliki and Shafi). Historically, the different schools are frequently in conflict with respect to the application of the *Shari'ah* to different factual or structural situations. Even within a school there are variable interpretations and there is considerable divergence between Southeast Asia (particularly Malaysia, Indonesia and Brunei) and the Middle East and Western Asia (particularly Pakistan).

As expounded by *Shari'ah* scholars over the last 1,400 years, and as applied to Islamic finance, the *Shari'ah* is a full body of law. It covers virtually every aspect of commerce and finance that is addressed by a mature body of secular law. Thus, for example, it addresses contracts, concepts of consideration, legal capacity, mutuality, sales, leasing, construction activities, partnerships and joint ventures of various types, guarantees, estates, equity and trust, litigation and many other activities and legal structures. As such, it will influence all aspects of an Islamic-compliant real estate finance transaction or the formation of an Islamic investment fund as well as every aspect of the operation and conduct of a real estate business. However, Islamic finance transactions involving non-Muslim parties are governed by secular law, such as English law or New York law.

Shari'ah supervisory boards and Islamic finance regulators

O–004 In many real estate finance transactions, it may be that only one party is concerned if the deal is Islamic-compliant. In that case, it is important that each party represents to the other that it is satisfied with the Islamic compliance from its viewpoint and will not seek to use a later finding of noncompliance as a reason to renege on the transaction.

However, how does an investor that wants to make *Shari'ah*-compliant investments ensure that its investment is in fact in compliance? Most individuals do not have the expertise to make that determination for themselves. Over the last few decades, the mechanism that has evolved to provide comfort with respect to *Shari'ah* compliance is the *Shari'ah* supervisory board (a "*Shari'ah* Board" or a "Board").

Most Islamic banks, financial institutions and real estate companies and many of the higher-net-worth families and individuals in the Islamic world have retained one or more *Shari'ah* scholars that comprise a *Shari'ah* Board. Each Board oversees the complete range of investment practices, and the principles, methodology and activities of operation of all aspects of the business, entity or individual that has retained that particular Board. Each Board is comprised of a different group of individual scholars. Each Board renders determinations with respect to structures and undertakings that are confidential to the entity that retains that Board, with the result that explanation of the *Shari'ah*, as applied in competitive financial markets, has occurred in isolated pockets rather than a manner that is coordinated across markets or even schools of Islamic jurisprudence.

Shari'ah Boards may be comprised of one scholar or a group of scholars. Frequently, a Board is comprised of one or more of the leading "internationalist" scholars, some regional scholars and some local scholars. Frequently, the internationalist scholars (who most often populate the Boards of the major banks and investment funds) have expertise and experience in sophisticated financial transactions in a wide range of jurisdictions throughout the world, including various secular tax and finance laws and other legal and regulatory regimes and the interplay between those regimes and the *Shari'ah* as applied and considered by specific investors.

The Bahrain-based Accounting and Auditing Organisation of Islamic Financial Institutions (AAOIFI) and the Kuala Lumpur-based Islamic Financial Services Board (IFSB) are strong forces in promoting greater uniformity across the schools and across the divide between Southeast Asian jurisdictions and Middle Eastern and Western Asian jurisdictions. AAOIFI standards prescribe additional international financial reporting standards to reflect the specifics of Islamic finance. The IFSB advises domestic regulators on how Islamic financial institutions should be managed. It has published standards on stress testing, liquidity, management, capital adequacy and corporate governance.

In April 2012, AAOIFI introduced seven new standards for Islamic financial institutions addressing issues including financial rights, bankruptcy, capital protection and contract termination. As a greater number and variety of multi-national conventional banks and investment banks enter, and expand their range within, the Islamic finance field, there will be increased pressure toward uniformity, if only to facilitate the implementation of internal policies and procedures of these institutions.

The Board will perform a number of different roles, including, typically, the following:

i. participation in product development activities;
ii. review and approval of the fund or entity structure and its objectives, criteria and guidelines and issuance of a *fatwa* in respect thereof;
iii. review and approval of disclosure and offering documents and issuance of a *fatwa* in respect thereof;
iv. review, approval and oversight of investment and business operational structures and methodology, and issuance of a *fatwa* in respect thereof;
v. ongoing review, oversight and approval of transactional or operational variances or applications to unique or changing circumstances; and
vi. annual audit of the operations of the fund or entity and issuance of an annual certification of *Shari'ah* compliance.

A *fatwa* (singular; *fatawa* is the plural) is a written certification of a *Shari'ah* scholar or Board. It has no binding legal effect under secular law in Europe. Over recent years, *fatawa* have been structured more like Anglo-American legal opinions, with discussion of the underlying *Shari'ah* precepts. It is common to see a copy of a more general *fatwa* reproduced in the offering circular of a *sukuk* issue.

Shari'ah principles

O–005 The outlook of the *Shari'ah* on finance is as a type of "ethical investing": it prohibits investment in, or the conduct of, businesses whose core activities:

i. include the manufacture or distribution of alcoholic or pork products or, in the case of certain *Shari'ah* Boards, firearms;
ii. have a significant involvement in gaming (gambling, including casinos), brokerage, interest-based banking or impermissible insurance;
iii. include certain types of entertainment elements (particularly pornography); or
iv. have impermissible amounts of interest-based indebtedness or interest income.

These activities are known as "Prohibited Business Activities". The growing, manufacture and distribution of tobacco may also be included by some *Shari'ah* Boards within Prohibited Business Activities. Cinema and music generally may also be included by some Boards. Although this is a broad interpretation of the entertainment exclusion it is attributable to the pornographic elements of these industries. Hotels may also be included because of the presence of alcohol in bars and mini-bars or in-room entertainment. Entities that have Prohibited Business Activities may not be tenants in properties owned and leased by a *Shari'ah*-compliant investor. Clearly this will exercise a fundamental influence on nature and operations of funds and businesses.

However, sometimes a pragmatic view must be taken by *Shari'ah* scholars in order to expand the number of properties available for investment. Many large office buildings and complexes have tenants that engage in Prohibited Business Activities, such as retail branches of conventional banks, restaurants that serve alcohol or supermarkets or convenience stores that sell pork, wine and beer. Under a strict interpretation these properties would be an impermissible investment. De minimis rules have been developed that allow investment in these properties for certain impermissible uses. For example, if the branch bank serves a retail market, there are insufficient other banking opportunities in the defined area, and the branch bank occupies a small percentage of the property (say, 1 per cent or less), some *Shari'ah B*oards will permit the property acquisition and allow renewal of the lease to that branch bank.

A fundamental *Shari'ah* principle is the prohibition of *riba*, best known by its prohibition on the payment or receipt of interest. This rule affects every aspect of the manner in which a *Shari'ah*-compliant transaction is structured and implemented. In the securitisation field, it (and other principles) precludes the pooling of conventional mortgages, credit card receivables and all interest-bearing debt instruments.

In the case of joint ventures (including partnerships which are a popular vehicle for joint ventures), numerous principles address allocation of work, profit and loss allocations and distributions and virtually all other operational matters. For example all distributions of profits and losses must be pro rata and preferred shares are not permissible. These rules affect real estate business, fund structures, many operational activities and, directly, *sukuk*. Partnerships can be used in a number of ways to bring capital and expertise into the joint venture. In one type of partnership (*mudaraba*), one partner contributes services and another contributes capital. Should the joint venture suffer a loss, only the capital provider may be penalised in cash. As an alternative there are other types of partnerships (*sharikat* and *musharaka*) which can be used. In these partnerships work and capital contribution may be allocated across all partners with corresponding loss sharing amongst them.

Shari'ah principles in relation to leasing are particularly important because leasing is the primary tool used in the implementation of *Shari'ah*-compliant transactions. The fully repairing and insuring lease which is common in leasing is prohibited. The lessor may not pass structural maintenance obligations, or corresponding obligations such as the maintenance of buildings insurance, to a lessee. The end-user tenant may not have Prohibited Business Activities and the lease to the end-user tenant must itself be *Shari'ah* compliant. These principles have a critical impact on Islamic securitisations.

Middle Eastern societies are heavily focused on trading activities, with the result that the *Shari'ah* precepts applicable to sales are especially well refined. Leasing is treated as a type of sale–sale of the temporary possession (or usufruct) of property. One can generally sell only tangible assets although there are some limited exceptions. Debt cannot be sold as a result, nor can other financial instruments that do not represent an ownership interest in tangible assets, property that one does not own and possess. These principles have a major influence on the structure of Islamic bonds and securitisations. In addition, there are very particular rules addressing delivery, receipt, ownership, allocation of risk, down-payments and virtually all other aspects of sales transactions. These rules affect both the ability to create secondary markets and the tradability of securitisation instruments.

Most types of conventional insurance and investments in conventional insurance companies are prohibited under *Shari'ah* precepts largely arising out of the prohibition on gambling and uncertainty. However the unavailability of *takaful (Shari'ah*-compliant insurance) has led to some practical accommodations to the prohibition on the use of insurance.

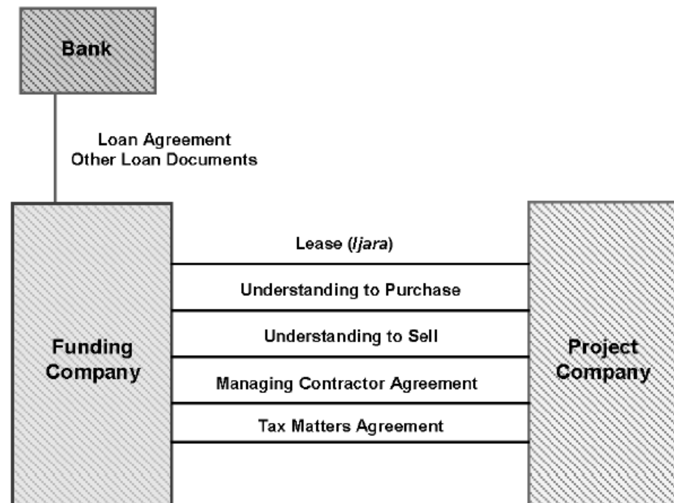
4 Islamic real estate finance structures

O–006 To help understand Islamic real estate financing, this chapter will outline certain of the component structures of Islamic-compliant finance. These are primarily the lease (*ijara*) and sale (particularly *murabaha*) structures. Two structures, the *mudaraba* and *musharaka*, are joint-venture structures. Each structure is briefly summarised in this section, and each of these structures is also the basis or a component of Islamic bond and securitisation structures.

Ijara (lease) structures

O–007 The predominant acquisition and operating financing structure in Islamic real estate finance in Europe is the *ijara*. Figure 1 shows a basic leasing structure. This example assumes 60 per cent conventional interest-based financing and 40 per cent contribution by the *Shari'ah*-compliant investors; these percentages will vary with each transaction.

Figure 1 – ***Ijara Structure***



The investors make their investment into the "Project Company". For tax reasons, this investment is usually made through a fund and at least one entity is usually inserted in the structure between that fund and the Project Company. A special purpose vehicle, the "Funding Company", is established to acquire and hold title to the property in which the *Shari'ah*-compliant investment is to be made (the "Property"). The Project Company contributes its investment (40 per cent of the acquisition price) to the Funding Company. A conventional interest-bearing loan is made by the "Bank" to the Funding Company (equal to 60 per cent of the acquisition price). The Funding Company then acquires the property from the seller.

Then, the Funding Company enters into an *ijara* with the Project Company, as lessee. The rent payable under the *ijara* is identical to the debt service on the conventional loan from the Bank and provides the funds to pay that debt service.

The lease must be *Shari'ah* compliant including:

i. the lessor must have ownership of the real estate prior to leasing it;
ii. the lease period must be specified;
iii. the real estate asset must continue to exist throughout the lease term;
iv. the lessor must be responsible for maintaining and insuring the property.

Future rents cannot be accelerated under a *Shari'ah*-compliant lease. Given that the outstanding principal is paid through the *ijara*, an acceleration mechanism is necessary outside the *ijara* itself. The Understanding to Purchase performs that function (it also mirrors all mandatory prepayment provisions of the Bank loan). The Bank, through the Funding Company, "puts" the Property to the Project Company at a strike price equal to the outstanding principal (and other outstanding amounts).

The Project Company may also want to sell the Property during the period that the loan is outstanding. The Understanding to Sell provides the mechanism (and also mirrors the voluntary prepayment provisions of the Bank loan).

Under the *Shari'ah* rules noted above, and others, a lessor cannot pass structural maintenance and insurance obligations to a lessee. However, a lessor can hire another entity to perform those functions. In this case, the Funding Company hires the Project Company to perform those activities pursuant to the Managing Contractor Agreement.

Finally, the Tax Matters Agreement provides that the Project Company is the tax owner of the Property and for income tax (and other) purposes, this is a loan from the Bank to the Project Company. The Tax Matters Agreement outlines the components as between the conventional loan documentation and the *Shari'ah*-compliant leasing documentation.

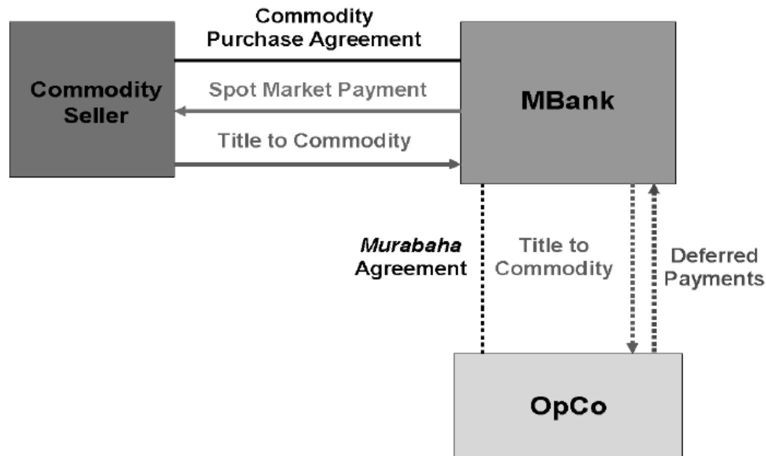
This structure is used in essentially all *Shari'ah*-compliant commercial real estate transactions in Europe (with some relatively minor country variations, as appropriate, under relevant tax and real estate laws) and, as noted below, it is easily modified to effect a *Shari'ah*-compliant securitisation.

Murabaha (sale at a mark-up) structures

O–008 The *murabaha* structure results in "OpCo" obtaining a cash amount that it can then spend towards purchasing a real estate asset. In Europe, a number of property investors have used this structure as a banking tool to finance investor purchases of real estate.

It is a widely used sales structure, and one that is used in some *sukuk* and in many working capital financings. Most simply defined, the *murabaha* is a sale at a mark-up. Figure 2 shows a simple *murabaha* transaction.

Figure 2 – Basic *Murabaha Structure*



In the simple *murabaha*, OpCo, a client of "MBank", wants to purchase a commodity, piece of equipment, or other asset. OpCo negotiates the terms of the purchase, including payment terms and precise specifications, with the "Commodity Seller". OpCo then asks MBank to finance the purchase of that asset.

OpCo and MBank enter into a *Murabaha* Agreement pursuant to which MBank agrees to supply to OpCo a commodity or asset meeting the precise specifications that were negotiated with the Commodity Seller. The *Murabaha* Agreement will require OpCo to make payment to MBank for that commodity on a deferred-purchase basis.

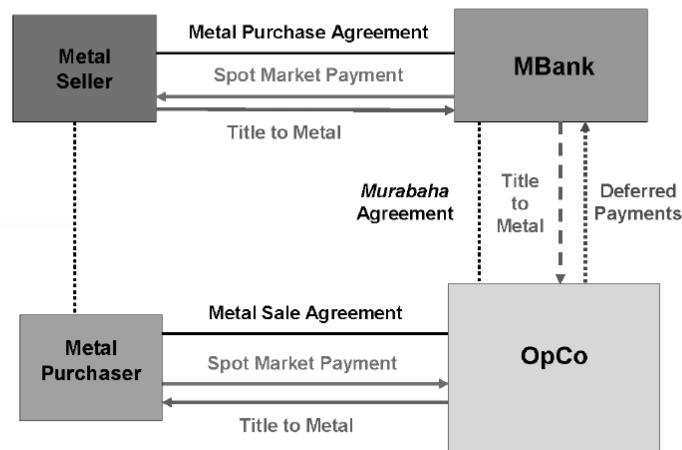
MBank, in turn, will enter into a Commodity Purchase Agreement with the Commodity Seller and will purchase the commodity from the Commodity Seller for immediate payment in full.

Upon accepting delivery of the commodity, MBank will fulfil its obligations under the *Murabaha* Agreement by re-selling the commodity to OpCo. While there are numerous other applicable rules, two are of particular note:

i. MBank must have ownership risk with respect to the asset; and
ii. OpCo can, under most schools of Islamic jurisprudence at the present time, act as the agent for MBank in completing the arrangements between MBank and the Commodity Seller.

A working capital *murabaha* is shown in Figure 3. This structure is used, in variant forms, in *sukuk* structures.

Figure 3 – Working Capital *Murabaha*



The transaction is substantially identical to the *murabaha* transaction shown in Figure 2. The additional element is that OpCo, upon taking title to the commodity (here, a permissible metal), immediately sells that metal to the "Metal Purchaser" for a cash payment at the same spot market price as obtained in MBank's purchase of that metal from the "Metal Seller" (fees ignored). The Metal Purchaser and Metal Seller are frequently affiliates. The net result is that OpCo ends up with cash equal to the spot-market price of the metal and a deferred *murabaha* payment obligation to MBank in respect of that amount plus a profit factor.

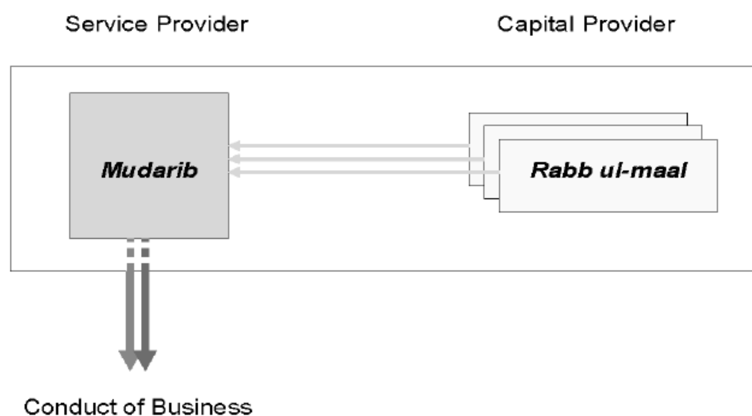
In the real estate context, UK and Irish banks have offered *murabaha* by taking notional possession of a property's title at closing and then selling the property to the investor at a higher price.

If the bank does not want to, or cannot, acquire title for regulatory reasons, then the bank appoints a transacting party to act as its acquiring agent. The agent then executes the sale in favour of the ultimate investor.

Mudaraba (service provider–capital provider) structures

O–009 A *mudaraba* is a type of joint venture and is a key method for organising and acquiring real estate investments. It is most frequently formulated as a limited partnership, a limited liability company or a fund. The base structure involves one partner providing services and management (the *mudarib*). One can equate a *mudarib* to a fund manager. In that case, the *mudarib* may sub-contract its duties to an experienced real estate management professional. Usually, the *mudarib* does not provide cash or other in-kind capital. Some *Shari'ah* Boards prohibit *mudarib* capital; all prohibit it without the consent of the other partner(s). The other partner(s) (the *rabb ul-maal*) provides capital, in cash or in kind, and generally may not interfere in the management or service component. A simple *mudaraba* arrangement with multiple capital providers is shown in Figure 4.

Figure 4 – *Murabaha Structure*



As a general matter, and with a few modifications, a conventional limited partnership agreement works well to structure a *mudaraba*. For example, while a capital provider may not interfere in the management function, most *Shari'ah* Boards permit "minority rights" protections such as are afforded to limited partners, and other rights are permissible in *mudarib* default, breach and infringement scenarios.

The partnership or fund then acquires real estate assets most commonly through *ijara* or *murabaha* structures. Profit in a *mudaraba* is that amount that exceeds the capital after deduction of all allowable *mudaraba* expenses. Conversely, loss is the decrease in the *mudaraba* capital. The critical *Shari'ah* rule pertaining to losses is that all losses are borne by the capital provider (the service provider has lost its services and is not seen as having incurred pecuniary losses). Profit allocations must be specified, and must be pro rata (although formulas specifying different allocations upon satisfaction of hurdles have been accepted). Importantly, there can be no predetermined or conclusive profit allocation to any of the parties and arrangements allocating all profit to a single party are impermissible. More difficult issues arise with respect to scenarios in which a clawback of distributions may be necessary, as with losses subsequent to distributions.

Musharaka (capital provider) structures

O–010 *Al-sharika* is a partnership for profit, *sharikat ul-amwaal* is a property partnership, and *al-musharaka* is a finance method derived from a partnership contract in which a bank participates with one or more clients. The term *musharaka* refers to a wide range of partnership or joint venture arrangements. In a *musharaka*, each of the partners contributes capital, and there is significantly greater flexibility in allocating management responsibilities among partners; joint rights of management are frequent and usual.

Limited partnership agreements are also useful models for structuring *musharaka* arrangements. Profit and loss definitions are mainly the same as with *mudaraba*, with some fundamental differences. Profits may be allocated in accordance with a points system, and that points system may be structured to take account of the amount of capital contributed and the period of participation. Profit from a specific period or operation may not be allocated to a specified partner, nor may a lump sum be allocated to a specific partner. In the majority view, losses, up to the amount of a partner's capital contribution, must be distributed in accordance with the relative capital contributions of the partners. A partner may not assume liability for the capital of another partner, including by way of guarantee.

Shari'ah rules applicable to purchases and sales of interests (*hissas*) from one partner to another (as well as *murabaha* rules) form the basis for securitisation transactions involving *musharaka*.

5 Two techniques and one transaction: combining conventional and Islamic-compliant finance

O–011 Co-financing by conventional lenders and Islamic-compliant financiers is increasingly common as businesses seek multiple sources of funding. The structural differences between these tranches mean that issues surrounding repayment, prepayment, security, voting and enforcement need to be documented carefully. Combining two or more lenders in any deal can involve differing viewpoints and commercial tensions. What happens when those lenders have different approaches to the fundamental principles of financing itself?

This section explores the solutions that have been found and the issues that remain when a conventional lender and an Islamic-compliant institution seek to co-finance a transaction. It also includes a case study from a real estate finance transaction showing how this combination can work in practice.

Bodies of law

O–012 It is key to bear in mind that *Shari'ah* principles in relation to finance do not form a codified system of law and may be subject to varying interpretation by Boards that oversee the activities of Islamic-compliant financial institutions. Interpretations of Islamic principles can differ substantially. Accordingly, it is important for a conventional lender to identify any specific *Shari'ah*-related issues early in the process of working with an Islamic-compliant financier.

In the vast majority of cases co-financing documentation will be governed by English, New York or other national law, so that the Islamic-compliant principles of the transaction need to be documented via such national law.

Documentation

O–013 Often on a co-financing, it is possible to include many of the usual representations, undertakings, events of default and boilerplate provisions in a single document, for example, a common terms agreement, to which both sets of financiers are a party. These types of clauses do not need to be tailored for the Islamic-compliant financier as it has a common interest in these types of provisions being included. However, the documentation that sets out the terms of utilisation, prepayment and repayment mechanisms for both the conventional facility and the Islamic-compliant financing structure will need to be kept separate as the fundamental principles underpinning Islamic-compliant financing demand these are treated differently. This core document may also deal with the treatment of amendments or waivers (particularly in relation to clauses that are common to both the conventional facility and the Islamic-compliant financing structure), pro rata drawdowns and the application of enforcement proceeds.

Drawdown

O–014 In a conventional loan, the principal amount may either be drawn in one amount or in stages during an availability period. This will not always be the case with an Islamic tranche, for example an *ijara* facility. Where the asset exists when the Islamic-compliant facility is entered into, the supplier or manufacturer must be paid the full purchase price upfront. However, if a forward lease is used in conjunction with an *istisna'a* (Islamic-compliant project financing structure), the payments could be made by instalments or at the end of the *istisna'a*. It is important to ensure that the *istisna'a* stage payments match the drawdown profile of the conventional lenders.

Payments

O–015 In order to coordinate payments to financiers, interest periods under a conventional loan should correspond to the relevant periods under the Islamic financing (which may, for example, depend on lease periods, deferred payment periods or periodic distribution dates) so that payments are made to the Islamic financiers and the conventional lenders at the same time, if this is the commercial deal.

Treatment of cash

O–016 One of the underlying principles of Islamic-compliant finance is that interest should not be charged or received by a compliant financier. This means that a return to the financier is structured in other ways, such as a rental or profit payment. In a co-financing, payments are often made in accordance with a common cash flow waterfall with cash being applied at a particular level of the waterfall towards payment of principal and interest under the conventional facility and, for example, the deferred purchase price or base rental and profit on the Islamic-compliant financing structure on a pro rata and pari passu basis.

A minor exception to this principle is that although certain amounts may be claimed by financiers on the conventional facility on an immediate indemnity basis (for example, increased costs), financiers of the Islamic-compliant financing structure may only be able to claim the equivalent amount at a later date because they will be factored into the deferred purchase price or rental payable by the obligor in a subsequent period.

Intercreditor issues

O–017 In certain circumstances, Islamic financiers and conventional lenders may enter into formal intercreditor documentation, documenting the priority of payments and the ranking of security. This is most likely to be the case where structural subordination (illustrated in the case study below) is not possible and where the same entity is the borrower under both the conventional and *Shari'ah* finance. An intercreditor agreement between Islamic-compliant financiers and conventional lenders is likely to deal with many similar matters covered in such an agreement between solely conventional lenders, with such adaptation as may be required to account for the Islamic financing structure and the compliance requirements of the parties.

The intercreditor agreement may need to identify the respective rankings of payments under the Islamic and conventional finance documents to deal with allocation of income or proceeds following acceleration. However, Islamic financiers may regard it as important that the payment waterfalls dealing with the process of payment are kept separate in the Islamic-compliant and conventional finance documentation and only cross-referenced in the intercreditor agreement. This is to avoid the possibility of the payment of interest to the conventional lenders tainting the Islamic-compliant element.

If the claims of the financiers on the Islamic-compliant financing structure rank pari passu with those of the financiers on the conventional facility, the intercreditor arrangements are usually relatively straightforward. However, issues can arise in determining the intercreditor voting entitlements.

For example, if a *murabaha* facility is used as the Islamic-compliant financing structure, the deferred purchase price payable by the obligor at the end of the relevant period is fixed at the start of that period and includes a profit element. If this profit element is counted towards the intercreditor voting entitlements, it artificially inflates the entitlement of the Islamic-compliant financiers compared to that of the conventional lenders, whose voting entitlements are usually determined only by reference to the principal amount outstanding at the relevant time. Thus, conventional lenders may require this profit element to be excluded from voting entitlement calculations.

Prepayment

O–018 Most Islamic-compliant financiers will permit the obligor to make prepayments. However, in the case of *murabaha* facilities, there are different views as to what happens to the profit element of the amount that is prepaid. Some Islamic-compliant financiers will commit to a partial rebate of the profit element, whereas others will insist that any such rebate has to be discretionary, albeit with a commercial understanding to provide such rebate at the relevant time.

Similarly, some Islamic-compliant financiers will require an indemnity for break costs in the event of prepayment (as is usual in the case of a conventional facility) either because they source their funds on the conventional market or they feel entitled to this amount given that they are taking the same risks as the conventional lenders. Others will not be allowed to charge break costs on the basis that their participation in the Islamic-compliant financing structure has not been funded privately and not in the interbank market. The Islamic-compliant interbank market is currently extremely limited although there are moves to grow the market, for example via the International Islamic Liquidity Management Corporation.

Title to security

O–019 Although there is not a general prohibition on the taking of security under Islamic law, some scholars object to the English law concept of a floating charge on the basis that the assets that are the subject of the relevant security interest are not specifically identifiable. This can raise intercreditor issues because the conventional lenders may want as extensive a security package as possible. Islamic financiers may want to take security over a specific pool of assets that can be readily identifiable. One of the key principles of Islamic finance is that of certainty. If so, then the assets of the obligors will need to be allocated between the different types of financiers for security purposes.

Some documents, such as purchase undertakings in Islamic finance structures, create proprietary or contractual interests in favour of the Islamic financiers. Often, the purchase undertakings cannot be mortgaged. The ability of the Islamic financiers to exercise their rights under a purchase undertaking will usually be triggered by an event of default. However, how and when those rights are exercised will need to be co-ordinated with the exercise of the rights of the conventional lenders.

A security agent may hold the security interests under the intercreditor arrangements for the benefit of both the conventional lenders and the Islamic financiers. A conventional lender will not own assets, but will have security interests granted in its favour. However, depending on the Islamic facility (such as an *ijara* or *musharaka*), an Islamic financier may have title to certain assets. In an *ijara* financing it will own the leased asset and in a *musharaka* financing it will own an equity interest in the partnership or joint venture.

Where assets are in the name of the Islamic financier:

- An intercreditor arrangement should set out the agreement to share any proceeds on disposal of the project or any assets on an event of default.
- Depending on the applicable law, it may be possible for the Islamic financier to grant a security interest in favour of the security agent as long as the monetary obligation being secured can be determined.
- If a special purpose vehicle (SPV) is used, the SPV could grant the security interest to the security agent so that any title transfer to the Islamic financier would be subject to that security interest.
- If the asset that the Islamic financier owns is merely a contractual interest (which may be done so that registration fees are not incurred on the transfer), the obligor (in whose name the legal title remains) could grant the security interest to the security agent.

Enforcement

O–020 In certain types of Islamic financing, on a default, the amount claimed will include a profit element that is calculated over the full finance period. In contrast, with a conventional financing, the amount of interest is that which has accrued up to the occurrence of an event of default. The conventional lenders may, therefore, feel that the Islamic financiers' pro rata entitlement to a share in any enforcement proceeds (based on amounts outstanding) means that they benefit more than the conventional lenders. A sharing mechanism must, therefore, be found if equality is the commercial deal.

The typical approach in relation to enforcement proceeds is that they are held by a designated security agent and applied in discharging the amounts outstanding under the conventional facility and the Islamic-compliant financing in accordance with a pre-determined order of priority. In some co-financing transactions, Islamic financiers may require that the portion of the enforcement proceeds earmarked for the Islamic-compliant structure be held in a separate account so as not to be tainted by the proceeds that are to be used to repay the conventional facility. Issues can arise when the enforcement proceeds include an element of interest (for example, interest accrued on cash balances in an account of the security agent or interest on a sum awarded by a court judgment). Financiers that are Islamic-compliant may be unable to share in these amounts, in which case, they may require an equalisation payment mechanism to uphold the principle of equal treatment.

Real estate financing case study

O–021 A recent transaction involved the use of conventional and Islamic-compliant financing to finance the purchase of a major city centre department store. The investor group had incorporated two special purpose vehicle companies—Holdco and Propco, Holdco being the parent of Propco. Holdco was to receive the Islamic-compliant finance and Propco to receive the conventional loan. There was, therefore, an immediate structural separation between the tranches of finance. This deal must be seen on its own facts as other Islamic-compliant financiers may immediately have an issue with a subsidiary of its customer taking on conventional debt.

The Islamic financiers comprised the investors and an SPV company incorporated for the purpose of the transaction (the ISPV). The Islamic financiers had their own Board of scholars who approved the whole transaction. However, there was a representation in the documentation that a party that itself abided by Islamic principles should not seek to later rely on this status to avoid or disclaim a contract:

> "Insofar as it wishes or is required for any reason to enter into transactions, agreements and arrangements which comply or are consistent with the principles of the *Shari'ah* ('*Shari'ah* compliant' or '*Shari'ah* compliance'), each party has made its own investigation into and satisfied itself as to the *Shari'ah* compliance of this agreement and all necessary action to confirm that this agreement is a *Shari'ah*-compliant agreement has been taken (including the obtaining of a declaration, pronouncement, opinion or other attestation of a *Shari'ah* adviser, board or panel relevant to it where required)."

The investors put their cash into the ISPV. Then the ISPV and the Holdco entered into a *tawarruq* (or reverse/monetising *murabaha*). This is a technique whereby the ISPV funded Holdco in order for Holdco to buy an asset (in this case, a quantity of platinum) on a deferred repayment basis (plus an agreed mark up). Holdco immediately resold the platinum on the spot market for cash to a third party. This transaction meant that Holdco had an amount of funds in order to make a shareholder loan into Propco. That shareholder loan was interest bearing, which was approved

within the context of this transaction; however, an equity investment or non-interest bearing loan by Holdco into Propco may have been required in other circumstances.

Propco then borrowed conventionally from a bank and used that loan and the shareholder loan from Holdco to purchase the investment property.

The terms of the conventional finance documents controlled Propco's cash flow so that rental and other income from the property was paid into an account controlled by the conventional bank and went first to service payments due in respect of the conventional loan. In addition, the conventional finance documents limited Propco's ability to distribute funds to its parent, Holdco. Dividend payments were restricted so that they could only be made in certain circumstances, such as while no default was continuing under the conventional finance documents. HoldCo's shareholder loan to Propco was formally subordinated in a subordination deed between the conventional bank, Propco and Holdco. Whether purely as a result of the structure and the conventional bank's control of cash flow, and/or by a formal subordination deed, the effect was that the Islamic-compliant finance was subordinated to that of the conventional bank.

Propco granted conventional security over the property and its other assets to the bank. In addition, Propco entered into a sale undertaking in favour of the ISPV, which gave the ISPV the right to call for the real estate to be transferred to it. This may seem broadly analogous to third-party security for Holdco's payment obligations under the *tawarruq*, but there were crucial differences:

- The sale undertaking was not expressed to be granted by way of security.
- The ISPV's rights pursuant to the undertaking were not exercisable only when Holdco defaulted.

Given the second of these points, the conventional lender required comfort that its security had priority over the ISPV's rights under the sale undertaking.

In this transaction, the effect of registering the conventional lender's security at the Land Registry gave rise to a restriction on the title. This meant that the sale undertaking could not be exercised without the conventional lender's written consent. That ought to remain the case, whether or not the sale undertaking was registered as an option over the land in question, provided there was sufficient evidence of the parties' intentions that the sale undertaking was to be subject to the conventional lender's security.

As this type of co-financing becomes more common, advisers will need to be adept at understanding and combining finance tranches with contrasting structures.

6 UK Islamic Banks

O–022 All the UK Islamic Banks are relatively recently established in comparison with conventional banks. First to be established was Islamic Bank of Britain (IBB) in 2004. Although we refer to it as a UK bank, in fact it has been owned by Qatar International Islamic Bank since June 1, 2011. Its chairman is chief operating officer of the Qatar Investment Authority. IBB is the only wholly Islamic-compliant UK retail bank. It serves individual customers and small businesses. It has about seven branches throughout the country and is headquartered in Birmingham. It runs a branch agency model, for example sharing office space with local estate agents. IBB's products include a Home Purchase Plan and a 'Buy to Let' Purchase Plan. In the latter, the customer puts down a 25 per cent deposit for the property and the Bank acquires the rest. The customer then pays a rental rate of 5.49 per cent and an arrangement fee of 1 per cent. It follows a joint ownership and rent model.

The European Islamic Investment Bank (EIIB) was formed in 2005. EIIB now looks primarily to the GCC countries for its investments and clients. In its annual report of 2010, its chairman said "EIIB's funding strategy has shown itself to be over-optimistic and incompatible with the dramatically changed business environment resulting from the global recession". It had previously advised in several areas, including investment management, private equity and banking. EIIB underwent a restructuring in November 2011 and then on January 6, 2012, EIIB made a major investment in Rasmala Holdings. Rasmala is a leading investment bank in the GCC and Egypt and is licensed by the Dubai Financial Services Authority. Rasmala has about 140 people in the region. There will be a leading management role for EIIB and its stake was paid for by the closure of one of its existing equities funds.

The Bank of London and the Middle East (BLME) was established in 2006. It is an Islamic-compliant wholesale bank. Its activities include leasing deals in the transport and equipment sectors based on *ijara* structures. BLME lends in the real estate and real estate construction areas. In May 2011, it established a Light Industrial Building Fund. The first purchase for the Fund was a 40,000-square-foot light industrial unit in Bournemouth. The Fund has an expected five-year life cycle and a target final value of £200 million. The Fund is expected to make annual cash distributions.

Gatehouse Bank was formed in 2007. It is ultimately under Kuwaiti ownership. Gatehouse has a reputation and specialisation in the real estate sector. It has made approximately £300 million of real estate investments in the past two years. The asset classes include office space, UK student accommodation, industrial facilities and US properties. Gatehouse has also partnered with others in new ventures: GNL Insurance, the world's first Islamic-compliant

insurance broker; and GSH Kuwait, a real estate advisory firm. Recent real estate transactions by Gatehouse include, in January 2012, the sale of a Californian medical facility, which it had held for 18 months and, in the same month, the purchase of a data centre in the south of England.

7 The application of real estate finance structures in *sukuk*

O–023 Having reviewed some of the typical Islamic finance structures used in real estate acquisition and investment, the next section of this chapter shows how such structures have been adapted to develop the market for *sukuk* (*Shari'ah*-compliant capital markets instruments) based on real estate assets. Although a number of significant *sukuk* transactions defaulted (or faced near default) in the global financial crisis, with issuances of new instruments being very limited during this period, one of the most active areas of Islamic real estate finance both before and after the global finance crisis has been *sukuk* issuance.

Asset-based versus asset-backed

O–024 Structurally, *sukuk* can be broken into two types of transactions–asset-based or asset-backed. Asset-based issuances are sometimes referred to as Islamic bonds, whilst asset-backed issuances are generally referred to as securitisations. There have only been a limited number of *Shari'ah*-compliant securitisations, with the vast majority of *sukuk* issuances being asset-based transactions.

In both types of *sukuk*, the issuing entity (which will usually be an orphan SPV company, as used in commercial mortgage-backed securities (CMBS) transactions) will issue certificates into the capital markets. The proceeds from the issuance will, depending upon the structure being utilised, either be used to purchase an asset (such as in an *ijara* structure), be invested (as in a *musharaka* or *wakala* (agency) structure) or purchase a portfolio of assets (as in a securitisation). It should be noted that in all these structures, the certificates issued are an indivisible ownership interest in the assets of the issuing vehicle. This can cause some tax issues, which will be discussed later in this chapter.

The difference between the asset-backed structures and asset-based structures lies in the type of credit risk which the investors are taking under each structure.

A *Shari'ah*-compliant securitisation is structurally similar to a conventional securitisation. The issuing vehicle issues certificates and uses the proceeds of the issuance to purchase a portfolio of assets (such as *Shari'ah*-compliant mortgages). The issuing vehicle declares security over this portfolio of assets, and in the event of a default, the security trustee enforces this security and may liquidate the assets. As with conventional securitisations, the investors will not have recourse to the seller of the assets on a default; their recourse will be limited to the assets of the issuing vehicle.

As such, the only structural difference between a *Shari'ah*-compliant securitisation and a conventional securitisation is the fact that the instruments are certificates evidencing an ownership right in the assets in relation to the former rather than a debt instrument in relation to the latter. As mentioned earlier, there have been a very limited number of *Shari'ah*-compliant securitisations issued (although a larger number have been structured), the most well known of which was the RMBS deal issued by Tamweel in 2008, under which a portfolio of *Shari'ah*-compliant mortgages originated by Tamweel was securitised.

Conversely, and from a credit perspective, asset-based *sukuk* structures are most similar to a corporate bond. Islamic bonds are based upon the credit of an entity that is participating in the transaction (which may be the seller, guarantor or other credit support provider and will be referred to as the "originator"). On execution of the transaction, an asset will be sold to the issuing entity by the corporate or funds will be invested with the originator. This asset will generate an income for the issuing vehicle. This income will be generated from payments made by the originator under the contractual arrangements with the issuing entity. However, often there will not be any security over the assets of the issuing entity to secure the certificates (and even where transactions do include security over the assets, it may be that the value of this security is difficult to ascertain). Only a minority of *sukuk* are structured to give *sukuk* holders direct recourse to the underlying asset. The majority are structured so that, following a default, the only recourse is to require the originator to repurchase the income-generating asset (either at a fixed price where fixed-price undertakings are permitted by AAOIFI or at some other price as set out in the documents).

It should be noted that a large number of *sukuk* issued have essentially been capital-raising exercises for the underlying corporate, albeit using real estate assets as a way to access this market. However, there have also been a number of *sukuk* transactions which have been used to raise capital for certain real estate and other projects.

Further, a *sukuk* issuance may be one element of a real estate financing. For example, a CMBS transaction could be executed which included both conventional bond financing as well as a tranche structured as a *sukuk*. There is increased market interest in the establishment of multi-funding platforms that incorporate tranches of conventional and Islamic finance and there is no reason why these structures cannot be applied to the commercial real estate market.

AAOIFI *sukuk* standard

O–025 Under the AAOIFI *sukuk* standard, *sukuk* are defined as certificates of equal value put to use as common shares and rights in tangible assets, usufructs and services or as equity in a project or investment activity. The AAOIFI standard carefully distinguishes *sukuk* from equity, notes and bonds. It emphasises that *sukuk* are not debts of the issuer; they are fractional or proportional interests in underlying assets, usufructs, services, projects or investment activities. *Sukuk* may not be issued on a pool of receivables. Further, the underlying business or activity, and the underlying transactional structures (such as the underlying real estate leases) must be *Shari'ah* compliant (the business or activity cannot engage in Prohibited Business Activities, for example).

AAOIFI has specified 14 categories of permissible *sukuk*. In broad summary, they are securitisations:

i. of an existing or to be acquired tangible asset (*ijara*);
ii. of an existing or to be acquired leasehold estate (*ijara*);
iii. of presales of services (*ijara*);
iv. of presales of the production of goods or commodities at a future date (*salam* (forward sale));
v. to fund the cost of construction (*istisna'a*);
vi. to fund the acquisition of goods for future sale (*murabaha*);
vii. to fund capital participation in a business or investment activity (*mudaraba* or *musharaka*); and
viii. to fund various asset acquisition and agency management (*wakala*), agricultural land cultivation, land management and orchard management activities.

A factor that had impinged upon the structuring and issuance of *sukuk* and *Shari'ah*-compliant CMBS transactions was the lack of *Shari'ah*-compliant hedging mechanisms and liquidity structures (which may both be required by rating agencies for a rated transaction). The issue of *Shari'ah*-compliant hedging mechanisms was rectified in March 2010 by the publication of the *Ta'Hawwut* Master Agreement by the International Swaps and Derivatives Association (ISDA) and the International Islamic Financial Market (IIFM). However, this development is still in its infancy compared to the conventional hedging market and will take time to consolidate. With regard to liquidity structures and other forms of credit enhancement (which in conventional transactions will be provided by facilities), various structures have been considered on a transaction-by-transaction basis.

Prohibitions on *riba* (interest), and on the sale of instruments that do not represent fractional undivided ownership interest in tangible assets, present a seemingly insurmountable problem for Islamic-compliant securitisation of conventional receivables, such as conventional mortgages, patent and other royalty payments, credit card receivables and the full range of other conventional receivables. Many of these receivables will never be made *Shari'ah*-compliant in and of themselves, but it seems likely that bifurcated structures will be developed to securitise these assets (just as conventional interest-based financing is used in most international *Shari'ah*-compliant real estate and private equity financings).

Tax and regulatory issues

O–026 One issue which needs careful consideration as part of the structuring of any *sukuk* transaction is whether the nature of a *sukuk* can raise any tax or regulatory concerns. These issues by their very nature differ across *sukuk* issuances, depending on the jurisdiction(s) of the issuing entity, of the assets and of the investors.

As mentioned earlier, the certificates issued in a *sukuk* are ownership interests in the assets of the issuing vehicle rather than debt instruments. This can raise a number of unexpected tax issues. In a conventional securitisation, it is fundamental that the issuing vehicle be tax neutral. However, the nature of a *sukuk* may mean that this is not the case. The issuing vehicle may not receive the benefit of tax deductions for interest as no interest is paid on the certificates.

Further, if the instrument is deemed to be an equity-like instrument rather than a debt instrument, transfers of the certificate may incur a transfer tax charge. Additionally, various stamp duty and land taxes may also be triggered in a real estate-based *sukuk* structure.

There have also been questions as to whether a *sukuk* is a collective investment scheme, and as such, whether in the European context, would need to be regulated by certain European Union legislation.

In a number of jurisdictions (such as the UK and Ireland), regulations have been introduced in order to ensure that *sukuk* structures are not taxed in a manner inconsistent with securitisations and other structured debt transactions. These regulations can take the form of deeming the cash flows under a *sukuk* to be equivalent to cash flows under a securitisation (for example, deeming periodic distribution payments to be payments of interest) and deeming the instruments to be debt rather than equity (and as such, removing the risk of transfer taxes being imposed).

Regarding the collective investment scheme issue, this needs to be considered on a case-by-case basis, as the market has yet to come to a position as to whether or not this is triggered.

Negotiability of instruments

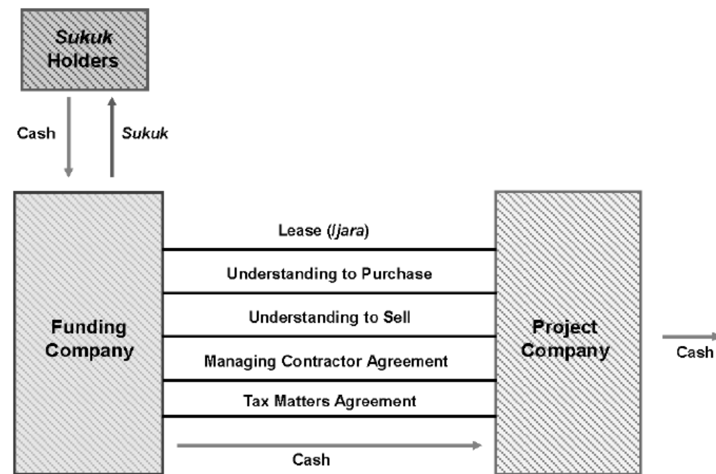
O–027 When structuring a *sukuk*, it is important to understand the nature of the asset underlying the structure. Trading in debt above or below par would breach *riba* principles (being interest) and be impermissible. As such, where the assets underlying the *sukuk* are receivables, either the instruments could only be traded at par, or their transfer must be prohibited. These limitations are generally problematic in capital markets transactions, where the ability to trade freely is critical for the creation of liquidity. Many capital markets instruments are held through central clearing systems (such as Euroclear or Clearstream) which require the instruments to be negotiable and tradeable.

The resolution of the apparent *riba* issue lies in the fact that in a number of *sukuk* structures (such as an *ijara sukuk*) the underlying assets are tangible assets rather than debts and through the trust certificate structure (under which the assets are subject to a trust declared by the issuing vehicle in favour of a trustee to be held on trust for the holders of the certificates) the *sukuk* holders have an interest in a tangible asset. This structure means that these *sukuk* can be traded above or below par, and if required by investors, held in central clearing systems.

The *Sukuk al-ijara*

O–028 The *ijara* structure that is so widely used in Islamic finance (see Figure 1) is readily adaptable to *sukuk* in a number of different ways. The simplest *sukuk* issuance utilising the *ijara* structure is shown in Figure 5. In this structure, the issuing entity issues *sukuk* into the capital markets and uses the proceeds to purchase an asset from the originator. It then leases the asset back to the originator. Often, the *sukuk* holders will not have a security interest in the asset (or, where they do have a security interest in the asset, it may be difficult to enforce). Each *sukuk* holder is entitled to receive the rental income generated under the lease pro rata to its ownership interest in the underlying real estate asset based on the *sukuk* held by it.

Figure 5 – *Ijara Sukuk*



The above *sukuk al-ijara* structure in Figure 5 has been utilised in a large number of *sukuk* issuances across the globe, and is seen by some as the "classic *sukuk"*.

In these structures, the rental stream from the *ijara* can be structured to produce a precise cash flow on the *sukuk* akin to conventional debt capital markets instruments. As such, the rate of return can be set as a fixed rate or a floating rate, and the capital return profile can be structured such that it is either through an amortisation schedule, a bullet repayment or a combination of partial amortisation with partial bullet repayment.

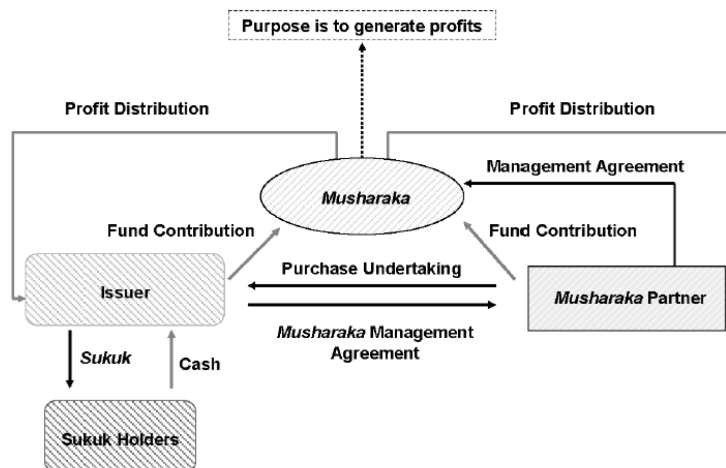
Where the structure involves a bullet repayment or partial bullet repayment at maturity, on the maturity of the certificates (or the occurrence of certain other events, such as an event of default), the originator will repurchase the asset at a price fixed at closing. This price will be equal to all amounts owing to the *sukuk* holders. Unlike some other structures, the scholars are comfortable with a fixed-price purchase undertaking being used in *ijara* structures. This may be part of the reason why these structures are so popular in the *sukuk* market.

There are some limitations to the use of the *ijara sukuk*. For example, many originators do not own appropriate underlying assets that are subject to *Shari'ah*-compliant leases or can be made available for such leases during the *sukuk* term, and, as discussed earlier, in many jurisdictions, there are significant adverse tax consequences associated with the introduction of the assets into a *sukuk* structure. However, a number of authorities such as those in Ireland, France and the UK are keen to encourage the growth of Islamic finance within their jurisdictions and have worked with participants in the Islamic finance market to implement regulations to minimise tax issues in *sukuk* and other Islamic finance structures. In fact, London, Dublin and Paris are all keen to try and be the centres of Islamic finance in Europe and have petitioned their relevant tax authorities accordingly.

The *Sukuk al-Musharaka*

O–029 In the *sukuk al-musharaka*, the issuing entity enters into a joint venture or partnership arrangement, pursuant to a "*Musharaka* Management Agreement", with the party seeking financing (the "*Musharaka* Partner"). As noted above, each party may contribute capital to the *musharaka.* Each of the partners receives "units" or "*hissas*" in the *musharaka* in accordance with their respective capital contributions. The Issuer's capital contribution is in cash and equals the proceeds of the *sukuk* issuance. The contribution of the *Musharaka* Partner is usually an in-kind contribution of a tangible asset (such as a piece of real estate). A *musharaka* structure is depicted in Figure 6.

Figure 6 – *Sukuk al-Musharaka*



The Issuer and the *Musharaka* Partner enter into a purchase undertaking pursuant to which the Issuer can require the *Musharaka* Partner to purchase designated units or *hissas* on specified dates either during the term of the *sukuk* or at maturity. Where units are purchased throughout the life of the transaction, the structure is referred to as a "diminishing *musharaka*". Economically, this is akin to an amortising bond. However, alternatively, the units may only be repurchased on maturity (or other certain events), in which case the *sukuk* is economically akin to a bond with a bullet repayment.

Under the *musharaka* structure, the issuing entity will receive profit distributions from the *musharaka* and the proceeds from sales of the units or *hissas*, which are then distributed to the *sukuk* holders in accordance with agreed formulae. Although profits and losses are required to be shared between the partners in accordance with their share of total units in the partnership, a number of *sukuk* transactions have been structured such that all profit has been paid to the issuing entity in priority to the *Musharaka* Partner, until such time as the issuing entities' contribution has been reduced to zero (and the *sukuk* holders have been repaid in full).

In 2008, AAOIFI issued guidelines which set out the parameters of how an exercise price under the purchase undertaking could be calculated. Prior to the issuance of the 2008 AAOIFI Guidelines, the exercise price would have been stipulated under the purchase undertaking as an amount equal to all amounts owing at the time of exercise to the *sukuk* holders. However, following the issuance of the Guidelines, where the purchaser under the purchase undertaking is the *Musharaka* Partner, the exercise price cannot be set at closing, but rather is required to be calculated on the basis of the market value of the assets on the date on which the purchase undertaking is exercised. As such, there is the risk that the exercise price may be less than the amounts owing to *sukuk* holders. Although structural mitigates can be built into a *sukuk* transaction utilising a *musharaka* structure (such as reserve funds and *Shari'ah*-compliant liquidity features) these may not entirely remove the risk of payment default under the certificates on the exercise of the purchase undertaking.

As such, the use of the *sukuk al musharaka* structure has declined in popularity following the issue of the 2008 AAOIFI Guidelines.

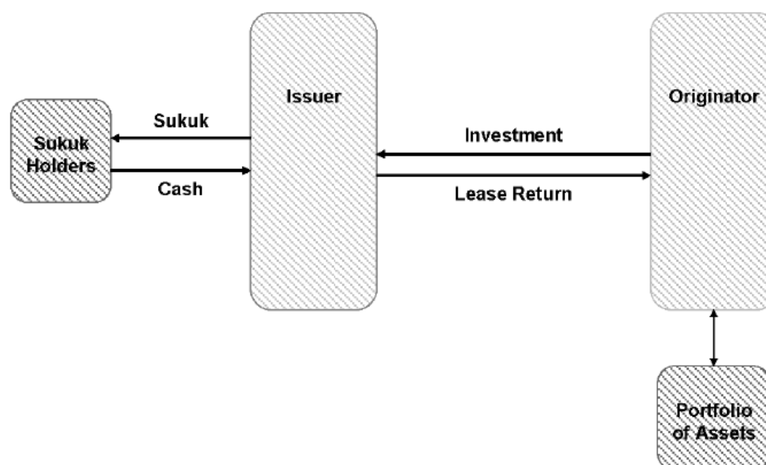
The *Sukuk al-Wakala*

O–030 One structure which we have recently seen utilised on *sukuk* transactions in the Middle East is the *sukuk al-wakala*. We have seen this financing structure used on a number of funding structures incorporating conventional and Islamic finance tranches.

In a *sukuk al-wakala*, the issuing entity as investor appoints the *wakeel* as agent to invest the proceeds of the issuance of certificates in accordance with the terms of a *wakala*. The *wakeel* will invest the funds in a portfolio of *Shari'ah*-compliant assets, which may be a portfolio of assets or parts of an asset already owned by the *wakeel*. At the outset, the parties to the *wakala* will agree the profit return to the issuing vehicle as investor. This profit return will be paid to the issuing vehicle periodically.

A *sukuk al-wakala* structure is shown in Figure 7.

Figure 7 – *Sukuk al-Wakala*



Under a *wakala* structure, any profit is used to pay the profit return to the investor, with the remainder being retained by the *wakeel* as an incentive fee. However, there is a risk that the return generated on the assets may not be sufficient to pay the agreed profit return to the issuing entity, and as such, the *sukuk* holders may suffer a loss. Prior to the 2008 AAOIFI Guidelines, a guaranteed profit return structure was utilised in the market. However, following the issue of the Guidelines, the majority of scholars appear to be of the view that a fixed rate of profit return is not acceptable in a *sukuk al-wakala* structure.

We have, however, seen *wakala* structures considered in capital raisings by real estate companies, where the companies want to access conventional and *Shari'ah*-compliant financing. For example, in the case of a financing of a shopping mall, certain *Shari'ah*-compliant parts of the mall could be used as a base for a *wakala* with the remainder funded by conventional financing.

The *Sukuk al-istisna'a*

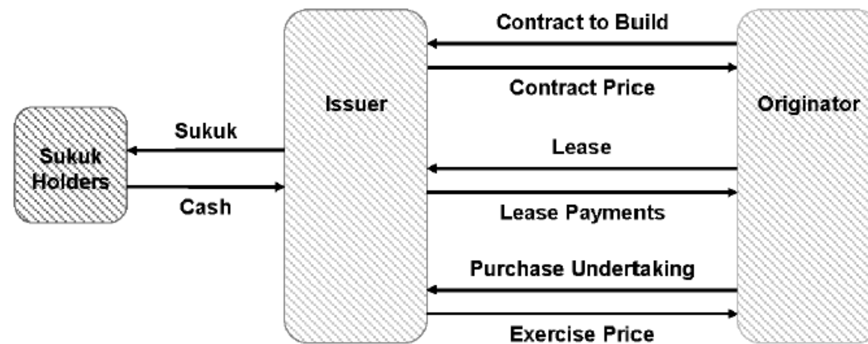
O–031 The *sukuk al-istisna* structure has been discussed as an option for project financing, where general bank debt or other forms of Islamic financing are not available. These structures are often referred to as "Islamic Project Bonds". However, the structure also has a number of characteristics which have limited its use by originators.

An *istisna'a* is essentially an order to a manufacturer to manufacture a specific asset for the purchaser. Under a *sukuk al-istisna'a*, the originator will agree to manufacture or construct certain assets and deliver those assets to the issuing entity in return for an amount equal to the proceeds of the issuance of certificates.

The issuing entity will then agree to lease the assets back to the originator under a forward lease agreement, under which it agrees to make rental payments to the issuing entity. On the maturity of the certificates or the occurrence of other events, such as an event of default, the originator will be required to purchase the assets from the issuing vehicle for an amount equal to amounts owed to the *sukuk* holders.

A *sukuk al-istisna'a* structure is shown in Figure 8.

Figure 8 – *Sukuk al-Istisna'a*



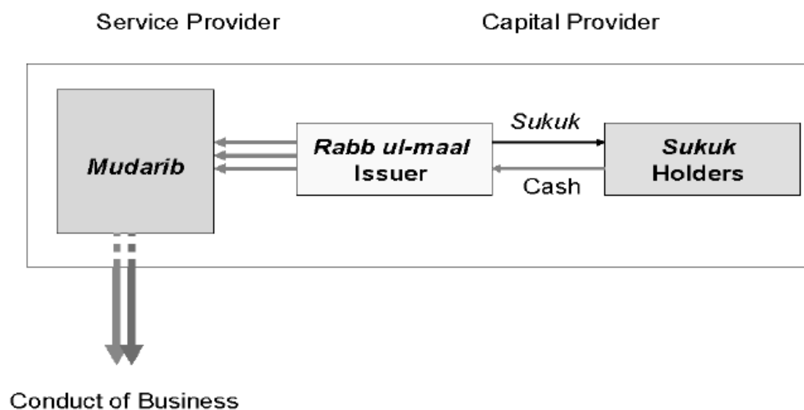
However, as noted earlier, there are a number of characteristics relating to these structures. In an *istisna'a*, there is a construction phase, and then a rental phase. During both phases, the originator will pay periodic rental payments to the issuing entity. There are concerns that during the construction phase, the *sukuk* is only backed by receivables, and as such is not tradable, unless traded at par. Further, some scholars have shown concern about forward leasing, and there is the risk that if the assets are not constructed, any advance rental payments would need to be repaid to the originator.

In light of increased interest in project bonds, it will be interesting to see if these structures become more common, in particular in large multi-funding project finance transactions.

The *Sukuk al-Mudaraba*

O–032 The *mudaraba* structure may also be incorporated into a *sukuk* offering in a number of different variants of the *sukuk al-mudaraba*. A generalised generic form of a *sukuk al-mudaraba* is set forth in Figure 9.

Figure 9 – *Sukuk al-Mudaraba*



The *sukuk al-mudaraba* is quite similar to the standard *mudaraba* structure presented in Figure 4. The *Rabb ul-maal* Issuer sells the *sukuk* to the *sukuk* holders and the proceeds of that issuance provide the capital for the *mudaraba.* The *Mudarib* will conduct the business of the *mudaraba* as the provider of services. As noted above, this is similar to a limited partnership or limited liability company.

This *mudaraba* may constitute the only entity necessary for the conduct of the relevant business. Or, as is more likely in a complex project or undertaking, this *mudaraba* may enter into joint venture and/or other contractual arrangements with other parties. For example, in a complex project financing, this *mudaraba* may enter into a further joint venture with a project sponsor in connection with the financing, construction and operation of the project.

Some of the primary structural considerations will focus, at each level of the transaction, on principles pertaining to allocation and distribution of profits and losses, and the permissibility of capital contributions by the *Mudarib*.

A separate set of issues arise in any financing in which capital is needed periodically (these issues also affect other structures, such as the *musharaka*). Consider, for example, the construction of a large-scale project where the construction cycle extends over a period of years and there is no project income during that period. All involved parties will desire that there be certainty of capital availability throughout the construction period. Periodic *sukuk* issuances do not provide that certainty. An initial *sukuk* issuance for the full amount of the construction costs will provide that

certainty, but is economically inefficient. The issuance proceeds in excess of immediate needs will be invested in short-term investments (such as *murabaha*) that have low rates of return. Further, the *sukuk* holders will probably expect periodic returns from the inception of the transaction. The project itself will be generating no income (it is in the construction phase) and the reinvestment income will be low. Payments on the *sukuk* during the construction and ramp-up phase are essentially self-funded by the *sukuk* holders.

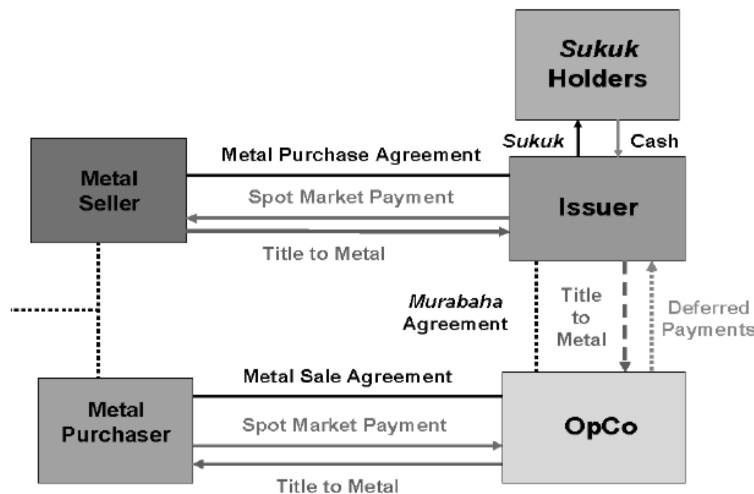
There have been very few *sukuk al-mudaraba* issuances, and following the 2008 AAOIFI Guidelines under which AAOIFI stated that the use of a fixed-price purchase undertaking was prohibited in *sukuk* structures, it is expected that these structures will remain rarely used.

The *Sukuk al-Murabaha*

O–033 One *sukuk* structure which probably has limited utility for commercial real estate transactions, yet merits a short discussion, is the *sukuk al-murabaha.* There have been a limited number of *sukuk al-murabaha* when compared to other forms of *sukuk*; however, under certain circumstances, they may be attractive to parties in a capital raising transaction. These forms of *sukuk* generally raise capital for general purposes and are not linked to a specific real estate asset of the originator. However, the capital raised could be used by the originator for real estate purposes.

Figure 10 shows a bond-type *sukuk*.

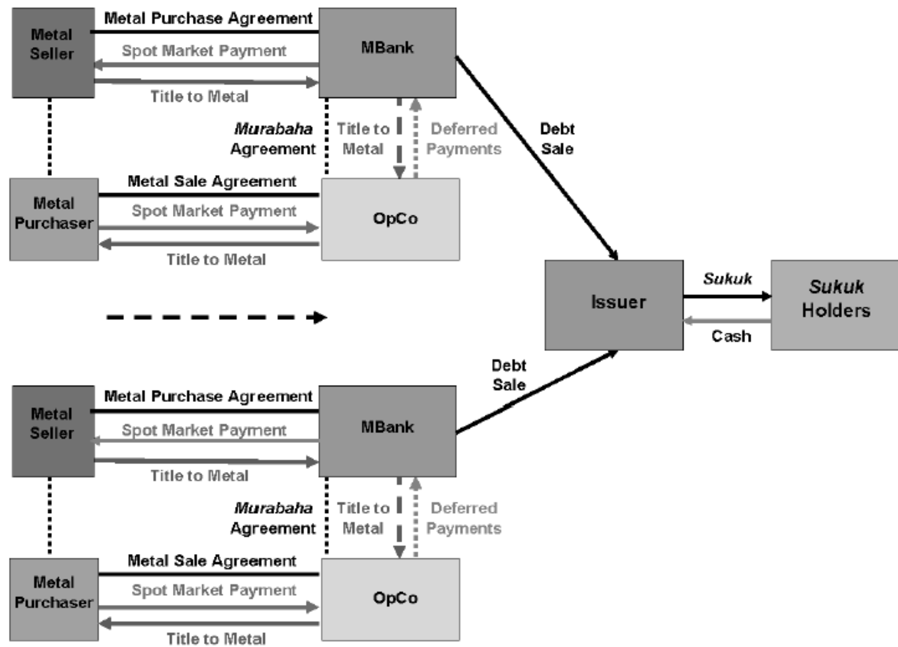
Figure 10 – *Sukuk al-Murabaha*



The *sukuk al-murabaha* is issued to the *sukuk* holders by the Issuer. The *sukuk* represents a "participation interest" in the underlying *murabaha* transaction. The issuance proceeds are used to purchase a metal on the spot market, the metal is then sold to the originator on a deferred payment basis, and the originator sells the metal to the Metal Purchaser on the spot market. The net result is that the originator holds cash equal to the spot market price of the metal which it can use in its real estate operations and the originator has a deferred payment obligation on the *Murabaha* Agreement that is used to service the *sukuk*.

Figure 11 illustrates a *murabaha sukuk* in which the deferred *murabaha* payment obligations under a pool of *murabaha* transactions are pooled, and the Issuer sells a *sukuk* based on that pool.

Figure 11 – *Sukuk al-Murabaha*



Under these *murabaha sukuk* structures, the party needing financing (the originator) obtains cash only by selling the tangible asset (the metal or other asset). Thus, on an ongoing basis, this *sukuk* does not represent an ownership interest in a tangible asset—it has been sold—and only the deferred debt obligation (a receivable) remains after sale of the asset.

As such, the assets underlying the *sukuk* are debts. One of the general principles of the *Shari'ah* is that debt cannot be traded except at par. As such, the certificates issued in a *sukuk al-musharaka* cannot be negotiable instruments and traded on the secondary market. This limits the possible investor base for these types of instruments. However, there have been a number of recent transactions which have utilised a *sukuk al-musharaka* structure where the investors have agreed to hold the assets for the term of the transaction.

Further, it is possible for a *sukuk* to have a number of underlying structures, including a *murabaha* structure, where the receivables derived from the *murabaha* are a small proportion of the overall structure.

It should be noted that the position of scholars in Southeast Asia is somewhat different to the position of scholars outside of that region. The Southeast Asian scholars accept that a *murabaha* may be used as the basis for a tradeable *sukuk*, making this structure a common feature of the capital markets in that region.

The Future

O–034 The future for the Islamic finance market is difficult to predict, although the hope is that it will continue to grow and develop globally. If the development in new legislation to encourage Islamic finance is an indicator of its future, its future does indeed look bright. In addition to developments in countries such as the UK, which have been discussed in this chapter, recently we have seen a number of other jurisdictions try to encourage the development of Islamic finance. South Africa has announced its intention of executing a sovereign *sukuk* to encourage the South African market whilst Australia and France have encouraged the development of the Islamic finance markets in their countries. Regulators have shown themselves willing to consider Islamic finance structures and equalise the tax position of Islamic finance structures with their equivalent conventional finance structures.

Regarding Islamic real estate finance, based on recent history, we should continue to see strong growth in this market. Liquidity needs will focus real estate market players on Islamic finance as an alternative financing channel. Progress in product development, coupled with strong demand, should sharply accelerate growth in Islamic finance due to pent-up demand. For example, there is a forecast need for £1.3 trillion of project finance in GCC countries and £60 billion of mortgage finance in Saudi Arabia.

Conventional banks will increasingly focus on refinancing, de-risking, improving capital ratios and deleveraging. They will vacate a significant part of the real estate finance field and Islamic finance can help to partly meet the remaining demand. Islamic finance and investment is poised to enter the mainstream of the global real estate market.

Regarding the *sukuk* market, recent *sukuk* defaults have led to a focus on the position of *sukuk* holders and, in particular, the rights they have to the underlying assets. This has highlighted the distinction between asset-backed and

asset-based structures, comparable to the rights of bondholders under secured and unsecured bonds. In asset-based *sukuk*, the holders can only require the originator to purchase the underlying *sukuk* assets and would have an unsecured debt claim against the originator from the payment of the purchase price after exercising their rights under the relevant purchase undertaking. This credit risk profile may not be what some investors expected. However, there has recently been a surge in *sukuk* issuances in the Middle East and Southeast Asia, including a number of sovereign issuances. These are very encouraging signs for the continued growth of the Islamic finance capital markets and Islamic finance market as a whole.

8 Dispute resolution in Islamic Finance

O–035 The number of *Shari'ah*-compliant products that are available has grown enormously over the past few years. Many Islamic finance transactions are governed by English law or the law of another country, instead of *Shari'ah* law. *Shari'ah* is a set of moral and religious principles rather than a codified body of laws. These types of transactions often take place on a global level, with parties originating from different regions in the world. For example, a Swiss bank may launch a *Shari'ah*-compliant financial product aimed at investors in the Middle East using documentation governed by English law. Due to the diverse backgrounds of the parties involved, the specialist nature of the agreements and the potential variety of legal jurisdictions in play, there may be considerable benefits in having an authoritative common platform to resolve disputes as they arise in a manner that is guided by *Shari'ah* within a modern commercial context.

The tendency to favour litigation

O–036 Litigation (the resolution of disputes through the courts) is the most well known method of determining disputes. Amongst some entities working in Islamic finance, there is scepticism towards alternative forms of dispute resolution, such as international arbitration and mediation. At the Asia Pacific Regional Arbitration Group Conference 2011, Ms Hakimah Yaacob, of the International Shari'ah Research Academy for Islamic Finance in Kuala Lumpur, stated that, following a survey that she conducted of 10 Islamic banks and 12 *takaful* operators (Islamic insurance providers) in Malaysia, she found that there was a "credit policy" in many of these institutions not to include alternative dispute resolution clauses in their contracts, but to opt for litigation instead. This was said by the financial institutions to have been done, in many cases, in order to avoid credit risks for legal uncertainty. The preference for litigation was further confirmed by enquiries made of arbitration centres in Malaysia.

Malaysia is not the only Islamic country where there is some reticence towards non-litigation forms of dispute resolution. In Middle Eastern states, many people have also been sceptical of using alternative dispute resolution since the outcome of a series of oil concession arbitrations conducted in the 1950s to 1970s. In these arbitrations, the local laws were refused and Western systems of law took priority. For example, prior to the tribunal award in *Saudi Arabia v Arabian American Oil Company (ARAMCO)* (1963) 27 I.L.R. 117, international arbitration was the most commonly used method of settling disputes between the Saudi government and foreign oil companies. In the ARAMCO case, the tribunal stated that the law of Saudi Arabia should be "interpreted or supplemented by the general principles of law, by the custom and practice in the oil business and by notions of pure jurisprudence", and therefore, ARAMCO's rights could not be "secured in an unquestionable manner by the law in force in Saudi Arabia". International arbitration was subsequently seen by the Saudi government as a tool to protect the interests of Western corporations. The Saudi Council of Ministers issued Decree No.58 of 1963 which prohibited any government agency from signing an arbitration agreement without prior authorisation from the council president.

In the renowned English case of *Beximco Pharmaceuticals Ltd v Shamil Bank of Bahrain EC* [2004] EWCA Civ 19, one of the issues concerned the governing law of the contract. The contract stated that "subject to the principles of Glorious Shari'ah, this agreement shall be governed by and construed in accordance with the laws of England". At trial, the judge, when dealing with the question of the applicable law, referred to the Rome Convention on the Law Applicable to Contractual Obligations 1980 and stated that the convention only made provision for the choice of law of a country, and did not provide for the choice of law of a non-national system of law, such as *Shari'ah* law. It was held that a contract can only have one governing law and that parties to a contract can only agree to adopt the law of a country as the governing law of a contract. Therefore, according to English law, as *Shari'ah* law is a non-national system of law it is not capable of being the governing law of a contract.

An alternative argument that was made to the English Court of Appeal was that, with English law being the governing law of the contract, it is possible to incorporate general *Shari'ah* principles as terms of the contract. This argument was also rejected. Lord Justice Potter found the attempt to incorporate by reference the "principles of Glorious Shari'ah" to be too vague to be given effect, he stated:

> "The general reference to principles of Sharia in this case affords no reference to, or identification of, those aspects of Sharia law which are intended to be incorporated into the contract, let alone the terms in which they are framed. It is plainly insufficient for the defendants to contend that the basic rules of the Sharia applicable in this case are not controversial. Such 'basic rules' are neither referred to nor identified. Thus the reference to the 'principles of . .

> . Shari'ah' stands unqualified as a reference to the body of Sharia law generally. As such, they are inevitably repugnant to the choice of English law as the law of the contract and render the clause self-contradictory and therefore meaningless."

This case demonstrates that general references to the principles of *Shari'ah* law will not be given any meaning, at least by the English courts. This is especially so given that there is a divergence of opinions amongst scholars as to the principles in question. On this, Potter L.J. made the following comment:

> "Finally, so far as the 'principles of . . . Shari'ah' are concerned, it was the evidence of both experts that there were indeed areas of considerable controversy and difficulty arising not only from the need to translate into propositions of modern law texts which centuries ago were set out as religious and moral codes, but because of the existence of a variety of schools of thought with which the court may have to concern itself in any given case before reaching a conclusion upon the principle or rule in dispute."

A further recent English Court case regarding incorporation of non-national laws was the Court of Appeal case of *Halpern v Halpern* [2008] Q.B. 195. Although that case related to a dispute between Orthodox Jews under Jewish law, the Court stated that:

> "it may be that for actual incorporation it is necessary to identify 'black letter' provisions, but that seems to me to be another way of saying that there must be certainty about what is being incorporated".

So, in summary, what these court decisions tell us is that, so far as the English Courts are concerned (i) the governing law of a contract has to be either English law or the law of a country; therefore, *Shari'ah* law cannot be the governing law of a contract; and (ii) it may be possible to incorporate as a term of the contract certain principles of *Shari'ah* law, provided there is certainty as to what is being incorporated.

The cases referred to demonstrate that, whilst there has been a tendency to favour court litigation as a means of resolving disputes in Islamic finance, the English courts have at times encountered difficulties in dealing with contracts where the parties have, at least to a certain extent, sought to have their dispute resolved in accordance with *Shari'ah* or other non-national laws or principles.

Professor Andrew White, associate professor at the International Islamic Law and Finance Centre in Singapore, recently stated at the Asia Pacific Regional Arbitration Group Conference 2011 that litigation is not geared towards solving Islamic finance disputes as judges often lack the education in many industry principles. In this context, some would say that arbitration is well placed to deal with these issues given that in arbitration, arbitrators can be selected that have the requisite knowledge both of *Shari'ah* and the relevant commercial transactions.

Additionally, there may be fewer difficulties in electing to have a dispute in relation to a contract decided in accordance with *Shari'ah* law by submitting the dispute to arbitration, rather than litigation. Taking the position in England as an example, the English Arbitration Act 1996 (which applies to all arbitrations seated in England and Wales) expressly permits the arbitral tribunal to decide the dispute in accordance with the law chosen by the parties or, "if the parties so agree, in accordance with such other considerations as are agreed by them or determined by the tribunal" (s.46(1)(b)). So in English-seated arbitrations, the arbitral tribunal can decide the dispute in accordance with such other considerations as are agreed by the parties, and this could include *Shari'ah* law.

The key features and foundations of arbitration

O–037 Arbitration is a non-court alternative method of resolving disputes, where a neutral, independent arbitrator or panel of arbitrators, known as a "tribunal", is appointed by the parties to make a binding decision, known as an "award", from which there are very limited grounds of challenge. Arbitration may be either administered (where the arbitration is conducted under the auspices of one of several arbitral institutions) or non-administered/ad hoc (where the parties agree between themselves the rules that will apply to the arbitration, without the involvement of an institution for the arbitration).

Further important features of arbitration include:

1. Arbitral rules and institutions—the procedural framework for the arbitration is stipulated in the arbitral rules. The arbitral tribunal obtain their procedural powers from the arbitral rules which are usually much briefer than court rules, and give the tribunal discretion on many matters unless the parties agree otherwise. Parties are able to choose which institution, if any, should administer the arbitration, and therefore, which rules will be applicable to their arbitration.
2. Seat of arbitration—the seat of arbitration is typically, but not always, where the arbitral hearing is held. It is usually expressed as a city. The seat is an important choice as the law of the seat will govern the arbitral procedure. As mentioned above, all English-seated arbitrations are governed by the Arbitration Act 1996. The courts of the seat will have certain powers, and the award will be treated as having been made at the seat.

3. Neutrality—arbitration in a third country is often an acceptable alternative when contracting parties are not prepared to submit to the jurisdiction of its counterparty's local court.
4. Finality—unlike a court judgment, an arbitral award is generally not subject to appeal on the merits, and may only be annulled for jurisdictional grounds or on the basis of serious procedural irregularity giving rise to substantial injustice. Whilst this is generally the position, it is always important to check the local arbitration law and practice at the seat of the arbitration to understand the scope for an award to be set aside and the likelihood of court intervention.
5. Procedural flexibility—arbitral procedures can be adapted to the circumstances of the contract or matter in dispute much more readily than court procedures. For example, the parties can agree to the location of the hearings, the language of the proceedings and the number and qualifications of arbitrators. In the absence of party agreement, the arbitral tribunal usually has a great deal of discretion on procedural matters.
6. Privacy and confidentiality—arbitral proceedings are generally private and parties may insert confidentiality wording in their arbitration clause (if none exist in the arbitration rules) so that the contents of the proceedings and the award are kept confidential.

There are two key foundation stones upon which arbitration as a method of dispute resolution has grown. First, the United Nations Commission on International Trade Law (UNCITRAL) Model Law. The UNCITRAL Model Law is a model national arbitration law designed to assist states in reforming and modernising their laws on arbitral procedure so as to take into account the particular features and needs of international commercial arbitration. It covers all stages of the arbitral process from the arbitration agreement, the composition and jurisdiction of the arbitral tribunal, the extent of court intervention, through to the recognition and enforcement of the arbitral award. It reflects worldwide consensus on key aspects of international arbitration practice and has been accepted by states in all regions of the world.

Secondly, the 1958 New York Convention on the Recognition and Enforcement of Foreign Arbitral Awards (commonly referred to simply as the "New York Convention"). The New York Convention seeks to provide common legislative standards for the recognition of arbitration agreements and for court recognition and enforcement of foreign arbitral awards. The Convention's principal aim is that foreign arbitral awards will not be discriminated against. It obliges parties to ensure such awards are recognised and generally capable of enforcement in their jurisdiction in the same way as domestic awards. Grounds for non-recognition of a foreign award are very limited. These include awards that are contrary to public policy; where the parties to the agreement were under some incapacity; the agreement is not valid under the law to which the parties have subjected it; or the absence of proper notice of the appointment of the arbitrator or of the arbitration proceedings. An ancillary aim of the Convention is to require courts to give full effect to arbitration agreements by requiring courts to deny the parties access to court in contravention of an arbitration agreement.

Historical connection between Islam and arbitration

O–038 Arbitration is specifically mentioned in the *Qu'ran* at *Surah* 4, verse 35:

> "If you fear a breach between them twain (the man and his wife), appoint (two) arbitrators, one from his family and the other from hers; if they both wish for peace, Allah will cause their reconciliation. Indeed Allah is Ever All-Knower, Well-Acquainted with all things."

Although the subject matter of this quote is a matrimonial dispute, the framework of arbitration has been applied to commercial disputes for many years. Arbitration under Islamic law is known as *tahkim* where parties agree to settle their dispute by referring it to an arbitrator known as a *hakam* or *muhakkam*.

Arbitration has a longstanding history as a form of dispute resolution in Islam, and with the development of international arbitration institutions in the Islamic world, there is, therefore, an ideal opportunity for international arbitration to establish itself as the method of choice for the resolution of Islamic finance disputes.

Development of international arbitration in the Islamic world

O–039 The previously described reticence towards international arbitration is now changing, with many Middle Eastern countries adopting the UNCITRAL Model Law for their arbitration laws, signing the New York Convention and establishing local arbitration centres in the region.

For example, there are four arbitration centres in the United Arab Emirates:

1. the Dubai International Arbitration Centre (DIAC) which was established in 1994 as the "Centre for Commercial Conciliation and Arbitration";
2. the DIFC LCIA Arbitration Centre which was launched in February 2008;
3. the Abu Dhabi Chamber of Commerce & Industry which was formed in 1993; and
4. the Dubai-based International Islamic Centre for Reconciliation and Arbitration (IICRA) which was established in 2005 by the Islamic Development Bank and the General Council for Islamic Banks and Financial Institutions in order to provide a *Shari'ah* based arbitration facility.

Of the four UAE institutions, the DIAC is probably the best known and busiest of the Gulf arbitration centres.

In Qatar there are two institutions: the Qatar International Centre for Commercial Arbitration and the Qatar Financial Centre (QFC). In Egypt there is also the prominent Cairo Regional Centre for International Commercial Arbitration.

Arbitration institutions in Islamic countries outside of the Middle East include the Kuala Lumpur Regional Centre for Arbitration, which has introduced specific rules to deal with Islamic banking and finance disputes. Other centres, such as Hong Kong, are also able to cater for Islamic finance disputes, with the establishment of the International Islamic Mediation & Arbitration Centre which was opened in 2008 by the Arab Chamber of Commerce & Industry after consultation with the International Chamber of Commerce, a pre-eminent arbitration institution. Singapore is also a major centre for international arbitration, with the Singapore International Arbitration Centre being its foremost arbitration institution.

However, the arbitration laws in the UAE, Saudi Arabia and Qatar are not based on the UNCITRAL Model Law. In Egypt, Singapore and Malaysia the arbitration laws are based on UNCITRAL Model Law (albeit with the Malaysian act modelled on the 1958 UNCITRAL Model Law with some modifications, rather than the newer 1985 Model Law).

In 2012, the UAE Ministry of Economy published the latest draft independent Federal Arbitration Law, which is based on the UNCITRAL Model Law. This draft is currently under review and it is unclear when it will be finalised and implemented in federal law. In the UAE and Qatar there are "free zones" for financial services. These free zones have their own legal jurisdiction and court system which is separate from the rest of the country. The DIFC and QFC are based in free zones and as such have their own distinct laws that are independent from the national laws governing international arbitration. Both the DIFC and QFC laws are based on the UNCITRAL Model Law. The parties do not have to have a connection with the jurisdiction in order to adopt these jurisdictions and their associated laws as the seat of arbitration.

All of the countries discussed above have acceded to the New York Convention. They are also contracting states to the Convention on the Settlement of Investment Disputes Between States and Nationals of Other States. Additionally the UAE, Saudi Arabia and Qatar (along with Bahrain, Kuwait and Oman) are members of the GCC. The GCC has a unified economic agreement between member states that they will recognise and enforce judicial and arbitral awards rendered in other member states.

The take up of international arbitration by parties to Islamic finance disputes appears to be very low. This could be due to a number of factors: many of these institutions are relatively new and are currently establishing themselves and certain regions favour litigation to settle disputes. Arbitration has many potential beneficial features as a form of dispute resolution, especially for Islamic finance disputes. Of course, another explanation might be that disputes involving Islamic finance may themselves be relatively rare or resolved by negotiation between the parties without reference to an outside body.

The benefits and the use of arbitration have been highlighted by Peter Werner, senior director of the EMEA office in London of the ISDA Financial Law Reform Committee. On March 1, 2010, ISDA and IIFM published the ISDA/IIFM *Tahawwut* (Hedging) Master Agreement. Mr Werner recognised a marked increase in the use of arbitration in the financial sector, and particularly in relation to ISDA Master Agreements involving parties established in or operating from emerging market jurisdictions.

The factors for this growth in the use of arbitration include globalisation, the increased involvement of parties from emerging markets in international finance and the clearing rules of most, if not all, of the world's clearing houses providing for disputes to be resolved by arbitration. The main reasons for using arbitration were stated to be the unattractiveness of litigating in the courts of many jurisdictions, particularly emerging markets, and the enforcement advantages of the New York Convention. If a party succeeds on the merits of a dispute that may prove to be a pyrrhic victory if it is not possible to enforce the resulting judgment. Leading international arbitrators are familiar with complex transactions, are able to get to grips with issues outside their core expertise and are likely to be much better able to deal with derivatives disputes than the courts of many jurisdictions. Arbitration agreements also provide for the parties to be able to nominate members of a tribunal whose main expertise is in derivatives.

Drafting the arbitration clause

O–040 In cases where arbitration is the chosen method of dispute resolution, it will be necessary to include in the contract a suitably drafted arbitration clause. Parties and their counsel should consider carefully, as a minimum: the seat of arbitration and the laws which would be applicable due to this choice, and importantly whether the seat of arbitration and the anticipated jurisdiction for enforcement are signatories to the New York Convention; the rules of any institution they wish to use; the categories of dispute covered; the method of appointment and number of arbitrators; the language of the arbitration; and the governing law of the contract, which should preferably be stated outside of the arbitration clause. Legal advice should be taken to ensure that the proposed choice of governing law will be respected in the arbitration. For example, whilst an election by the parties to have their dispute referred to arbitration and decided in accordance with *Shari'ah* law should be respected for arbitrations seated in England (per s.46(1)(b) of the Arbitration Act 1996), that is not necessarily the case in all seats of arbitration. Special care should be taken in seeking to draft arbitration clauses for multi-party arbitrations and multi-contract arbitrations. Optional provisions which may be considered for inclusion in the arbitration clause include, for example, making provision for: a specific procedure to be followed relating to the disclosure of evidence; allowing for remedial powers, such as interim relief; rights of appeal; confidentiality; and the qualifications of the tribunal.

In order to avoid ending up with an ill-suited arbitration procedure, it is very important that the arbitration clause is given careful consideration at the time of contracting, and appropriate legal advice is taken. It is unfortunately the case that all too often the arbitration clause is very much the "midnight clause" thrown in at the last minute without due consideration. This can have very serious time and cost consequences if a dispute should arise and can seriously hamper a party's ability to obtain a fair and efficient resolution of a claim.

Mediation

O–041 Mediation (*sulh*) is another important method of alternative dispute resolution. Mediation is a flexible process conducted confidentially in which a neutral person (the mediator) actively assists parties in working towards a negotiated agreement of a dispute or difference. The parties are in ultimate control of the decision to settle and the terms of any resolution. Mediation can be used alongside litigation or arbitration at any stage.

As with arbitration, *sulh* is also a traditional method of reconciliation in Islam and is mentioned in several verses of the *Qu'ran*. *Sulh* is usually conducted in an informal manner, but can be facilitated by an institution. Unlike in international arbitration or litigation, mediation does not result in a binding award or judgment. At the conclusion of the mediation process if the mediation has been successful, the parties draft and sign a contract that reflects the settlement terms.

Not all mediations result in a settlement being concluded, and for that reason, mediation is not a standalone means of dispute resolution. However, it is commonly used alongside, or to prevent, litigation or arbitration.

A form of facilitated negotiation, mediation can have considerable benefits in terms of saving time and costs. Parties may also wish to select the mediator based on their expertise in Islamic finance. However, mediation may not always be

suitable, for example where there is a need for a precedent or a binding award or judgment or the same issue arises in related agreements or matters.

Summary

O–042 The *Qur'an* and sunna repeatedly stress the importance and benefits of settling disputes quickly and discreetly. International arbitration is a method that can be used to achieve this. When parties have carefully considered and drafted international arbitration clauses in their Islamic finance agreements, they can have greater confidence that any disputes which may arise will be handled in an equitable, confidential and, importantly, *Shari'ah*-compliant manner.

Precedents

O–043 The use of precedents within the Islamic finance industry is one that is the subject of constant debate and development amongst business people and legal practitioners. There are many within the Islamic finance world who would like there to be a greater use of standard documents and precedents and who believe that the lack of use of such documents is holding back the development of the industry. However, given the relatively short life of the modern Islamic finance community, it is not surprising that the use of precedents has been restricted to date. The development of precedents has been run by Islamic financial institutions, law firms and also international organisations such as the Loan Market Association (LMA).

The LMA has developed a "Users Guide to Islamic Finance Documents" currently dated November 2013. The purpose of the Guide is: to help promote greater liquidity for Islamic products amongst LMA members and the banking market generally; to consider how provisions of the LMA's Primary Documents may be addressed or otherwise dealt with in the context of Islamic facilities or products; and to serve as an introductory guide for new investors in Islamic facilities or investors who are not yet fully familiar with the structures and products used in the Islamic finance market. The Guide takes as the principal form of Islamic facility it discusses as a *murabaha* facility. Inevitably, these types of precedents are the subject of debate as there are those in the Islamic finance community who do not want to copy conventional facilities or use them as a starting point for drafting. However, as a way of spreading the word to the "conventional" finance community it is a logical place to start.

The basic structure of a *murabaha* facility has been described above. Therefore we will approach the use of a precedent of such a facility by referring to Precedent A5 (Sterling Loan Facility Agreement, Single Bank) above. By taking this basic document, one needs to add further definitions and amend other clauses in order to turn it into a *murabaha* facility. It is important to note that the terminology used in Islamic finance documents can vary from transaction to transaction. One of the primary issues is that the preferred terminology of financial institutions may differ depending on the school of Islamic thought to which they adhere. Again, the lack of standardisation is demonstrated in these types of issues.

In a *murabaha* facility, the purchaser (sometimes the buyer) is considered to be the equivalent of a borrower under a conventional facility. The purchaser under a *murabaha* trade (of which there may be many trades) is under an obligation to purchase the relevant commodity from the seller of that commodity (i.e. the lender).

The seller under a *murabaha* trade will sell the relevant commodity to the purchaser. Under a bilateral facility, the seller will be acting for its own account (whereas, under a syndicated facility agreement, that seller will typically be an investment agent (acting for and on behalf of a group of lenders)). Under a syndicated *murabaha* facility, the investment agent represents a lender group and is therefore akin to a "facility agent" in a conventional syndicated loan transaction. This relationship between the investment agent and the other participants will be governed by a separate investment agency agreement.

There will also be offer and acceptance documents between the purchaser and the seller under which the purchaser is required to effect each *murabaha* transaction. In a conventional syndicated facility agreement this would normally be dealt with in a single document. This is not possible in the case of a *murabaha* agreement, which (for *Shari'ah* reasons) only documents the bilateral relationship between the seller and the purchaser.

Any investment agency agreement will contain the standard agency provisions and protections which lenders would normally expect to be covered in a syndicated facility agreement.

A commodity *murabaha* (or *tawarruq*) transaction will require the involvement of commodity brokers. They will not be a party to the *murabaha* agreement itself. This relationship will be documented in a separate commodity sale and purchase agreement. The first commodity broker will be involved in selling the commodity to the seller (i.e. the lender). After conclusion of the *murabaha* contracts, the purchaser will then on-sell the commodity to a second broker. For *Shari'ah* purposes, it is important that the two brokers are not the same.

Definitions

O–044 In order to turn a traditional facility agreement into a *murabaha* agreement, additional definitions will need to be added. These include those around the involvement of the brokers, the commodities, any investment agency arrangement, the sale and purchase of the commodities, the removal of references to interest and the insertion of references to profit.

Conditions precedent

O–045 The conditions to utilisation in a conventional facility will need to be augmented by additional conditions precedent in relation to: the intent to purchase the commodity; no default continuing or resulting from the entry into a *murabaha* contract; and that the amount of the purchase price is above a certain minimum level and equal to or less than the available commitment. Upon the conditions being met, the seller will purchase the commodities from the commodities supplier in accordance with its notice of intent. The seller will also determine the applicable profit and the deferred payment price and will confirm these in an offer notice it sends to the purchaser. Upon receipt of a valid offer notice, the purchaser will then purchase the commodities from the seller by sending an acceptance notice to the seller. There will need to be a clause specifying the point of which the *murabaha* contract is completed between the seller and the purchaser in order to ensure that it is clear when title and risk to the commodities pass over to the purchaser.

Risk mitigation

O–046 The seller will be the legal owner of the commodities for a brief period of time. The lender will therefore be taking additional risk over and above that which it would take under a conventional loan facility. It will not be possible to eliminate all risks as this would not be *Shari'ah*-compliant. Risk taking is a key component of the *Shari'ah*. It is therefore usual to limit the length of time for which the financier will be the owner of the commodity. It is common to see a "time is of the essence" clause which imposes a time limit on the purchaser to accept an offer notice by sending an acceptance notice to the seller/lender. If the acceptance notice is not issued within that pre-agreed time-frame, the lender would then be free to cancel that offer notice and dispose of the commodities to a third party.

Additional clauses in a *murabaha* agreement also include:

1. limitations on the number of *murabaha* contracts which can be entered into whilst others are outstanding (similar to the restriction on the number of outstanding "loans" in conventional facilities); and
2. payment of the purchase price plus the applicable profit amount on the relevant deferred payment date.

Availability period

O–047 Under a *murabaha* facility, as the profit amount is determined at the outset, the amount outstanding at any given time is inclusive of the total profit amount. If there is to be any rebate of profit due to early prepayment, then that needs to be documented. However, it is often not an obligation for the seller to provide a rebate to the purchaser, only an option. A commitment fee cannot be charged as it is not permissible for a person to use money to make money under *Shari'ah* principles. However, this does mean that it is in a lender's best interest to keep the available facility period as short as possible.

Profit not interest/late payment amount not default interest

O–048 The profit is the return obtained (i.e. the equivalent of "interest" under a conventional loan facility) under a *murabaha* facility. Ironically, it is often calculated using LIBOR or another reference rate and a margin. Together, these are used to calculate the deferred payment price to be paid by the purchaser. It is essential that the deferred payment price is known and agreed at the outset in order to comply with *Shari'ah* principles.

In relation to the equivalent of "default interest" in a conventional loan facility, the usual term applied under a *murabaha* facility is "late payment amount". It is typically dealt with in the same way as a conventional facility, i.e. by reference to the quantum of the unpaid amount, a reference rate such as LIBOR and a pre-agreed margin. It is relatively common for the lender to direct any late payments to an Islamic charity. The seller may be entitled to deduct any actual costs that it has incurred before the remaining amount it donated to charity.

A *murabaha* agreement will typically provide for an undertaking by the purchaser to indemnify the seller against any actions or claims incurred in connection with the commodities themselves.

Representations and warranties

O–049 The representations and warranties may be largely similar to those in a conventional facility agreement. However the issue of *Shari'ah* compliance/non-reliance needs to be dealt with. It is important that the parties do not use actual or perceived lack of *Shari'ah* compliance in order to avoid a contract. Therefore, it has become the convention to include representations within the document to make this clear.

For example with regard to satisfaction as to compliance with *Shari'ah*:

> "Insofar as a party wishes or is required for any reason to enter into transactions, agreements and arrangements which comply or are consistent with the principles of the *Shari'ah* ('*Shari'ah* compliance'), each party has made

its own investigation into and satisfied itself as to the *Shari'ah* compliance of this agreement, and all necessary action to confirm that this agreement is a *Shari'ah*-compliant agreement (including the obtaining of a declaration, pronouncement, opinion or other attestation of the *Shari'ah* adviser, board or panel relevant to that party where required)".

In relation to non-reliance:

"Neither party has relied, directly or indirectly on the other party or in any declaration, pronouncement, opinion or other attestation or document prepared by, on behalf or at the request of the other party for the purposes of a determination or confirmation that this agreement is *Shari'ah*-compliant".

These clauses seek to prevent the purchaser from raising any arguments in the future in order to try and renege on its obligations under the documentation. They seek to remove any possible duty of care being placed by one party on the other in relation to *Shari'ah* compliance.

Undertakings

O–050 With regard to undertakings, if there are restrictive covenants (such as a limitation on disposals or a negative pledge) these may need to be expressly carved out in relation to any Islamic transactions or structures that the purchaser may enter into from time to time, subject to agreed criteria.

Events of default and termination events

O–051 Often Islamic documentation distinguishes between fault-based events (i.e. events of default) and non fault-based events (i.e. termination events). The events of default usually arise as a result of an action or inaction on the part of the purchaser e.g. failure to pay. The non fault-based events are usually those that arise as a result of no action or inaction on the part of the purchaser e.g. total loss or destruction of assets or expropriation. However, there is no requirement that there be a difference in the consequences that flow from the occurrence of either of these.

Assignment and transfer

O–052 In relation to the ability to transfer commitments, one fundamental requirement of any debt transfer in relation to an Islamic transaction is that it must be made at par value i.e. there cannot be any profit to the existing participant as a result of that transfer. As a result, the documentation may state that any assignments or transfers must be carried out in a *Shari'ah*-compliant manner or the documentation may stay silent on any additional requirements for an effective assignment or transfer on the basis that it is for each financial institution to make its own determination as to *Shari'ah* compliance.

Conclusion

O–053 There have been efforts from time to time in order to standardise Islamic finance documentation. One of the most recent examples is the International Swaps and Derivatives Association/International Islamic Financial Market *Tahawwut* Master Agreement which sought to offer a standard hedging agreement to the Islamic finance market. The documentation was finalised in March 2010. However, many Islamic banks still prefer to use their own standard forms created in-house and negotiated bilaterally with each new counterparty. This leads to documentation risk for participants as well as increased costs and closing times for *Shari'ah*-compliant currency or rate protection transactions.

As further precedent documents are issued by international organisations, the use of precedents will spread within the market. Until then many participants use bespoke in-house documentation or seek to retro-fit conventional documents with *Shari'ah*-compliant concepts.