

## **PART TWO**

# **Islamic Finance in Practice**

## 2.1

# Retail Banking: Current and Savings Accounts and Loans

*Roderick Millar*

## Introduction

Retail banking covers the wide range of services commercial banks offer to private individuals. For the vast majority, this does not go much further than a current account, possibly a savings account and access to various loans for everyday items (overdrafts) and larger items (car loans, home improvement loans, etc).

Islamic finance started as an experiment, perhaps even a slightly cynical marketing experiment, in building a retail bank. The Mit Ghamr Savings Association in Egypt ran for a few years in the mid-1960s and achieved great initial success, but a change in the political climate led to the bank being closed down. It sold itself as offering a way for Egyptian farmers to save money within a Shari'a-compliant framework, and the rural devout of Egypt found this attractive. At the same time in Malaysia, the Tabung Haji was established offering individuals a way of saving to go on the Hajj pilgrimage with their savings invested in a Shari'a-compliant way.

The oddity is that the growth and development of Islamic finance, despite these early institutions, has been a top-down process and not one that has developed from serving the public at large first. The real growth in Islamic financial institutions over the last 25 years has come from financial products aimed at large infrastructure projects of governments and large corporations, resulting from the high liquidity of the Muslim oil surplus countries. This has expanded more recently into investment products, again for the institutional market and more sophisticated investors. Only in recent years have products designed for private individuals really appeared on a widespread basis, and much of this development has been intended for high net-worth bank customers.

The advance of simple current and savings accounts and personal loans is the latest stage in Islamic finance's development into a mainstream sector of banking. It should eventually be the most significant sector, at least in terms of the numbers of people involved on both the customer and supplier sides, if not in raw cash terms. Islamic retail banking is really the "coming of age" of Islamic finance.

What sets one retail bank apart from another? In essence the actual products – current and savings accounts and personal loans, as well as credit cards and mortgages (which we cover in other chapters) are all fairly straightforward financial products. In technical terms, the only differences will be in the rates of interest they are charged out at. Clearly these are not part of the Islamic equivalent products as *riba* (interest) is prohibited. This leaves customer service as the main product differentiator – and is something that banks are always keen to promote their excellence in, even if they sometime fall short of the mark in reality.

## The main retail banking products in Islamic form

### Current accounts

This most basic form of bank product does not necessarily require any particular changes to be made from a conventional current account to make it a Shari'a-compliant one. In many countries, it is not expected that conventional current account deposits will earn interest – and equally it is not allowed for account holders to have overdrafts. In these circumstances, no interest elements are involved in such conventional current accounts; these accounts sole purpose is to provide a safe place for the account holder to hold their money and to pay their earnings and other income into and from which to draw money for cash and through cheques and electronic withdrawals and payments.

Islamic current accounts are no different in practice to these basic conventional accounts; they offer the account holder a way of managing their earnings and payments so that they can operate in today's economy. No interest is applied at any stage.

It is attractive to banks to offer these services even if they cannot earn any money from them, as they build relationships with the customers that they potentially can develop into use of other services for which fees can be charged. The account holders' deposits also help to strengthen the banks balance sheet which improves its ability to meet regulatory requirements and potentially lend money profitably elsewhere.

Banks do run the risk of account holders overspending with unapproved overdrafts; in these circumstances pre-defined "management" fees are usually applied and in certain circumstances "penalty" fees can also be charged to disincentivize the account holder from creating an overdraft situation. While management or administration fees are usually retained by the bank to cover their costs, penalty fees will normally be paid into a charitable account so that the bank, the lender, does not profit from the borrower which would be contrary to core *riba* principle.

Most Islamic current accounts will provide cheque books, debit cards and allow direct debits and standing orders to be permitted. Internet and telephone access to accounts is also standard.

## Savings accounts

Savings accounts in conventional banking attract higher rates of interest from the bank to the saver than might be available in an interest paying current account. They usually will not offer any form of lending (overdraft). Competition to provide the most attractive rate of interest is strong in conventional banking, and usually the higher rate accounts have more restrictions in terms of the frequency of times withdrawals can be made and in what form they can be made.

An Islamic savings account is structured completely differently from a conventional savings account. An Islamic savings account is in fact an investment account, where the bank invests the money deposited in the account. This is a straightforward *mudaraba* process. *Mudaraba* is where the provider of the funds, the saver, entrusts their money to an expert investor, the bank, so that they can make a profit from it.

The bank will pool all such savings account money and invest it collectively in Shari'a-compliant businesses. The profits from such investment are then shared between the saver and the bank. How the profits are distributed between savers and the bank will depend on the contract applicable to the account. The amount returned will vary according to the profit generated and will be paid to the saver usually as a percentage figure based upon the lowest balance retained in the account during the period of calculation, whether that be a month, quarter or year. In the event of a loss occurring then the saver will lose money but under most terms the bank will not.

The fact that the holder of the savings account may lose capital indicates that Islamic savings accounts are very different products to conventional savings accounts where deposits held in a conventional savings account would only be lost in the event of the bank itself going into liquidation (and even then most banks have such deposits insured by central bank schemes to a certain extent).

## Personal loans

The third major product of retail banking is that of secured loans to private individuals. Secured loans are those that are guaranteed by the value of an underlying asset. The most obvious secured loan, although it is not commonly referred to as such, is a mortgage where the bank lends a significant sum of money to the lender to purchase an asset, usually property, but retains the right to take ownership of it if the borrower is unable to repay the loan amount. Other secured loans would be a car loan, where the ownership of

the car is retained by the bank until the loan is repaid. Unsecured loans do not have such assets to guarantee the repayment of the loans and as such are charged at considerably higher levels of interest in conventional banking products.

Clearly in Islamic banking loans cannot be made through the same structure as in conventional banking. If interest cannot be charged the whole loan structure as it exists in conventional banking is void. For this reason retail banking customers requiring funds through an Islamic-compliant product have to apply for loans that are rather more complex.

The most popular retail loan is made through a *murabaha* contract or process. The *murabaha* sale contract allows the seller of a good to make a profit on a transaction and requires the profit margin to be agreed at the outset of the contract. In banking, this at its simplest form would mean that the bank customer approaches the bank and seeks funding to purchase a particular good or asset, say a car or a new kitchen or a household good. The bank would then purchase the good from the supplier or manufacturer and immediately resell it to the bank customer at a pre-agreed cost-plus profit price. The customer would then be contracted to repay the bank in instalments over an agreed time period. This deferred payment in return for a higher cost of the original good is an acceptable arrangement in Shari'a. In *murabaha*, the ownership of the goods would pass to the customer who will be liable for all expenses related to it; however, the good will be pledged to the bank as security.

The drawbacks with *murabaha* are that the repayment terms are inflexible. Unlike with a conventional interest-bearing loan which may be repaid early with a consequent reduction in the interest charge, a *murabaha* contract is made for a fixed price which will not vary regardless over what time the payments are made. Although the contract will stipulate a schedule for the repayments, there will be no reduction for the bank customer should they repay it early (and so no incentive to do so) and similarly there are, in its purest form, no cost penalties should the customer miss a payment or take over the due period to repay the cost of the asset.

There are a couple of incentives/penalties that are sometimes imposed. A "negative penalty", which is applicable for other financing transactions, where if the customer makes all their payments in full and on time then they may gain a reduction in the final cost or some other benefit; or a "charity fine" where any missed payments, etc, incur a payment to a charitable institution nominated by the bank.

For larger items and fixed property assets, there is an alternative contract available to retail bank customers to provide funding. This is *ijara* or lease-to-purchase.

Unsecured loans to customer are offered by use of *bai al-inah* (sale and buy-back) or *tawarruq*. The *bai al-inah* structure, normally used in Malaysia for personal financing, is also a mechanism for customers to obtain immediate cash from Islamic banks. *Bai al-inah* transactions are between a bank and a customer, without involving an intermediary. It involves the bank selling

a commodity to the customer on a deferred payment price, and the bank subsequently buying back the commodity to pay the customer a cash price, which is lower than the deferred price. It can also be applied when a customer sells a commodity to a bank on a cash basis and then buys back the same asset on a deferred payment basis. In other words, it is simply a sale by one party at a higher price on deferred payment, and then buy-back at a lower price (and vice versa) to realize immediate cash for the other party. However, this structure is questionable in other Islamic finance markets, such as the Gulf Cooperation Council region and South East Asia, and is considered contrary to Shari'a rulings by some, as it involves dealings between two parties for the purpose of generating cash between them by using a financing structure where the only purpose is to obtain cash and purportedly distinguishing interest in the bank's deferred payment price.

Therefore, in those markets, a variant of the *bai al-inah* contract (often referred to as reverse *murabaha* or *tawarruq*) is now also common in retail banking for obtaining cash through personal financing. In *tawarruq*, the bank purchases an amount of a tradable commodity, say £5,000 of a metal, that is equal to the amount a customer is seeking as a loan. The commodity is purchased at a financial commodity exchange, such as the London Metal Exchange, and resold to the customer for a specified cost, plus a mark-up amount, say a 10 per cent profit of £500. The customer does not pay the bank the new price of £5,500 for the quantity of the metal but contracts to pay them in deferred instalments over a specified period as in the example above. However, once the customer has contracted to this the metal becomes their property – of course the customer does not actually want £5,000 of metal, so the customer, or the bank on behalf of the customer, arranges to sell the metal through an authorized broker for the prevailing market price of £5,000. This amount is then transferred to the customer's bank account.

It is different from *bai al-inah*, which is normally practised in Malaysia, as it involves a third party and the purchase and resale are considered to be independent of each other. The permissibility of using this mode is on the basis that in the past, Islamic jurists have allowed *tawarruq*; however, there are concerns. An important concern is explained by Munawar Iqbal in "A Guide to Islamic Finance" (2007) below:

“...the way this instrument is being practised by banks is very different. It appears to be simply a "devious artifice" (*hilah*) to get around the prohibition of interest through an intermediate process, the end result being what was prohibited... The few scholars who have allowed *tawarruq*... require the banks to actually buy and at least take constructive possession of the commodities, and then sell them.”

*Tawarruq* has three main attractions; it is very flexible, and the customer can acquire virtually any amount of money through this process as commodities such as metals can be bought at any amount. It does not require

the original seller of the desired asset, eg. the car, kitchen or holiday, to be involved so simplifying the transaction in terms of guarantees and resale values. And finally it enables the bank customer to borrow money for non-specific items.

## Conclusion

Islamic banking has developed in market terms from the top-down. Growth over the last three decades has been seen in the development of large corporate bond issues and more recently the growth of investment products to sophisticated investors. High net worth individuals have driven the growth of the personal finance products but it is the burgeoning of mass market retail banking that will finally cement Islamic banking into the mainstream of the financial sector.

Islamic retail banking is growing as Islamic regions experience a rapid growth in their middle class populations. The huge increase in the oil price also has had its effect on the Gulf region economies, bringing more people into a position where they have the opportunity to make a choice in how they handle their personal finances. This increasing sophistication is driving the growth of Islamic banking in Asia and the Gulf region. In the UK, Western Europe and North America, there is also a growing appetite from Muslim residents for more appropriate banking facilities to meet their religious requirements. All these factors have made Islamic finance the fastest growing sector of the global retail finance sector; Yasaar Research have estimated the sector will account for some 12 per cent of global finance by 2015.

## 2.2

# Personal Finance: Credit Cards

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## Introduction

A credit card can be defined as a method of payment that a card issuer gives to its customers to make purchases and/or withdraw cash. The issuer pays for the transaction and then bills the customer for the amount. The cards are called credit cards as they provide a loan to the customer. “Credit” can be defined as the provision of resources (such as granting a loan) by one party to another party, where that second party does not reimburse the first party immediately.

Credit cards can be used in two ways:

1. Withdrawing cash from an automated teller machine (ATM) – here, the card issuer gives cash to the cardholder as a loan and asks him/her to repay it on a specific, later date. The issuer charges the customer a cash advance fee which is either a fixed amount, or a percentage of the total loan amount; or
2. Buying products or renting a service – here, the issuer pays the purchase amount or the rent amount to the merchant on behalf of the cardholder and considers it as a loan on the customer. The issuer will then ask the cardholder to pay it on a later, specific date. In these kinds of transactions the issuer does not charge the customer any fee. Instead the merchant is charged a percentage of the total amount.

Credit cards can be classified according to their loan repayment method, as either full or partial loan repayment cards.

## Full loan repayment cards

With this type of credit card, the holder has to pay the entire amount due in full on the due date after the grace period. This type of card is also called a charge card. This type of card is *halal*, given two conditions are met:

1. The agreement between the issuer and the cardholder should not state



that the cardholder pays any late fees where payment has not been made on time. This is considered *riba* because the loan amount will be increased at repayment; and

2. The cardholder does not withdraw cash using the card in case the issuer charges a fee as a percentage of the withdrawal amount.

The fee an issuer accepts from the merchant is allowed since it is a commission (*samsara*), either as a percentage of the loan amount or as a fixed fee.

## Partial loan repayment cards

With this type of credit card the holder can pay a percentage of the due amount at the due date after the grace period. The issuer will add some percentage to the loan amount for giving this revolving capability. This type of card is *haram* (forbidden), since the issuer adds a percentage on the loan amount because of the delay in payment and this is a pure *riba*.

## Sources of revenue

Credit cards are one of the most profitable products in the banking sector; net profits can reach more than 26 per cent per annum. These profits come from six main sources:

1. Annual and subscription fees;
2. Interest;
3. Penalties for late payments or overdue amounts;
4. Interchange fees;
5. Fees for cash withdrawal; and
6. The exchange difference coming from foreign currency purchases.

Islam does not approve all of these six sources. This section will examine each one in more detail and look at its feasibility from the point of view of the two Islamic schools of thought. The first school is the “liberal school” which takes the Quran and *Sunnah* literally, and allows things without taking the current situation and the reality surrounding it into consideration. The second school is the “conservative school.” This also takes the words of the Quran and the *sunnah* literally, but also considers the reality behind them, the current situation and decides whether to allow or prohibit actions.

Usually the “conservative school” will not allow something that is prohibited by the Quran and *Sunnah* if the situation dictates, since these two sources have the final say. However, if something is allowed in the Quran and *Sunnah* but the conditions being presented might make it harmful for people or may lead to something that is eventually prohibited,

they will not allow it. For example, selling knives is allowed in Islam, but in some situations (eg. if the vendor is sure that the one who wants to buy the knife is going to harm or kill someone with it) it is prohibited to sell knives.

The “liberal school” takes the opposite stance; if something is allowed, then there is no need to look for a reason to prohibit it. If it is *haram*, they will look and see if a need for it exists in society and find a way to make it *halal* (permissible).

Both schools are acceptable in Islam. However, depending on the subject, the *fatwa* that people will follow may differ. As stated before, *riba* means taking interest on loans and is something expressly forbidden in Quran. For that reason, most Muslims prefer to go with the “conservative school” when it comes to the issue of *riba*.

## Description of the six sources of revenue

### ***Annual and subscription fee***

Cards issuers claim that this fee is the administration cost for the card for one year (that is why they make an annual charge). It is clear that this is not the true cost, since they charge different fees for different types of cards (eg. classic, gold, platinum, etc.) even though the administration overhead is almost the same for all types of cards.

The “liberal school” allows banks to take any fee they like by saying it is not *riba*; it is a fee for a service the bank or credit card issuer is providing to the customer. However, the “conservative school” does not accept this argument and rules that if a bank wants to charge for it, then it must be the actual cost.

This latter view makes more sense. Take the case of someone who wants to borrow an amount from a friend (eg. \$100 in the form of traveler checks). The lender needs to post it to the borrower and the post cost is \$10, but the lender decides to charge the borrower \$45. Since the cost of the post is only \$10, this will be a clear *riba* to give \$110 and take \$145.

### ***Interest***

Interest can be defined as “a charge for borrowed money, generally a percentage of the amount borrowed”. Thus it is clear that banks and credit card companies are not allowed to take interest, since it is pure *riba*, and neither of the two schools allow it.

### ***Penalties for late payments or overdraft amounts***

These charges are also not allowed by both schools since asking for more than the loan amount is *riba*. Even if the customer’s payments are late, issuers should not take more than what they actually gave as a loan. Some

scholars allow taking a “collection fee” related to the actual cost of collection. However, this is merely a collection fee, not a “late fee”, and the difference is that a collection process should only be initiated to be able to charge for amounts related to such items as telephone calls, emails, target mails, personalized visits, etc.

With regards to an overdraft amount, which arises when someone uses their credit card for an amount over their credit line, this is completely ignored since in Shari’a there is nothing called a “credit line”. The customer is allowed to withdraw or make purchases and this is considered a loan. The customer has to return the same amount that he/she took out. If the customer makes an offline transaction that causes them to go over their limit, this will be considered an attempt to steal from the issuer (since he/she knew they would be over their limit by this transaction). However, the credit card company cannot force the customer to sign a clause to make him/her pay the overdraft amount.

### ***Interchange fee***

Banks and credit card companies can charge merchants a fee as the issuers of the card. This fee is usually collected by the acquirer (ie. the merchant’s bank) and then sent to the issuer through an international company, such as VISA or Mastercard – this is called an “interchange fee”.

This fee is the only clear fee and is approved by both schools since the customer does not pay any extra money and the merchant is the one to pay the fee. Fees usually range from 1.1-1.85 per cent of the purchase amount. However, this fee should be reconsidered by Visa and Mastercard as more Islamic cards are currently being introduced into the market. Demand for these newer Islamic products is high and Islamic credit card issuers might try other ways of making profit out of their cards, which makes some of the customers reluctant to apply for a card; however, if this fee is more attractive to the issuers then they will not try to charge more fees or go with semi-Islamic approaches.

### ***Fee for cash withdrawal***

This fee is exactly the same as the fee described as an “annual fee”, and therefore the same argument between the two schools applies.

### ***Exchange difference coming from purchases with foreign currencies***

This fee is the most complicated fee and it is the most difficult to solve. The issue here is that there are two transactions in one – there is a loan transaction and an exchange transaction in the same purchase transaction. This is a problem because the exchange rate to calculate the amount should be calculated at the rate of the date when the customer is going to pay the

loan: Ibn Omar (a companion of the Prophet) said: I used to sell camels in Baqi' (a place in Al Medina) by dinars and took darahim (a kind of money) and sold by darahim and took dinars, which had an effect on me, so I came to the Prophet while he was in Hafsa's house and asked him about this. The Prophet said: "It would be unobjectionable if you take them at the price of their day, unless you depart and leave something between you."

However, it is almost impossible to do that since banks and credit card companies pay Visa in dollars and charge their customers in local currencies, and they need to send the statement at least 15 days before the due date, but the calculation should be with the rate on the due date.

It is not practical to send a statement with two or more currencies, although this would solve the Shari'a-compliance problem. The alternative would be to have the currency of the country of the issuer bank as an acceptable settlement currency, and in this case both the charge and the settlement will come with the same currency. This would be similar to customers who have their cards in dollars and make purchases in Japanese Yen; they receive their statement in dollars and their bank will also pay Visa in dollars.



## 2.3

# Islamic Mortgages

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## Introduction

It is estimated that over £1 billion of finance has been advanced by banks in the UK to finance residential property in a Shari'a-compliant manner. The size of this market is estimated to grow to £1.4 billion by 2009. Islamic home finance products have been available in the UK for over 10 years, and even mainstream institutions such as HSBC offer Shari'a-compliant products. There are already similar offers of home finance services in the US and Canada. Institutions in the US, such as Guidance Financial, have been providing *halal* home finance for many years, and providers like LARIBA have proved so far to be a success amongst the growing and affluent American Muslim population. The Islamic Cooperative Housing Corporation based in Toronto, Canada has also been operating productively since its establishment in 1981. Expansion in the market is taking place despite the recent credit crunch in the US. However, to date the availability of these products in Europe has proved to be a challenge despite the large numbers of Muslims residing there.

## Islamic housing finance in the UK

Historically, there have been two notable attempts by financial institutions to provide Shari'a-compatible financial products to the UK Muslim community. The first attempt was made in the late 1980s by Al-Baraka bank; another attempt was made in the late 1990s by the United Bank of Kuwait (currently Ahli United), followed by a major breakthrough when HSBC bank became the first high street bank in the UK to offer Shari'a-compliant home finance. Soon after, ABC bank and Bristol and West building society (now part of Bank of Ireland) joined efforts to launch Alburaq – a brand name of ABC – to sell a new home finance product. Currently there are five providers of home finance in the UK, including Islamic Bank of Britain.

Although, to date, market participants are few and the market in general is a modest niche, this market can potentially grow due to the relatively

large size of the Muslim population in the UK. The provision of these “home purchase plan” options and other Islamic products and services has so far led to significant growth of the Islamic finance industry in the country.

The UK government has introduced many legislative and regulatory changes as part of its efforts to compact financial exclusion. The new laws regarding “alternative finance” came as a result of realising the importance of providing Muslims with financial products that is acceptable to their way of life and its social and economic impact on the community.

From a social perspective, there are estimated to be about two million Muslims residing in the UK (3 per cent of the total UK population – the largest ethnic minority faith group) with a further 0.5 million Muslim visitors each year. The rationale therefore exists for social and financial inclusion to accommodate this growing population of Muslims.

From an economic perspective, the UK is one of the world’s largest capital market centres, and the impressive global growth of Islamic finance at an average of 15 per cent per annum over the last two decades means that there is an economic imperative to establish this sector for inward investment purposes. The UK is positioning itself as the global gateway to the Islamic finance industry, which is worth approximately \$400 billion currently but predicted to grow to \$4 trillion with London emerging as a global “hub” for Islamic finance.

## Islamic home finance instruments

Islamic banking practitioners (with the help of Islamic scholars) have utilized a number of instruments that are acceptable within Shari’a to offer Islamic home finance products in a modern day economic system. In the UK, the commonly used methods for the purchase of property are *ijara* (lease) with diminishing *musharaka* (diminishing partnership) and *murabaha* (a sale transaction for costs plus profit). These instruments and their relevance to the UK market are discussed in full below, in accordance with the current practice in the UK market.

Conventional banks use interest-based loan contracts as the main instruments to provide finance to their customers. As a result of interest being prohibited by Islam, Islamic financial institutions cannot provide traditional products and services, which involve interest based contracts. Therefore, contemporary Islamic jurists and financial practitioners have had to adopt and develop a number of instruments and facilities to allow Islamic banks to operate an interest free system.

Islam does not deny that capital deserves to be rewarded, but Islamic teachings present “risk sharing” finance as the most efficient and correct way to provide finance. Therefore, an Islamic financial institution should mainly use profit/loss sharing contracts on both sides of its balance sheet. On the liabilities side, it invests depositors’ funds in various types of businesses. A portion of the earned profit is paid to depositors in a pre-

determined profit sharing ratio. The depositors' profit is not and should not be determined *ex-ante*. On the assets side, the Islamic financial institution uses various kinds of non-interest based contracts as finance instruments; for example profit/loss sharing contract (*musharaka*), investment partnership (*mudaraba*), leasing contract (*ijara*), cost-plus financing contract (*murabaha*), and *istisna'a* contract (manufacturing or construction finance).

Almost all of these types of contracts have been or can be used to provide home finance. The market and customers demand, the legal environment and the financial institution preferences will be the main factors to decide which of these contracts is the best to be used.

The most significant Islamic home finance instruments used are:

- *Murabaha*, which provides a fixed rate of return to the financial institution; and
- Two instruments that provide the flexibility to vary the return to the financial institution:
  - *Ijara wa iqtina*; and
  - *Ijara* with diminishing *musharaka*.

## Murabaha-based home finance

The term *murabaha* refers to a special type of sale where the seller has to disclose the costs plus the profit made from the transaction. In order to use the *murabaha* contract as a financing technique, the Islamic financier incorporates the feature of credit sale (or deferred payment) in the *murabaha* contract.

The modern *murabaha* contract has become a very popular technique of financing amongst the Islamic banks as it provides similar risks to conventional interest based loan. The *murabaha* finance instrument operates in the following way:

The customer approaches an Islamic bank to get finance in order to purchase a specific commodity. The bank purchases the commodity in cash and sells it to the customer for the cost plus a profit. Since the customer does not have the funds, he/she buys the commodity on a deferred payment basis. Thus, the customer attains the commodity for which he/she wanted and the Islamic bank makes some profit from the sale price.

The transaction will usually follow the following steps:

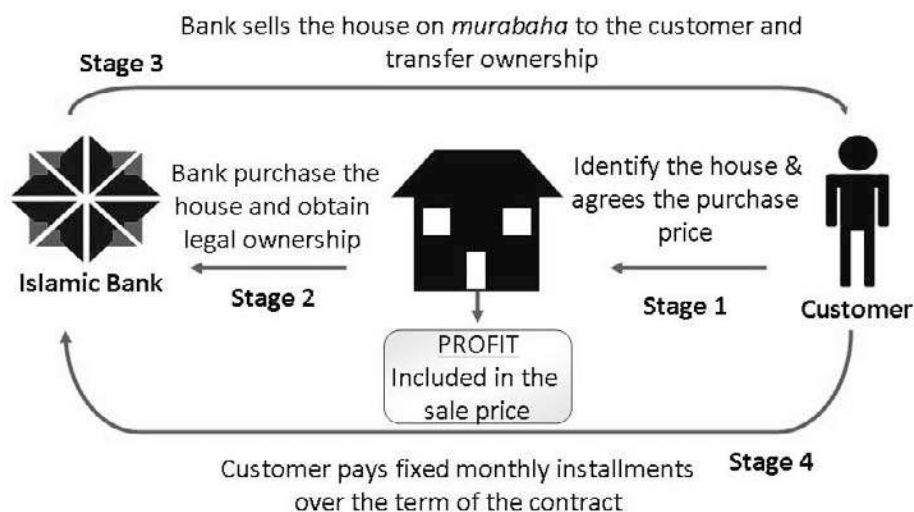
1. The customer determines their needs (ie. identifies the house he/she wants to purchase and agrees the initial price with the seller). The customer then applies to the bank and promises to buy the house from the bank if the bank agrees to provide the finance;
2. The bank notifies the customer of its approval of financing the house. The bank then purchases the house from the seller for the initial price



- agreed with the customer and obtains title of the house before selling it to the customer;
3. The two parties (the bank and the customer) sign the *murabaha* sale contract for the agreed new price (which is the cost plus the profit) to be paid over the term of the contract, and the bank transfers the legal title to the customer; and
  4. The customer pays the new price through monthly instalments. The bank cannot change or increase the sales price after concluding the *murabaha* sale. Any increment on the sale price would be considered interest.

The whole of the *murabaha*-based home finance transaction is to be completed in two different sale contracts: one through which the bank acquires the house, and the other through which the bank will sell the house to the customer.

### Home finance - *murabaha* Instrument



The *murabaha* principle creates a fixed, predetermined indebtedness. This has made the *murabaha* principle attractive for Islamic banks as an alternative to interest rate based transactions. However, this mode of finance receives some criticism as it incurs high transaction costs and is inflexible compared to interest based transactions.

*Murabaha* is a sale contract, this means that the sale price will not change for the duration of the contract. Therefore, the *murabaha*-based instrument provides a fixed rate of return on home finance.

## Ijara-based home finance

The term *ijara* refers to a leasing contract. The *ijara* contract has not been used traditionally for finance purposes; rather it was used for normal leasing activities. However, Islamic banks have found that leasing is one of the main recognized types of finance throughout the world and it is a lawful transaction according to Shari'a, therefore it makes perfect sense to develop new financial instruments based on *ijara*, including home finance instruments. The home finance *ijara*-based instrument are usually called "*ijara wa iqtina*" (lease and purchase), which is in a way similar to financial lease and hire purchase.

Under this agreement, the Islamic bank purchases the house selected by the customer, and the customer enters into two contracts with the bank – a leasing contract and a promise to sell. The first contract is a leasing contract where the customer agrees to pay periodic rent to the bank during his occupancy of the house until the end of the *ijara* contract term, and the second contract is a promise to sell, where the bank undertakes to sell the house to the customer, usually for a nominal price at the end of *ijara* contract.

The rent paid by the customer can be usually reviewed on a quarterly or semi-annual basis allowing the rent rate to be changed based on an agreed benchmark, usually London Interbank Offered Rate (LIBOR) or similar indices. The customer pays the bank monthly instalments; each instalment is a combination of a variable rent payment under the leasing contract, together with a fixed payment to pay for the house price which usually will be divided over the term of the contract.

The *ijara wa iqtina* method for home finance has decreased in popularity due to the fact that technically, the customer is paying rent, although part of this rent is to cover the purchase of the property; this part of the rent payment does not create any ownership right as the ownership will only be transferred at the end of the contract when the customer will exercise the promise to sell.

## Diminishing musharaka and ijara-based home finance

Home financing based on diminishing *musharaka* and *ijara* is unique to Islamic finance. It is based on the idea of shared equity rental. Under this housing finance instrument, the customer and the bank jointly acquire and own the house. The bank then leases its share of the house to the customer on the basis of *ijara*. The bank will allow the customer to gradually purchase the bank's share so that the share of the bank reduces and the customer share increases gradually over time, until the end of the contract term, where the customer will become the sole owner of the house.

The customer will make two monthly payments; the first is for the rent charged by the bank for allowing the customer to use the bank's share in the house. The rent rate is normally bench marked to LIBOR, or similar indices. The second payment is for the acquisition of a portion of the bank's share. The bank will sell its share usually at the same purchase price of the property and any depreciation or appreciation of the house value will be passed to the customer.

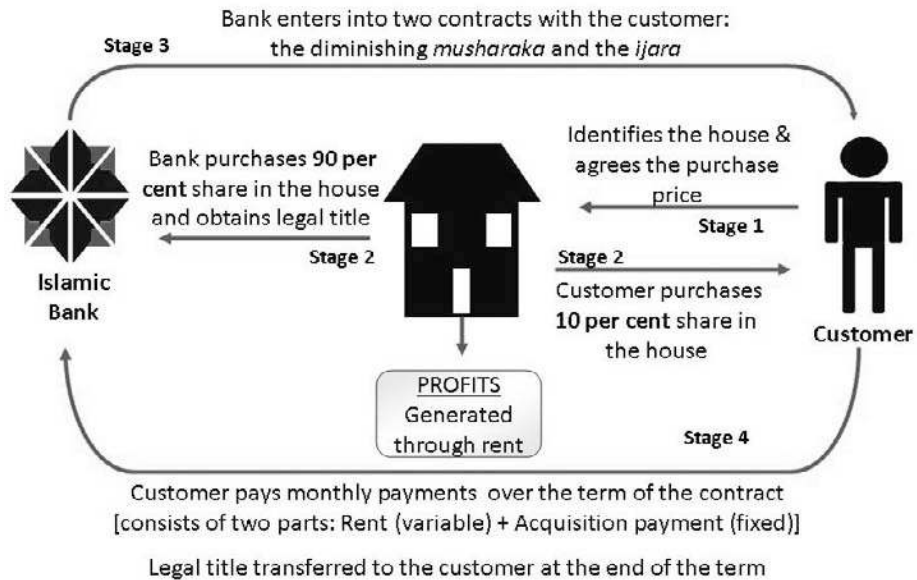
The *musharaka* and *ijara* based home finance transaction will usually follow the following steps:

- The customer identifies the house and agrees the price with the seller. The customer then will apply to the Islamic bank to finance the house; and
- The bank notifies the customer of its approval. Then both the bank and the customer buy the house and become partners. At this stage, both parties will first sign the diminishing *musharaka* contract where the bank agree to sell its share to the customer over the term of the contract, and then will sign the *ijara* contract where the bank leases its share to the customer.

The bank will usually keep legal title of the house for the duration of the contract, and the diminishing *musharaka* contract will record the customer's share (or the customer's beneficial interest). The bank and the customer will share the costs, *pro rata*, of all major costs including the provision of the house insurance, but all the expense related to the ongoing use of the house should be paid by the customer. Both partners will also share the risks associated with the house ownership in accordance with each partner's share. If the house is destroyed during the lease period, both parties, as partners, should suffer the loss. If the leased house loses its usufruct without any misuse or negligence from the customer side, then the bank will not be entitled to receive any rent until the house is restored to usable form.

*Ijara* is a lease contract; this means that the rent can be reviewed periodically. The review period is usually set at quarterly or semiannual basis but can be as long as a few years or as short as a month. This makes *ijara* more flexible than *murabaha* as it provides a variable rate of return, which can be locked as long as required.

## Diminishing *musharaka* & *ijara* home finance instrument



### ***Diminishing musharaka and English law***

English law recognizes equity ownership and distinguishes between legal ownership and equity ownership. The closest structures to diminishing *musharaka* under English law are co-ownership agreements.

Diminishing *musharaka* and *ijara* home finance products will usually use three main documents:

1. The diminishing *musharaka* agreement, which governs the relationship between partners (ie. the bank and the customer). In this agreement, the bank will have legal title, but the customer will have his beneficial interest (or equity) documented. The customer promises to purchase the bank's share over the term of the contract. The customer share will increase by making monthly payments;
2. The lease agreement, under which the bank leases its share to the customer for monthly rent. The rent will be calculated on the bank's outstanding share in the property. The customer will be the leaseholder and by registering the lease at the land registry, the customer protects his right to occupy the house; and
3. The charge agreement, through which the customer provides a charge over his share in the property and the lease with the bank. This is important to the bank to secure the ongoing payments. The charge document is the equivalent of the mortgage contract in conventional home finance products.

## Comparison of home finance instruments

	Murabaha	Ijara wa iqtina	Diminishing musharaka
Title holder	Customer	Financial institution	Both (freehold with financial institution and long leasehold with customer)
Rate of profit / rent	Fixed	Fixed / variable	Fixed / variable
Prepayments allowed?	No	Yes	Yes
Refinance available?	No (unless the financier agrees to a discount for the customer on the original finance)	Yes	Yes
Asset risk	Customer	Financial institution	Both the financial institution and the customer

The diminishing *musharaka* and *ijara*-based home finance is by far the most popular product in the UK. Currently all providers of the home purchase plan provide this product. This is mainly due to the flexibility of the product for both the customer and the bank as it allows the bank to change rates or fix them for as long as required, and it allows the customer to benefit from an increasing share in the house over the term giving him more confidence.

## Barriers to Islamic home finance

In 2002, Datamonitor estimated that the UK's Islamic mortgage market could be worth as much as £9.2 billion in outstanding balances. However, a combination of factors served to suppress the market at that time:

- Stamp duty was required to be paid twice, that is because the nature of Islamic home finance products involves initial ownership by the financier, with ownership passing to the customer at the end of the term. This led to amendments in taxation legislation in the UK to remove this requirement for Islamic home finance products;
- Higher regulatory capital ratio, where conventional mortgages and indeed *murabaha* home finance attract a capital risk weighting of 50 per cent, *ijara* mortgages attract a higher rate of 100 per cent. However, under

Basel II, all Islamic home finance products now have a risk weighting of 35 per cent (provided the finance to value of the property is under 80 per cent);

- Disadvantages under the various public sector home ownership schemes, such as “right to buy”, where because of the involvement of the financier as the owner of the property, the customer may be unable to take advantage of the benefits offered under the schemes. This remains an issue at the current time.

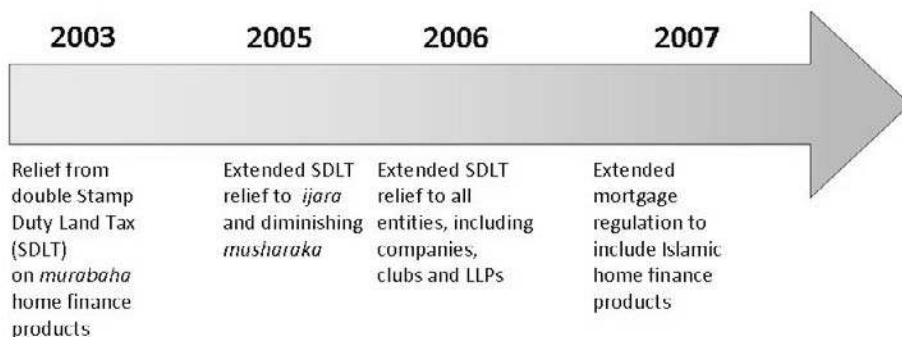
Another Datamonitor report in 2005 stated that the market has grown at an average of 68 per cent per year since 2000, and that by 2009 the market will be worth £1.4 billion in gross advances. This figure was more realistic than the 2002 report as they were based on actual market figures.

## Regulation and legislative changes

The government and the UK financial authorities have adopted a flexible stance towards the regulation of Islamic financial products, which is critical to innovation and growth of this promising Islamic home finance industry.

The Financial Services Authority (FSA) – the independent body that regulates the UK’s financial services industry – have recently included Islamic home finance in its regulated products (this new regulation came into effect on April 2007). This move was the latest of many regulatory and legislative changes which took place over the last few years in an attempt from the UK government to provide a levelled playing field for Islamic financial products with conventional ones.

### Legislative and regulation changes in the UK to accommodate Islamic home finance products



## Lessons for Europe

Although the take-up of Islamic financial products has been slow, there is increasing demand for these products in the market. As Islamic finance spreads in retail and investment markets, it brings with it various challenges. Therefore, the regulatory framework must be continually reviewed and amended with the support of the relevant government and financial authorities as to meet these challenges to allow the effective governance of the sector and most importantly to provide a solution to the recognized predicament of the Muslim community and their specific need for Islamic finance.

In European countries, the foundation of the Islamic housing finance services and products is yet to be set and the process is at its initial but budding stage. The European Muslim population is relatively large; particularly the French Muslim population which is nearly three times larger than as the British Muslim community, with proportionately high populations in Germany, Netherlands and Denmark as well.

In May 2008, the Dutch central bank and the Netherlands Authority for Financial Markets published a statement in which they informed of possible developments in the Netherlands. However, they also stressed their concern over the lack of knowledge of the Islamic finance sector.

There is need for much understanding and education of Islamic finance globally amongst suppliers, consultants and consumers. The education about Islamic finance within the legal consumer protection framework is necessary in order to attain a level playing field with the conventional set-up.

With the foundation of Islamic home financing already put in place in the UK, it is anticipated that there will be increased impetus for the growth of Islamic financial services in Europe. Europeans should consider the risks and challenges that the UK has faced in the process of implementing Islamic home finance and benefit from the experiences in the UK in order to facilitate Islamic finance in their countries. Clearly there are large groups of Muslims in Europe that would benefit from Islamic home finance and this would facilitate social and financial inclusion in those countries. If the willpower of European authorities to implement Islamic finance to the retail sector is there then appropriate legislation with respect to taxation and the financial regulatory authorities can be enacted. This has wider benefits as it demonstrates that countries wider commitment to Islamic finance, and helps position them to take advantage of the significant inward investment opportunities emanating from the Gulf.

## 2.4

# Trade Finance

*Richard T de Belder, Denton Wilde Sapte LLP*

## Introduction

With the recent growth in Islamic finance, there are now more Islamic finance products available, but Islamic trade finance still represents a significant proportion of Islamic finance transactions. The most common forms of Islamic trade finance are *murabaha* and *salam*.

## The nature of Shari'a-compliant sale and purchase agreements

Islamic trade finance can be made available within the parameters that apply to Shari'a-compliant sale and purchase agreements. Some of the main features are as follows:

### Goods must be in existence

As a general principle, the goods that are the subject of a sale agreement must be in existence when the agreement is signed. There are some exceptions to this rule such as:

- ***Salam*** – An agreement to purchase a commodity for future delivery but with payment being made upfront; and
- ***Istisna'a*** – This form of agreement is similar to *salam* in many respects; it is a contract for the sale of an item that is still to be constructed or manufactured. Payment can be immediate or deferred, and payment by instalments is possible. However, it is different from a *salam* contract in various respects such as:
  - there is no requirement for the purchase price to be paid when the contract is entered into;
  - there is no requirement to stipulate when the asset is to be delivered (although in practice this is usually done); and
  - the asset need not be an item that is commonly available in the market.



## Transfer of title

Subject to the exceptions mentioned above, title and possession of the sold assets must pass when the agreement is entered into.

## Halal goods

The assets being sold must be *halal* – in other words they must not fall within categories that are prohibited by Shari'a, such as pork, alcohol, munitions, etc.

## Purchase price

Subject to the exceptions mentioned above, the purchase price can be paid after title to the assets has passed. However, the price must not be calculated in a manner that includes *riba*. While *riba* is often referred to as interest, it is wider than this; it can cover any return that is based upon the mere use of money, and which is calculated by reference to the passage of time.

## Murabaha

*Murabaha* is the most commonly encountered Islamic trade finance product. It can be used to finance goods and also (in a non-trade finance capacity) to create a form of working capital facility (*tawarruq*). However, many Shari'a scholars do not approve of *tawarruq*.

## Basic parameters

The customer will require assets for use in its business operations. With a conventional bank, the customer would obtain a loan and the bank would take security over the financed assets until such time as the loan was repaid. The approach taken with *murabaha* is fundamentally different, and the difference is due to it being a sale and purchase agreement.

Under *murabaha*, the Islamic financier will purchase the assets in its name from the supplier and sell them to the customer. While title and possession will pass to the customer when the *murabaha* is entered into, the arrangements will only require the customer to pay the purchase price after a period of time. This period will usually be fairly short, such as 180 days.

The purchase price will be calculated by reference to the price that the Islamic financier paid to the supplier together with a mark-up. That mark-up will take into account the fact that the customer will only pay the purchase price to the Islamic financier on a deferred payment basis.

The mark-up is usually calculated by reference to a benchmark that is a conventional interest rate, such as the London Inter-Bank Offer Rate (LIBOR). The arguments that are currently put forward to support this practice are usually twofold; the first is a technical argument, which is that it is possible to use any benchmark as part of a mathematical calculation to produce the return on an Shari'a-compliant product. The position taken by most Shari'a Supervisory Boards is that provided the relevant clause is carefully drafted to provide that a return is calculated by reference to a formula that includes an interest rate benchmark, but does not say that the return is interest, such an approach is Shari'a compliant. The better position is that the reference to an interest rate is acceptable based on the Shari'a grounds of necessity or public need because, at present, there is no viable Shari'a-compliant alternative.

In essence, therefore, a *murabaha* involves the Islamic financier purchasing assets and then selling them to its customer on a deferred payment basis (cost plus formula), and with title and possession passing to the customer immediately.

It is of critical importance, however, that from a Shari'a perspective, there is clear evidence that assets have been acquired by the Islamic financier and then onward sold to the customer. This can be achieved through bills of sale or other documents that show legal title passing. If there are no assets being bought and sold, then the transaction will be void under the Shari'a as all that is happening is that a sham conventional loan is being extended.

## Advanced features and issues

### *Acting as an agent*

The reality is that it will be the customer and not the bank that has a relationship with the supplier, and will be in a better position to negotiate with the supplier details such as the specifications and the price. In view of this, the customer will often be appointed as the agent of the Islamic financier to purchase the assets on its behalf.

The *murabaha* agreement will usually have a mechanism whereby the customer can send a notice to the Islamic financier detailing the specifications and price of the goods it is willing to purchase as an agent from the supplier and then itself purchase from the Islamic financier. If the Islamic financier wants to proceed (and usually it will not be required to do so, if an event of default has occurred), it will accept the notice and this will trigger the agency arrangements.

In these circumstances, it is important from the Islamic financier's perspective that it has some assurance that the customer will actually buy the assets once they have been purchased from the supplier. While in practice the purchase by the Islamic financier of the assets (through the customer acting as its agent) and the onward sale by it to the customer will

happen contemporaneously (but not forgetting that there must be evidence of legal title passing from the supplier to the Islamic financier and then from the Islamic financier to the customer as purchaser), there is still the risk that the customer could renege.

Usually, therefore, the notice that is originally issued by the customer to the Islamic financier offering to purchase the assets on behalf of the Islamic financier as agent will contain an undertaking or covenant to purchase those assets from the Islamic financier. The Islamic financier would, therefore, have an action against the customer if it breached that undertaking or covenant.

Often the customer will not want the supplier to know that it is acting as the agent of the Islamic financier. This is often not due to legal concerns, but rather because it may be difficult to explain to the supplier why it is selling the goods to the Islamic financier rather than the customer. Accordingly, the *murabaha* arrangements often will provide for the customer to act as undisclosed agent of the Islamic financier.

### **Letters of credit**

The Islamic financier is the purchaser of the goods and, therefore, it is the person that should be paying for the goods. If a letter of credit is required, then the applicant would be the Islamic financier. If, however, the customer is acting as the undisclosed agent of the Islamic financier, then the letter of credit arrangements would involve the customer being the applicant. However, as the customer is acting as the agent of the Islamic financier, it would be entitled to reimburse any fees and expenses that it might incur as the applicant of the letter of credit.

Often the Islamic financier will take into account these fees and expenses when calculating the *murabaha* deferred payment price. It is also possible to have set off provisions such that the Islamic financier can set off any such reimbursement obligations against amounts due to it by the customer in relation to the *murabaha* sale price.

### **Late payment**

If a deferred payment is not made on the due date, it is not possible to charge the equivalent of default interest. Normally there will be provisions saying that if there is a delay in payment, then an additional amount will be payable. The method of calculation will usually be by reference to an interest rate benchmark. However, the provision will then stipulate that this amount cannot be retained by the Islamic financier (at least to the extent it does not cover real expenses rather than the lost use of money) but will be donated to charity. Its purpose is more to do with encouraging the customer to pay on time than to recompense the Islamic financier for the loss of use of money, which would be *riba*.<sup>1</sup>

<sup>1</sup> This late payment provision is also found in other Islamic finance agreements.

## ***Warranties***

As the Islamic financier will be the owner and seller of the assets (albeit with those assets chosen by the customer and often purchased as its agent), the sale of those assets will generally be subject to statutory warranties, which often cannot be excluded by contractual provisions.

Such warranties are a liability issue for the Islamic financier. However, the taking on of a liability or risk in a transaction is the fundamental justification for an Islamic financier to sell the assets at a profit/markup. Often there will be contractual provisions imposing on the customer (as agent of the Islamic financier) an obligation to ensure that the assets that it acquires for the Islamic financier are in accordance with the stated specifications, not subject to any defects, etc. These provisions are included in order to form some basis for a claim against the customer, as agent, if the customer, as purchaser, should bring an action for breach of warranty against the Islamic financier. An Islamic financial institution should not, however, presume that this would offer a watertight method of handling this risk.

It will be important for the Islamic financial institution, therefore, to assess the potential risk that goes with being the owner of the asset on a case-by-case basis and see whether, for example, some of these risks can be covered by insurance (and with the costs being built into the *murabaha* sale price).

## ***Security over the financed assets***

It would seem that the majority of the different schools would permit the assets that have been sold by the Islamic financier to the customer to be mortgaged or pledged to secure the deferred payment obligations. There can sometimes be problems under local law in relation to the perfection and release of the assets in a manner that protects the security interests of the Islamic financier and also, at the same time, enables the customer to access and use the charged assets in its business operations.

## ***Early payment***

What if the customer wants to pay the deferred payment obligation early? If it was a conventional financing, a discount might be offered to the customer (less, perhaps, breakage costs).

However, under Shari'a principles, the payment due by the customer is a purchase price, which has been fixed when the *murabaha* contract was entered into. It is not permitted in the *murabaha* contract to stipulate that if the customer pays the deferred purchase price early, the purchase price will be discounted. Sometimes, the Islamic financial institution may provide a statement of understanding or intent expressing that, in this situation, it would favourably consider reducing the purchase price. However, that

statement of understanding or intent cannot rise to the level of a binding agreement.

## Salam contracts

A *salam* contract differs from a *murabaha* in that when it is entered into, the goods do not exist. Historically, *salam* has been used for the financing of agricultural products, although it can be used for other items.

### General parameters

The sale price is paid immediately and the ownership in the *salam* goods is also transferred, but subject to a restriction that the purchaser cannot dispose of the goods until they are delivered to it.

The *salam* goods will not be in existence when the *salam* contract is entered into. The general rule is that the description of the *salam* goods cannot mention a specific asset on the basis that as the asset does not exist, it is only possible to refer to goods in a general manner. However, the specifications of the goods, their quality, quantity and other relevant details must be clearly stated.

It is up to the seller to source goods that meet the specific requirements. Using an agricultural example, if the *salam* contract was to describe 100 kilograms of wheat from a particular field, there is the potential for the contract to become void if the wheat in the field was destroyed. It is for this reason that the goods must be described in enough detail for the seller to deliver the required goods to the purchaser but must not describe a specific source.

### Specific matters

#### ***Mode of financing***

*Salam* was originally used to assist farmers who needed to purchase seeds for their crops. The Islamic financier would agree to purchase the crop before it existed and would pay the purchase amount upfront. This would enable the farmer to purchase the seeds.

#### ***Can the Islamic financier onward sell?***

The Islamic financier will not want to retain the goods. It is permitted for the Islamic financier to onward sell but within limitations. It can sell using a back-to-back *salam*, but the date of delivery to its purchaser must be after when it has received delivery of the goods that its customer has agreed to

sell to it. In addition, this back-to-back *salam* must also specify the goods in general terms (as in the first *salam*) and must not make specific reference to the goods being purchased by it in the first *salam*.

The sale price in the second *salam* will be higher than the price paid by the Islamic financier in the first *salam* and this profit will represent its return. It is permissible to have a profit in relation to the second *salam* as the Islamic financier is taking on a liability (to sell goods under the second *salam*), and it is permitted under the Shari'a to receive a profit in return for taking on a liability.

It is also possible for the Islamic financier to wait until the goods are delivered to it and then for it to dispose of them in another Shari'a-compliant manner, such as through a *murabaha*.

Generally, it is not permitted, however, to sell the *salam* goods before delivery has been made; this is because the *salam* contract could be rescinded if the seller reneged on delivering the *salam* goods.

### ***Immediate payment of purchase price***

The majority opinion is that the purchase price must be paid when the *salam* contract is entered into. It is understood that the Shari'a imperative behind this rule is that if there is a delay, this will amount to the sale of a debt by debt which is prohibited.

### ***Specificity of the goods***

The majority rule is that it is not permitted to state that the goods will be produced in a particular factory or come from a specific field.

### ***Delivery to be after the date of the contract***

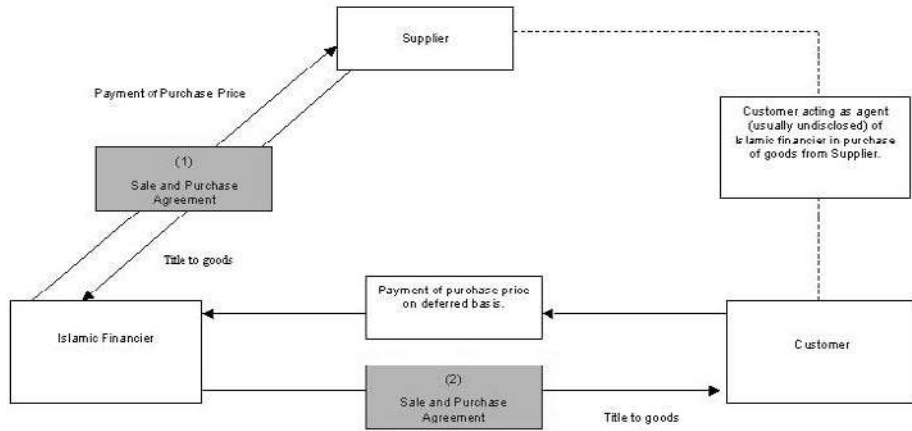
The majority of the schools state that delivery must come after the date of the *salam* contract. As the rationale of *salam* is to provide funds to allow the customer to grow or manufacture the asset, if there were immediate delivery then this would mean that the asset already existed, which would not be in accordance with the rationale underpinning *salam*.

### ***Existence of the goods***

The majority of the schools are of the view that the ability to deliver the goods will be evidenced on the contractual date of delivery through actual delivery taking place. The Hanafi school takes the position that, in determining whether the customer is able to deliver, it is necessary to see if the goods of the type described in the *salam* were capable of being acquired throughout the period of the *salam* and, if this requirement is not met, the contract would be void.

**Delivery in tranches**

If this were required, the Shari’a scholars would have to be consulted. Some schools permit delivery in stages, but there is an argument that this creates *gharar* (uncertainty), because the price being paid for the assets that are delivered later is the same as those being delivered first.



**Diagrammatical depiction of a trade *murabaha* financing.**

**Schedule 1: Form for a transaction request<sup>1</sup>**

From: [the customer]  
 To: [the Islamic financial institution]  
 Date: [\_\_\_\_\_]

**Murabaha agreement dated [•] (the Agreement)**

Terms defined in the Agreement have the same meaning when used in this document. This is a transaction request.

We request your approval to purchase the goods indicated below as your undisclosed agent upon the terms and conditions of the Agreement. Please notify us of your approval by facsimile by sending a transaction approval to us by no later than the close of business on the date [•], \_\_\_\_\_ business days after the date of this transaction request.

We wish to enter into a purchase contract as follows:

(a) Transaction date: [\_\_\_\_\_]

<sup>1</sup> The schedules are for illustration purposes only and should not be solely used as a basis for a transaction.

- (b) Goods: [\_\_\_\_\_]
- (c) Cost price: US\$[\_\_\_\_\_]
- (d) Value date: [\_\_\_\_\_]
- (e) Payment instructions: [*insert details of account*]

We hereby irrevocably and unconditionally undertake that immediately after we purchase and take possession (physical or constructive) of the goods on your behalf, we shall purchase in our own name the goods from you on the proposed transaction date for the deferred sale price. The deferred sale price (comprising the cost price (to be paid in instalments) plus profit calculated by you) shall be payable by us in accordance with the Agreement.

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Authorized signatory  
[the customer]

## Schedule 2: Form for a transaction approval

[To be addressed to the customer as the purchaser]

[Date]

We refer to the Agreement dated [•] and your transaction request dated [•] in relation thereto.

We hereby authorize you to purchase and take possession (physical and constructive) of the goods having the general description set out in the transaction request as our undisclosed agent upon the terms specified in that transaction request and the conditions specified in this transaction approval.

Subject to you complying with the terms of the Agreement and the conditions numbered (a), (b) and (c) below, the cost price in the amount of US\$ [•] shall be paid by us on the value date to the following bank account:  
[details to be inserted]

## Conditions

- (a) In accordance with the terms of the Agreement you shall inform us of the purchase of the goods referred to in the transaction request no later than 11.00 am (London time) on the transaction date by way of a facsimile transmission substantially in the agreed form, failing which this transaction approval shall be deemed to have been immediately revoked and, accordingly, you shall be deemed to have purchased the goods solely for your own account.
- (b) You have irrevocably and unconditionally undertaken that immediately after you have purchased and taken possession (physical and constructive) of the goods on our behalf you shall purchase in your own name the goods from us on the transaction date for the deferred sale price in



accordance with the Agreement, through an offer letter and acceptance of the offer in such offer letter.

- (c) The deferred sale price plus profit calculated by us shall be payable by you to us in instalments as set out in the transaction request.

---

SIGNED by [NAME]  
duly authorized to sign for and on behalf of  
**[Islamic financial institution]**

## Schedule 3: Form of offer letter and acceptance

From: [the customer]  
To: [the Islamic financial institution]  
Date: [\_\_\_\_\_]

### Murabaha agreement dated [•] (the Agreement)

Terms defined in the Agreement have the same meaning when used in this document. This is an offer letter.

### Confirmation

We refer to the Agreement and the transaction request dated [•] and the transaction approval dated [•].

We hereby certify and confirm to you that we have contracted as your undisclosed agent, and purchased and taken possession (physical and constructive) of the goods referred to in the transaction request from the seller in the manner contemplated by the transaction request for a cost price of [•].

### Offer

We now hereby offer to buy the goods from you on the following terms:

- (a) Transaction date: [\_\_\_\_\_]  
(b) Quantity and type of goods: [\_\_\_\_\_]  
(c) Cost price (per unit goods): US\$[\_\_\_\_\_]  
(d) Cost price: US\$[\_\_\_\_\_]  
(e) Profit: US\$[\_\_\_\_\_]

- (f) Deferred sale price: US\$[\_\_\_\_\_]
- (g) Payment instructions: [*insert details of account*]

The deferred sale price shall be paid by us on [•].

\_\_\_\_\_  
Authorized signatory  
**[the customer]**

## Acceptance

We accept the offer contained in the above offer letter.  
Date:

\_\_\_\_\_  
**[the Islamic financial institution]**



## 2.5

# Working Capital

*Dr Salman Khan, Abu Dhabi Islamic Bank*

## Introduction

Capital investment is an obvious prerequisite for the establishment of new businesses, firms and productive enterprises of all descriptions. However, once they are in operation, businesses and firms also need to maintain access to capital resources and liquidity on a regular basis in order to be able to function smoothly and efficiently. This latter type of capital is defined as working capital – “working” in the sense that it allows enterprises to carry on working and functioning in accordance with their business objectives and production goals. As a more formal definition, working capital is defined as current assets of the business, less current liabilities, where the balance provides the figure available to the business to develop, build, and expand its operations further.

Working capital financing may be required for a number of purposes. Among the most common of these are:

- raw material purchases;
- buying inventories;
- purchasing equipment/land/resources to expand productive capacity;
- advertising;
- paying staff salaries; and
- meeting other business-related costs (eg. utility bills, etc.).

## Working capital loans

In conventional finance, the typical method of providing working capital finance (WCF) is to advance a working capital loan to a business. The loan may be of variable duration and value, depending on the requirements of the enterprise. A conventional bank obtains its return by charging interest on the loan, which is usually paid back in instalments.

Often, but not always, such working capital loans may be taken for well-defined needs of the firm that arise now and then, for instance to fund new machinery. Alternatively, a finance facility or credit line may be made available to a firm, such that over a specified period of time, the customer is provided access to a certain amount of credit.

At the outset then, we may identify WCF needs as belonging to three categories:

1. Finance required to fulfil a specific asset-based<sup>1</sup> need may be defined as WCF-1;
2. Finance needed to pay either certain defined monetary costs or other miscellaneous costs, which sometimes may include paying back previous debts, may be defined as WCF-2; and
3. A third category may be defined as WCF-3, which is naturally designed to meet both WCF-1 and WCF-2 needs, and as such may be regarded as a unique category.

A number of Shari'a-compliant product options may be used to address the WCF needs of businesses. Before explaining those, however, a few points should be observed. Firstly, it is useful to note that since products designed to solve WCF-2 needs effectively provide the customer "cash-in-hand", such products can in theory be used to purchase assets and address other WCF-1 needs as well.<sup>2</sup> However, in principle, most banks ascertain at the outset from the client the purpose for which the finance is needed. If it is for a specific asset-based need (as WCF-1 was defined above), the bank generally seeks to offer only WCF-1 solutions. Of particular interest, a product (to be considered later) has been developed very recently, which is somewhat unique in that it naturally solves both needs.

## Shari'a-compliant solutions

### Finance for specific needs – WCF-1

#### *Murabaha*

One option for the financing of specific needs is *murabaha*. The client informs the bank on the exact specification (type and quality) and quantity of goods required. The bank purchases the requisite goods and sells them to the client on *murabaha*, earning an added profit mark-up over the price of the goods. The client then usually pays the *murabaha* price in instalments, although on occasion a lump-sum deferred settlement may be preferred.<sup>3</sup>

<sup>1</sup> This could also be a service-based need. Service-based needs can only be satisfied through a sale of usufruct contract, in which the usufruct is first acquired (ie. owned) by the bank, and then sold on to the client. However, this product (in particular for business needs) is not widely used at present.

<sup>2</sup> However, clearly, WCF-1 solutions cannot directly be used to solve WCF-2 needs.

<sup>3</sup> For instance, in the case of where the client holds a receivable bill due to mature after a short duration (eg. two or three months) for goods exported earlier. In this case, especially if the face value of the bill is equal to the *murabaha* price, it may make sense to have a full deferred settlement of the *murabaha* price upon maturity of the bill.

### ***Istisna'a***

Another potential solution to providing Shari'a-compliant WCF-1 needs may be achieved through the use of *istisna'a*. *Istisna'a* is a manufacturing contract in which goods are produced on order by the supplier or seller, according to very precise specifications of quality and quantity given by the buyer. By implication, a wide range of raw material and other inventory/stock needs of businesses may be fulfilled this way, including most durable goods and commodities. Typically, the bank will enter into two parallel *istisna'as*. In the first *istisna'a*, the bank would be the seller, and the client the buyer; and in the second *istisna'a*, the bank would contract with the eventual producer of the raw material or inventory to supply the required items. An important consideration is that the goods should not already have been produced.

Additionally, in order to help minimize the subsequent likelihood of dissatisfaction of the client when the bank delivers the required goods to it in the first *istisna'a*, the bank may ask from the outset that the client itself recommends various producers/suppliers of choice, from amongst whom the bank will select one. In other cases, the bank may appoint the client (who is the buyer in the first *istisna'a*) as its agent in the second *istisna'a*, charged with the task of ordering the goods and inspecting them once they arrive on behalf of the bank, to ascertain they fulfil the necessary quality specifications. Again, the aim is to ensure the goods supplied are to the precise satisfaction of its client.

A particularly useful benefit of *istisna'a* purchases relates to the unique flexibility with regard to the mode of payment made to the supplier. Thus, virtually any payment arrangement may be structured that is mutually acceptable to the buyer and the seller with respect to the payment of the *istisna'a* price. For example, payment could be made in a lump sum upfront, a lump sum *ex post*, via instalments beginning in advance of delivery, or at any other time acceptable to both parties. In the context of WCF, a payment schedule based on instalments starting after delivery of the goods is likely to be the option of choice of the buyer, which is the business seeking WCF.

### ***Ijara***

Carrying on with WCF-1, it is also possible to use the contract of *ijara* via the application of "*ijara muntahiya bit tamleek*" (which translates to "lease of an asset, culminating in ownership by the lessee") to address certain WCF-1 needs, particularly relating to durable goods. Here, the bank purchases the asset needed by the business, and then provides the same on rent to the business on lease for a certain duration. The lease payments are structured in such a way that by the end of the lease period, the bank receives the price it paid for the asset, plus its expected profit. Hence when the lease term expires, the bank sells the asset to the business at a nominal price, and thereby transfers ownership to the client, which is the primary

purpose of the arrangement. By way of example, if a business needs new machinery, equipment, or durable office supplies (eg. furniture) then *ijara muntahiya bit tamleek* may be used. Clearly, goods *murabaha* is also a candidate here for such transactions; however, *ijara* extends an added potential advantage to the bank as compared to *murabaha*. In *ijara*, the bank has the option of choosing floating rates of rent, which can be adjusted up or down in line with market fundamentals. This protects the bank's position better than *murabaha*, where the bank's return (cost plus profit) once determined at the outset remains fixed. The option of variable rental is particularly useful for longer term leases<sup>1</sup>, where the possibility of fluctuations in the benchmark or average market rate(s) of return is greater.

### **Musharaka**

*Musharaka*, regarded as embodying the true spirit of Islamic finance, provides more than one potential solution for WCF needs; one of these is for specifically for WCF-1 which is considered now; the other is a unique product classified as WCF-3 (which may fulfil both WCF-1 and WCF-2 needs), and is considered below.

With regards to obtaining durable assets (eg. tractors, machinery, equipment, etc.) *ijara muntahiya bit tamleek* has already been discussed as a tool to solve WCF needs. For the same sort of durables, diminishing *musharaka* can also be used (also called *musharaka mutanaqisa*).

The arrangement of diminishing *musharaka* is based on the use of two separate contracts of lease, and (periodic) sale. Here, the bank and the client business jointly purchase the asset (eg. an electricity generator) at the outset. Usually, the bank pays a majority portion of the price (in this example, say 90 per cent) and this is how the client's need for finance is met. The remaining 10 per cent is paid for by the client, with the result that the client owns 10 per cent of the generator and the bank owns 90 per cent. The client then rents the 90 per cent bank-owned portion of the generator from the bank over a certain lease period, for instance three years. Over this lease period, the client also periodically buys further portions of the bank's share of ownership in the generator, such that by the end of the lease period, the client owns the generator fully. So for example, the client could (separately) undertake to purchase 30 per cent at the end of each year of the lease period, to take its own membership up to a full 100 per cent. It is noted that as the client's ownership proportion rises, it would normally pay less rent to the bank, given that the bank now owns a smaller share of the asset. So for instance, after one year, the client buys a further 30 per cent share, increasing its share of ownership to 40 per cent, and now will only have to pay rent of the remaining bank-owned 60 per cent share (until it purchases a further share from the bank). The bank makes its profit via the sale of its

<sup>1</sup> corresponding to longer term periods of finance in *murabaha*.

asset shares, plus the rental charged to the client on the bank's share of the asset leased to the client.

The bank may use a simple *ijara muntahiya bit tamleek* lease as well for this purpose, as described above. One reason why banks sometimes may prefer *ijara muntahiya bit tamleek* to diminishing *musharaka* is that while using the former, the bank retains ownership of the asset until the very end of the lease term, and this means that in case the client/lessee defaults on the rental, the bank has the option of selling off the asset in the market, which helps it cover its position somewhat better. In contrast, with diminishing *musharaka*, ownership of the asset is jointly held by the client and the bank (in accordance with their *pro rata* contribution towards the asset's purchase); hence in case the client defaults on the rent and the bank seeks to liquidate the asset to close its position, there is the possibility of the bank facing extra legal costs and wrangles, *vis-à-vis* forcing the asset sale (if required).

For WCF-1, *murabaha* probably remains the most popular tool used by banks, given its fixity of return. An important issue to always keep in mind relating to the use of *murabaha* is that it can only be used by the bank for the sale of tangible goods (ie. WCF-1 needs only). Other needs, in particular cash requirements to pay salaries or utility bills, etc, cannot be addressed by *murabaha*, since it is not possible to "buy" salaries or utility bills or other cash-based items and sell them on at a mark-up, given that earning cash-on-cash is clear *riba*. Neither is it possible to use *ijara*, *istisna'a*, or diminishing *musharaka* for WCF-2 needs. However, the need for "cash in hand" for WCF commitments is a very frequent and an ubiquitous need for many businesses.

## Finance for defined costs – WCF-2

### ***Salam***

What solutions, then, are available for WCF-2? One possibility is that for WCF-2 needs (such as salaries, utility bills, advertising costs, or other monetary costs, etc.), a sale-based solution using the contract of *salam* may be used (instead of *murabaha*) such that the client gains access to finance in an indirect way, via a *salam* commodity trade.

*Salam* is a deferred delivery sale, in which the price is paid in full upfront, while the commodity is delivered later on at a specified time and date. For the purpose of WCF, the bank contracts to buy a *salam*-eligible commodity<sup>1</sup> from the client as seller, and the value of commodities being sold (ie. the *salam* price) is usually equal to the amount of finance sought by the client for his liquidity needs. So if a business requires \$20,000 to pay its staff's

<sup>1</sup> Not all goods are *salam*-eligible. Typically, fungible goods such as agricultural commodities (wheat, barley, etc.) or standardized manufactured products are suitable candidates to be the subject of *salam*, since they are usually easily and generally available in the market.



salaries, for example, it arranges to sell a quantity of wheat to the bank (deliverable at a later date) for which the bank is willing to pay \$20,000. Typically in *salam*, to incentivize the buyer to pay upfront and receive delivery later, the buyer will pay a below-market price, enticed by the prospect of selling the commodity upon delivery at a profit. This is how the bank makes its profit, on the one hand, and on the other the business fulfils its WCF needs.

A related issue is that normally in *salam*, delivery is made in full on the due date. However, since this usually necessitates the client to purchase a large quantity from the market prior to the delivery due date, delivery in full may pose further liquidity problems for the business. A permissible solution is to stagger the delivery of the goods over a certain duration, making it manageable for the client by enabling the delivery to be made in quantity instalments.

Viewed from another angle, the above *salam*-based solution for working capital needs is intrinsically rather similar to another possible arrangement that may be employed to solve WCF-2 necessities, namely *tawarruq*. In *tawarruq*, the client buys a commodity<sup>1</sup> on deferred payment, and then sells the same immediately on spot to obtain the cash-in-hand that he needs, in this case for WCF-2. The notable similarity between *salam* and *tawarruq* is that in both cases, the client receives money upfront, in exchange for a deferred financial liability. In *tawarruq*, this liability takes the form of an explicit deferred money price; in *salam*, the liability is a deferred delivery obligation, which implies that the client must gain access to money resources to be able to purchase the *salam* commodity in advance of delivery. Thus, in a way, both *tawarruq* and *salam* for WCF imply money in advance being exchanged for a subsequently higher monetary liability, using a sale transaction as a stepping stone. In both instances, the commodity as the subject matter of the sale is rendered more or less insignificant, since the sole purpose is to receive the finance.

Interestingly, while *tawarruq* is considered to be controversial by some across the Islamic finance spectrum, the same view is not usually expressed about *salam*, despite the similarity of purpose and operation described in the paragraph above. Therefore, so far, the use of *salam* for WCF is broadly accepted, while *tawarruq* is not. However, there may be three reasons for this. Firstly, *salam* for WCF is not widely used across the Islamic finance industry. As a result, it has probably not received the same kind of attention that *tawarruq* has, given the ubiquity of *tawarruq* in particular with regards to being a liquidity management tool currently used by virtually all Islamic banks. Secondly, in *salam*, the entire period between payment and delivery (usually a few months long, or more) is set aside for the “production” of the deliverable commodity. This appears to lend more acceptance to the overall arrangement, rather than *tawarruq*, where the credit purchase and the

<sup>1</sup> In practice, some kind of metal (eg. aluminium) is normally preferred for *tawarruq* transactions, since it is subject to very low depreciation, and hence acts as a good store of value.

subsequent spot sale are done in as quick succession as possible.<sup>1</sup> Thirdly, the original permission to carry out *salam* transactions given by the Prophet Mohammed was granted specifically so that poor farmers could have access to funds when they needed them most (ie. in the period before the harvest when farmers faced many costs, but didn't have liquidity). Thus, *salam* by design was meant to be an arrangement to generate finance for production.

### ***Musharaka***

Returning to *musharaka*, a somewhat unique product has been developed recently in Pakistan, that provides a solution for WCF-2, but is also applicable to WCF-1, thus it can theoretically address all WCF needs<sup>2</sup>, and can be classified as a WCF-3 product.

The WCF-3 solution based on *musharaka* is meant to provide an alternative to the conventional running-finance facility. The mode of operation of the latter is that customers can withdraw variable amounts of money, depending on need. In addition, the customer is also able to replenish or pay back amounts into the finance facility at any time as well. For these reasons it is commonly referred to as a "running" account. Thus, the client draws upon and/or refills the running account periodically, and pays interest to the bank based on a measure of average money utilized over the duration of the finance facility.

The Shari'a-compliant alternative to such a conventional finance facility is the recently-designed *musharaka* running finance facility, and would work as follows. The bank sets up a running *musharaka* bank account for its client business, and sets a finance ceiling or "upper limit" for the client. The client can draw upon this account up to this limit, and can also pay money into this account. Thus, the client will use this account to make payments periodically for various costs it faces from time to time, using his finance limit. These costs could relate to both WCF-2 needs such as bills, staff salaries, and advertising, etc, as well as WCF-1 needs such as inventories, raw materials, equipment, etc. At the same time, the client will also receive payments for various orders received, and may credit these into the account, thus replenishing it. On any given day, depending on how much money the client has used for payments drawn on the *musharaka* account, and how much money the client has paid back in that day, there will be a daily balance position for the account.

This daily balance position represents the money contributed by the bank to the *musharaka* that day, and equals the amount used by the customer from his/her finance limit, less the amount paid back by the customer into the *musharaka* account.

<sup>1</sup> However, it is noted that in *salam* (as practiced today), unless the client is an agricultural producer, the seller usually purchases the commodity from the market at the last minute prior to delivery, leading critics to point out that even in *salam*, the seller often doesn't produce the traded good.

<sup>2</sup> Subject, of course, to the condition that the credit limit set by the bank in favour of the client is sufficient to cover the needs.

For instance, assume the finance limit is \$100 – on day one, the client makes a payment of \$80 to a supplier for some raw materials drawn on the *musharaka* account, and later the same day, pays a sum of \$10 (received as payment for goods delivered to a buyer) into the account. At closing on that day, the account balance will be \$30 ( $\$100 - \$80 + \$10$ ), which implies that the bank has contributed \$70 to the client’s business on that day. How? Well, the bank made \$100 available to the customer, he used \$80 of that, and “paid back” \$10, so he ended up using \$70 of the bank’s money in his *musharaka* on that day.

From the outset, the bank and the customer will agree on a profit distribution ratio for their *musharaka*. The business will earn a certain profit every period (where the period will be defined beforehand), which will be distributed between the bank and the customer based on this profit ratio.<sup>1</sup> Depending on the daily balance of the *musharaka* account (which tells us how much of the bank’s capital is utilized per day by the business from the *musharaka* account), and the profit earned over the period, it is possible to obtain an “average profit per dollar per day” figure. This enables a calculation of the profit entitlements of the partners. This method of using an “average profit per dollar per day” formula to calculate profit entitlements represents an *ijtihad* (or Shari’a legal ruling based on interpretation), and herein lies the novelty of this product.

The most convenient method of calculating and sharing profit would probably be on the basis of gross profit. The business would quite likely agree to absorb all the costs and share gross profits because of the associated operational simplicity and independence, and also in exchange for a higher than proportionate profit share to compensate it for bearing all the costs.

## Conclusion

The number of Shari’a-compliant avenues available to solve WCF needs is increasing. At present, many options are potentially available, in particular for WCF-1 requirements, with the number of WCF-2 solutions available also on the rise. As we have seen, in addition to *murabaha*, it is possible to use *ijara*, *istisna’a*, and diminishing *musharaka* to provide WCF-1. Based on recent innovations and efforts in product development, a new *musharaka*-based product has emerged, which acts as a substitute for the conventional running finance facility, and may offer a solution to composite WCF needs (both WCF-1 and WCF-2); hence, it is referred to as WCF-3. In addition, so far *tawarruq* and *salam*-based solutions have been developed to meet WCF-2 needs, but are not that widely available. In this regard, certain reservations exist about employing *tawarruq* as a general tool for finance; however, the

<sup>1</sup> The exact profit calculation method is based on a somewhat complex formula, but is fully disclosed to the client, and in addition to the bank-client basic profit distribution formula, involves the use of investment category weightings to derive weighted average liabilities (among other things). Since the purpose here is mainly to outline the product, and for need of brevity, a full working cannot be displayed.

use of *salam* for WCF-2 does not share such controversy, especially given that it may be reasonably argued that the very *raison d'être* for *salam* is to fulfil the need of providing liquidity to producers.

In practical terms, as with so many products, with regards to WCF requirements too we find differences in the products on offer across jurisdictions. For instance, in the Middle East we find that *murabaha* is used most often for WCF-1 needs, and *tawarruq* for WCF-2, though not widely. In contrast, in Pakistan diminishing *musharaka* has also been used for WCF-1, and perhaps most notably, the running *musharaka* account (which meets both WCF needs) is available, although only with one bank at the moment. In Sudan, *salam* is often used for WCF-2.

By bringing together the different possibilities for addressing WCF needs, including both the products which are in operation, as well as those which are theoretically workable (even if not being applied anywhere at present), the aim has been to provide a useful overview on existing Shari'a-compliant solutions for WCF needs. It is hoped that there can be a move away from predominantly using *murabaha* and *tawarruq* for WCF, given the substantial range of products that can be adopted to fulfil most working capital requirements in line with the Shari'a.



## 2.6

# Commercial Real Estate and Project Financing

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## Introduction

The commercial development of real estate will often involve the acquisition of real estate interests, usually coupled with the construction and onward sale or leasing of a building. Project finance will invariably involve a real estate interest and will often be coupled with some exploitation rights, such as a concession agreement. The term “project finance” is usually also associated with financing on a non-recourse basis; in other words the financiers will primarily look to the project assets and revenues as being the main source of repayment (although there can be other methods of support, such as equity contributions by the sponsors, shareholder guarantees, etc).

Islamic finance offers enough flexibility for different structures to be created to meet with customers’ requirements. The structures will usually be a mix of Islamic financing techniques, with the choice being determined by a variety of factors, some commercial, some legal and some Shari’a driven.

The Islamic finance techniques that are considered in this chapter are as follows:

- *Istisna’a*;
- *Ijarah*;
- *Murabaha*;
- *Tawarruq*;
- *Mudaraba*; and
- *Musharaka*.

Depending on the situation, other techniques can be employed, such as Shari’a-compliant currency exchange products, and the underlying Islamic financing techniques might be capable of being packaged in the form of sukuk.

## Istisna’a

This is a contract for the sale of an asset that is still to be constructed or manufactured. Payment can be immediate or deferred, and payment by

instalments is also possible. It differs from a *salam* contract, however, in various respects, such as:

- the purchase price does not have to be paid when the contract is entered into;
- there is no requirement to stipulate when the asset is to be delivered; and
- the asset need not be an item that is commonly available in the market.

On the face of it, therefore, this form of Islamic financing is well suited to a building that has yet to be constructed. However, from a financier's perspective, there is a significant drawback in that, as the sale price must be fixed, it is not possible to mimic a variable rate of return as is found in a conventional loan. If the period of construction extends over a long period of time (as will likely be the case) the fixed nature of the return to the Islamic financier may not be attractive.

Using this structure, the Islamic financier would be the manufacturer (*al-saani*). The customer is the purchaser (*al-mustasni*) of the building to be constructed. Usually the Islamic financier will not have the capability to construct the building. Therefore, it will in turn enter into a back-to-back *istisna'a* or construction contract to construct the building. The Islamic financier will need to ensure that the price it pays in the back-to-back arrangements is less than the price it receives from the customer under the *istisna'a*.

There are various risks that the Islamic financier will face as the *al-sani* which include the following:

- Various warranties will attach to the constructed buildings that it is selling – often statute prevents them being excluded by contract;
- There are likely to be statutory liabilities that relate to the structural aspects of the construction; these often cannot be excluded by contract due to statutory restrictions; and
- The customer, as the *al-mustasna*, may be able to reject the building if it does not comply with the specifications described in the *istisna'a*.

The rationale for an Islamic financier making a profit under an *istisna'a* is that it is taking on risks and liabilities as the seller of the constructed building. However, and especially in large scale projects, these risks and liabilities can be substantial and, therefore, an Islamic financial institution will need to carefully consider them to see if the projected profit is adequate compensation.

Accordingly, the Islamic financier must ensure that the contractual arrangements that it enters into with the entity actually constructing the building for it, provide enough protection so that, if the customer as the *al-mustasna*, were to reject the building under the *istisna'a* or to bring a warranty claim, the Islamic financial institution can make itself whole by seeking compensation from the entity that actually constructed the building.

Another important issue which is often overlooked is that the Islamic financier can only agree to sell a constructed building to the customer (*al-mustasna*), if it has some legal right to the land on which the building is to be constructed. This can raise rather complex issues as to the type of land grant it requires, what legal liabilities are attached to that grant, whether any registration of that right is required (and the consequences that attach to that registration) and payment of any fees (both in relation to the initial registration and on any de-registration).

## Forward lease (*ijara*)

A forward lease is a lease that relates to the leasing of an asset that does not exist when the forward lease is entered into. On the face of it this would seem to violate the rule against *gharar* (uncertainty) in that the general proposition (subject to certain limited exceptions) is that an asset must exist when a contract relating to that asset is entered into.

The way that a forward lease is framed, however, is that the leasing of the building does not commence until it has been constructed. There will also usually be a drop-dead date after which, if the building has not been constructed so that it is substantially completed and ready for use, the lessee will not be under an obligation to lease the building. It is therefore incumbent on the Islamic financier, as the lessor, to ensure that the building is constructed in accordance with specifications and on time, otherwise its customer, as lessee, will not be obliged to lease.

It is possible during the construction phase for the Islamic financier to require the lessee to pay advance rent (which is often calculated based on a benchmark that refers to a conventional interest rate). However, if the building is not constructed in accordance with the specifications or available on time for leasing, and the lessee lawfully refuses to lease the building, the advance rent must be returned to the lessee. If the leasing of the constructed building does commence, then the advance rent must be taken into account and offset against the rent payable as from the commencement date of the leasing. From an Islamic financier's perspective, this is usually not attractive because it means that during the construction phase, it would not receive any financial return.

To deal with this issue, the rent that becomes payable after the lessee takes possession and starts to use the completed building, is normally increased (usually in the first or second lease period) by an amount that equals the advance rent. This increased rental amount is, therefore, set off against the obligation of the lessor to credit the lessee with the advance rent. The end result is that the Islamic financier effectively does obtain a return that relates to the construction period.

If the leasing does not take place (due to the building not being in compliance with the specifications or due to delay) then the Islamic financier will be in a difficult position. It will have a building that it owns and also



could face claims brought by the customer. One technique that has been used is for the customer to enter into an *istisna'a* with the Islamic financier, in which it agrees to sell to the Islamic financier the constructed building (subject to the same specifications and delivery date as in the forward lease). The customer in turn will usually enter into a contract with the main contractor. The financing of the project is therefore achieved by the Islamic financial institution making payments under the *istisna'a* (which are then passed down to the main contractor). To the extent that there are any claims by the customer (as lessee under the forward lease) there would be equivalent claims of the financier against the customer (as the *al-sani* under the *istisna'a*).

Under Shari'a principles, once leasing arrangements have commenced, the Islamic financier is liable to perform and pay for structural and major maintenance, to take out and pay for property insurance and to pay ownership taxes. Practically speaking it will usually not be in a position to handle these matters and also will not want to bear the cash flow effects of these payments. It will, therefore, usually appoint the customer (the lessee) to be its service agent to perform these functions and to make the payments.

Under the Shari'a (and most legal systems), an agent is entitled to be repaid expenses that it incurs on behalf of its principal. This means that any payments made by the service agent must be reimbursed by the Islamic financial institution. In reality the Islamic financier will usually not want to bear the ultimate liability for such costs. Accordingly, the rental payments will include a component (often called supplementary rent), which will equal the amount that the Islamic financier must pay by way of reimbursement to the service agent. As the lessee and the service agent are the same party, these two payment obligations are set off, with the result that the economic burden of these payments is borne by the customer.

There are issues that need to be considered in the context of the reimbursement obligation relating to the last rental period. Expenses incurred during this last rental period cannot be added to a rental amount (by way of supplementary rent) because the reimbursement obligation only arises at the end of the last rental period (ie. at the end of the lease). Normally, this amount is clawed back by being added to the exercise price that is paid by the lessee when the property is transferred to it at the end of the lease.

There will usually be two forms of undertakings or promises as part of these *ijara* arrangements. The first will be given by the Islamic financial institution and will usually permit the customer to terminate the leasing arrangements at any time upon notice and have the title to the property transferred to the customer against payment of a price.

The other is provided by the customer in favour of the Islamic financial institution in which the customer undertakes, upon notice from the Islamic financial institution, to purchase the title to the property for a price. It will also often deal with the transfer of title at the end of the lease for a nominal amount (and often including an amount that equals any reimbursement

obligation owed to the customer, as the service agent, which has not been clawed back through rent).

There has been a debate recently within the Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI) about these types of undertakings in the context of *sukuk* and certain principles were included in a statement issued by AAOIFI on *sukuk*. The principles mentioned in the statement may well also be applicable to financings based upon *musharaka*, *mudaraba* and *ijaras* that are not part of a *sukuk* issue. Where the assets of *musharaka sukuk*, *mudaraba sukuk* or *wakala sukuk* are “lease to own” contracts (*ijara muntahia bittamleek*) then the AAOIFI statement (fourth paragraph)<sup>1</sup> permits the *sukuk* manager to purchase the assets when the *sukuk* ends, for the remaining rental value of the remaining assets. This is allowed on the basis that the remaining rental value is treated as being equal to net value at the time of the purchase.

The AAOIFI statement (fifth paragraph) also permits a lessee in *ijara sukuk* to undertake to purchase the leased assets when the *sukuk* ends for a nominal amount. However, this is predicated on the lessee not being a partner, *mudarib* or an investment agent.

The debate is still on-going, however, as to the exact meaning of this statement and its actual implementation.

## Murabaha

It is possible to use murabaha in relation to the financing of assets that are required as part of a construction project. This would, however, normally be a short-term facility.

## Tawarruq

This structure has been used to create working capital facilities for certain projects. It is not a favoured product and many Islamic scholars do not accept it.

It involves the use of commodity contracts, such as metals. The Islamic financier will purchase, at spot, various metals contracts for, say, \$100,000. It will then sell those contracts to the customer on a *murabaha* basis (with title passing immediately and with payment being deferred for the agreed

<sup>1</sup> The AAOIFI Statement on Sukuk was issued in February, 2008. The fourth paragraph states, in part: “it is not permissible for the *mudarib* (investment manager), *sharik* (partner), or *wakil* (agent) to undertake to re-purchase the assets from *sukuk* holders, or from one who holds them, for its nominal value, when the *sukuk* is extinguished at the end of its maturity. It is, however, permissible to undertake the purchase on the basis of the net value of assets, its market value, fair value or a price to be agreed, at the time of their actual purchase, in accordance with Article (3/1/6/2) of AAOIFI Shari’a Standard (12) on Sharikah (Musharaka) and Modern Corporations, and Articles (2/2/1) and (2/2/2) of the AAOIFI Shari’a Standard (5) on Guarantees. It is known that a *sukuk* manager is a guarantor of the capital, at its nominal value, in case of his negligent acts or omissions or his non-compliance with the investor’s conditions, whether the manager is a *mudarib* (investment manager), *sharik* (partner) or *wakil* (agent) for investments...”

financing period – often short term). The customer will immediately sell the metals contracts to a broker (usually not the broker that sold the contracts to the Islamic financier) for spot (ie \$100,000 less the brokers' charges). If increasing amounts of financing is required over an extended period, then, as each *murabaha* contract ends, it is replaced with a *murabaha* for a larger amount.

However, as stated above, many Islamic scholars do not accept this type of structure.

## Mudaraba

A *mudaraba* is a contract in which an investor gives a cash amount to another person in order to use it to generate a profit which will be split between the parties. The person supplying the asset (such as money in the case of an Islamic financier, or investor) is called the *rabb al-maal*, and the manager is called the *mudarib*.

The *mudarib* will not, in that capacity, provide funds but will contribute its skill and expertise in deploying those assets to make a return. If there are no profits then the *mudarib* will not receive anything. It is acceptable for the *mudarib* to share in the profits as it is taking the risk of receiving nothing if the venture is not successful.

If there is a loss, the *mudarib* will not be responsible unless it was caused due to its negligence or default. It would appear that, under Shari'a principles, if a loss is proven, then the burden of proof is on the *mudarib* to show that it was not responsible for the loss.

The capital provided to the *mudarib* remains the property of the *rabb al-maal*, which is why it bears any loss to the property (subject to the *mudarib* being liable on the grounds mentioned above). While the property is in the hands of the *mudarib*, he acts as a trustee in relation to that property in the sense that he is obliged to take care of it but he is not liable for any loss unless caused by his negligence or default. He can also be viewed as acting as the agent of the *rabb al-maal* in deploying the property of the *rabb al-maal*. It is also possible for the *mudarib* to be paid an incentive fee which is a technique often used to reduce the return to the Islamic financier to what would have been achieved under a conventional financing.

The *mudarib* should produce a business plan and a feasibility study relating to the proposed venture. It would normally be expected that projected (although not guaranteed) profits would be detailed. These documents could be very important if there were a loss because an analysis as to whether the *mudarib* had been negligent might be benchmarked against statements contained in these documents.

In the context of project financing, this structure has been used, including in relation to *sukuk*. Using this approach the investors would pass their funds to the developer. There would be a business plan and a feasibility study in which the developer would describe the types of real estate projects

that it intended to invest in. The funds would be used to construct the properties and the proceeds from their sale or leasing, would be shared between the Islamic financier and the developer (as the *mudarib*).

Often there will be an undertaking or promise from the *mudarib* to purchase the interest of the *rabb al-maal* at an exercise price but the same issues as have already been discussed with this type of undertaking or promise in relation to *ijaras*, also applies to *mudaraba* arrangements.

It is important to note that some Shari'a schools are of the opinion that the *mudaraba* contract cannot stipulate that the *rabb al-maal* will have a role with the *mudarib* in the management of the *mudaraba* property. If there were such a condition, then the *mudaraba* would be void. It would appear that if a *rabb al-maal* volunteers to perform such functions (and there is no obligation for it to perform such functions contained in the *mudaraba* contract) then this would be acceptable.

## Musharaka

In the context of real estate and project financing, a *musharaka* would likely take the form of a partnership or joint venture (*sharikat al aqt*). Under this arrangement, the Islamic financier would contribute funds and the customer would contribute another asset, such as real estate or some other valuable Shari'a compliant asset related to the project.

The agreement would need to describe the capital contributions and the split of profits and losses, as well as the management responsibilities (which would normally be undertaken by the customer who has the required knowledge and expertise).

The customer, as the managing partner, would then undertake the project using the funds and the other contributed assets in the construction and operation of the project. During the construction phase there would be no income being generated and so no profits. As such this type of structure would not usually, in and of itself, be attractive to an Islamic financial institution. In some instances, the Islamic financial institution's share in the partnership or joint venture has been leased to the customer and, in this way, the Islamic financial institution has been able to achieve the required returns, both during and after the construction phase.

Often there can be difficulties with this type of structure when tested against the applicable governing law(s). Some of these issues include the following:

- Does the partnership or joint venture need to be licensed and, if so, are there any fees to be paid, accounts to be filed, etc. (all of which an Islamic financial institution would normally not want);
- In whose name would the assets be held? If it is an unincorporated joint venture, the assets might have to be held in the name of the customer – this raises credit risks on the customer;

- Does the transfer of property or property interests into and out of the partnership or joint venture trigger any transfer or documentary taxes or value-added or sales tax?;
- What operational liability issues attach to the Islamic financial institution being a partner owning the project?; and
- Would any critical documents (such as concession agreements) be capable of being terminated by the grantor if they had to be transferred to the *musharaka*?

The resolution of these issues is sometimes not easy, especially if there are cross border matters to consider.

## 2.7

# Syndicated and Structured Islamic Finance

*Richard T de Belder, Denton Wilde Sapte LLP*

## Syndicated finance

Syndicated finance involves a group of investors or financial institutions pooling their resources to provide finance to the customer. This principle applies equally to both conventional and Islamic finance. The Islamic financiers will act through one Islamic financier and will cooperate through an agreement, which will describe their respective rights and obligations. It is often called a participation agreement or an investment agency agreement.

Under this arrangement, there would be just one Islamic financier that interfaces with the customer and the parties' respective rights and obligations will depend on the role of the Islamic financier that interfaces with the customer. Generally there are two possibilities, namely:

1. *Wakala* (agency); or
2. *Mudaraba*.

It is always possible that legal issues unrelated to the Shari'a may impact the role being played by the representative Islamic financier or the ability to extend certain types of finance. For example, if the finance involved real estate, local laws might require the person holding title be a national of the country or licensed to do business in the country where the real estate is located or might prohibit real estate being held by one person on behalf of others who were not nationals or residents of that country. The syndicate members and their representative in a conventional financing, however, would also likely face similar issues.

## Wakala arrangement

A *wakala* is an agency arrangement. The Islamic financiers will appoint one of them or a third party to be their agent (called a *wakil*). With a conventional facility there will be a facility agent and, to the extent that security is provided, there would be a security trustee or a security agent (and

sometimes both). In terms of security, the decision as to whether to use a security trustee or a security agent will depend on the applicable governing law where the security is located. If the jurisdiction follows an English common law system which recognizes trusts (or if it is a civil code jurisdiction but which has passed specific laws recognizing trusts) the representative of the syndicate will be termed a security trustee. If the applicable jurisdiction does not recognize trusts, then the role will be that of a security agent. In some financings (for example with *sukuk*), one sometimes sees both roles being used (one being documented under English law and one under the local law); often this is done out of abundance of caution although, as security would normally be enforced in the jurisdiction where the security is located, if that jurisdiction does not recognize trusts, the local courts will probably either not enforce the trust arrangements or would interpret them as being agency arrangements.

The same sort of issues will arise with a *wakala* arrangement. The *wakil* is an agent and therefore would, on the face of it, act as the agent of the participating Islamic financiers and hold the security as agent. Nonetheless, there may be reasons why the Islamic financiers would want the *wakil* to hold security as a trustee, if this was recognized under applicable law. The reason for this centres on what would happen if the *wakil* became insolvent. Here the security might, as a matter of local law, fall into the general asset pool of the *wakil* such that the participating Islamic financiers would only have an unsecured claim against the *wakil*. If a trustee is recognized under applicable local law then, if the trustee became insolvent, the usual outcome will be that the security will remain the property of the beneficiaries, being the participating Islamic financiers.

A *wakil*, while an agent, does have various “trust” obligations towards its principals under Shari’a principles, and as such there would not appear to be any restriction on a *wakil* taking on trustee obligations as these do not cut across the broad concept that the *wakil* is supposed to be acting and holding property on behalf of and in the interests of, its principal.

In practice, the participation agreement between the syndicate members and the *wakil* contains provisions that are very similar to those found in a conventional loan agreement. For example, one will normally find the following provisions:

- Appointment of the agent;
- Participation of the participating financiers;
- Prepayment (where applicable) and increased costs (although there are certain Shari’a issues relating to increased costs);
- Payments by the participants and by the agent;
- Refund, sharing and further payments;
- The role and duties of the agent;
- Costs and expenses; and
- Assignment procedures.



There can sometimes be problems about including exculpatory provisions that favour the facility agent/security trustee which are routinely found in a conventional facility agreement. Statements that a facility agent has no trustee or fiduciary obligations are sometimes questioned by Shari'a advisers on the grounds that a *wakil* does have certain "trust" obligations as an *amin* – these broadly can be considered to be acting in good faith and for the best interests of the principal, which can get quite close to fiduciary responsibilities.

It is a requirement that the *wakil* is paid a fixed fee (although additional fees, such as incentive fees, can be paid; however, with this type of finance, incentive fees would not be likely) and that the *wakil* is reimbursed any expenses that it makes on behalf of its principals. These Shari'a requirements will not normally be an issue and are also found in conventional financings.

## Mudaraba arrangements

Sometimes when parties are structuring a transaction, they will talk about the representative of the participants being a *mudarib*. This means that the arrangements contemplate using a *mudaraba* structure. This involves investors (called *rabb al-maal*) providing funds to a *mudarib* (an investment manager) to invest on their behalf pursuant to a business plan and feasibility study. It is critical for Shari'a compliance that the *mudarib* is entitled to a share in the profits rather than a flat fee. A *mudarib* can also be paid an incentive fee but, as stated above in relation to a *wakala* arrangement, this would not normally be found with a syndicated financing.

Any losses would be borne by the *rabb al-maal* unless the losses were caused by the negligence or default of the *mudarib*. If a loss is shown then, under Shari'a principles, the burden of proof shifts to the *mudarib* to prove that the loss was not caused by its negligence or default. It may be, however, that the law of evidence followed by a secular court before which any dispute came, would still place the burden of proof on the Islamic financiers.

It would be incumbent on the *mudarib* to produce a business plan and a feasibility study and these are likely to be important if any losses were suffered because, while the *mudarib* cannot be required to guarantee profits or a return, if the business plan and/or the feasibility study were negligently prepared and losses subsequently suffered, they could be used in evidence against the *mudarib*.

Due to the additional obligations imposed on a *mudarib*, usually the financier that is to act as the "facility agent" will not want to take on this role. To the extent that the representative of the syndicate members wants to take on a role that is similar to that under a conventional facility, it will usually elect to be a *wakil*.



## Structured Islamic finance

Structured finance has no particular definition. Generally, it will involve the packaging together of various legal structures to produce a financial product or solution. The starting point will be to analyse the commercial objectives of the customer. Once those are known then it is a question of looking at the possible Shari'a-compliant financing techniques and undertaking any necessary due diligence, which can extend to matters such as legal research, tax analysis and a review of any underlying assets that are to be employed in the Islamic financing.

With complicated transactions (which is often the case with certain structured Islamic finance products) the challenge is to find a structure that will simultaneously line up the Shari'a requirements, the secular legal parameters and the commercial objectives of the customer. Especially with capital market structured products, there will usually be many documents and the structure will often involve a large number of transactional sequences, all of which will require to be vetted and approved by the Shari'a Supervisory Board that must issue its *fatwa*. From a transactional perspective, therefore, it is important to obtain initial approval from the Shari'a Supervisory Board as soon as possible in relation to the structure. Once this has been approved, then it is usually prudent to have the Shari'a Supervisory Board vet the initial drafts of the documents to ensure that there are no fundamental errors from a Shari'a perspective; it is not advisable to only ask the Shari'a Supervisory Board to approve the documentation once they have been fully negotiated. By that time closing dates would have been pencilled in but, if the Shari'a Supervisory Board at that stage reverts with material objections, the documents may have to be significantly amended and this is likely to have a knock-on impact on the projected closing date.<sup>1</sup>

Two examples of Islamic structured products are considered to show some of the issues that will be faced from a practical perspective. Clearly, however, these two examples are not all encompassing, as the scope of Islamic structured products is unlimited.

## Derivative style products

Derivative style financial products raise particular difficulties under the Shari'a. When viewed in a Shari'a context, conventional derivative products

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<sup>1</sup> The Accounting and Auditing Association of Islamic Financial Institutions based in Bahrain which has issued numerous standards relating to Islamic financial products, issued a statement in relation to *sukuk* in February 2008. Paragraph six of that statement provides as follows: "Shari'a Supervisory Boards should not limit their role to the issuance of fatwa on the permissibility of the structure of *sukuk*. All relevant contracts and documents related to the actual transaction must be carefully reviewed (by them), and then they should oversee the actual means of implementation, and then make sure that the operation complies, at every stage, with Shari'a guidelines and requirements as specified in the Shari'a standards. The investment of *sukuk* proceeds and the conversion of the proceeds into assets, using one of the Shari'a-compliant methods of investments, must conform to Article (5/1/8/5) of the AAOIFI Shari'a Standard (17)."

often involve speculation and uncertainty and these two principles are Shari'a repugnant. Structuring techniques have been used recently to create financial products that increase their projected returns by reference to indices that are not based on Shari'a products. These have employed *salam* or *murabaha* investments (often backed up with capital guarantee mechanisms) coupled with *wa'ad* (undertakings or promises) from a financial institution to pay the investors additional amounts over and above the returns on their investments if an index (which may be based on non-Shari'a compliant products) produces a higher rate of return. This is an example of a structured Islamic finance product that uses various interlocking agreements, investments and indices to create a level of return which the customer wishes to achieve. It is fair to say, however, that this particular type of product has not been accepted as being in compliance with the Shari'a by all Shari'a scholars.

## Sukuk

An example of a *suk*<sup>1</sup> as a structured product was the \$210 million secured floated rate notes issued by Tamweel Residential ABS CI (1) Ltd in July 2007.<sup>2</sup> A diagram of this highly structured product is attached as an exhibit to this chapter.

The customer, Tamweel PJSC (based in Dubai, United Arab Emirates [UAE]) wanted to free up its balance sheet by selling part of its residential financing portfolio (which, as an Islamic financial institution, had been structured to be Islamically compliant through the use of an *ijara* structure). Under the *ijaras*, its customers would lease a villa or apartment from Tamweel and pay rent. At the end of the lease term, if all of the rental payments had been made, the customer lessee would obtain title to the property.

From a Shari'a-compliant perspective, some of the main structuring issues were as follows:

- The investors should only have recourse to the assets;
- The issue had to have multi-tranches;
- There had to be a liquidity facility; and
- As the revenue stream from the *ijaras* was in UAE dirhams and the issue was to be in US dollars, there had to be a currency exchange mechanism.

### **Recourse to assets**

The issue was structured along the lines of a securitization. *Sukuk* should involve the investors being the owners of the pool of assets that they acquire

<sup>1</sup> Suk is singular; *sukuk* is plural although market practice is to use the term *sukuk* even when it refers to a single transaction.

<sup>2</sup> This transaction won the Euromoney Islamic Finance Deal of 2007 award and the Islamic Finance News 2007 Structured Deal award.

and with the investors looking to the revenues and returns generated by the assets as being their sole payment source. This is the classic conventional securitization model. Most *sukuk* have involved investors acquiring assets but, in reality, the main focus of the investors has been on the credit worthiness of the party that issued an undertaking to purchase the assets from the investors if, for example, there was an event of default. This meant that often *sukuk* have been asset backed, rather than asset based. The recent statement issued by AAOIFI (Accounting and Auditing Organization for Islamic Financial Institutions) has, however, raised concerns about the use of such undertakings in certain circumstances.<sup>1</sup>

The Tamweel issue did not have this type of purchase undertaking. The commercial objective of the originator was to ensure that the pool of assets that it was disposing of would become off balance sheet; having any form of contingent liability through a purchase undertaking issued by the originator would, therefore, not be acceptable. It should also be noted that when one is structuring *sukuk* on a securitization basis and in particular where *sukuk* are to be rated, the rating agencies will also want to see a true sale legal opinion that will clearly establish that title to the assets has passed to the investors with no recourse back to the originator (other than in limited circumstances, such as misrepresentation). Accordingly, structuring the issue to be non-recourse to the originator (other than in very limited circumstances) met the requirements not only of the customer but also the rating agencies and also fell within Shari'a parameters.

### **Multi-tranches**

It is customary with a conventional securitization for there to be different classes which will be paid differing returns and which have different priorities. The challenge in structuring the transaction was that this seemed to be against Shari'a principles, which require that all investors should be equal. The Shari'a advisers undertook a significant amount of research and concluded that the issue could be structured in such a manner because it was possible for the investors to agree to subordinate their interests so that different classes of investors obtained differing returns and at different

<sup>1</sup> Statement relating to *sukuk* issued in February 2008. The fourth paragraph states: "It is not permissible for the *mudarib* (investment manager), *sharik* (partner), or *wakil* (agent) to undertake to re-purchase the assets from *sukuk* holders or from one who holds them, for its nominal value, when the *sukuk* are extinguished, at the end of its maturity. It is, however, permissible to undertake the purchase on the basis of the net value of assets, its market value, fair value, or a price to be agreed, at the time of their actual purchase, in accordance with Article (3/1/6/2) of AAOIFI Shari'a Standard (12) on Sharikah (*musharaka*) and Modern Corporations, and Articles (2/2/1) and (2/2/2) of the AAOIFI Shari'a Standard (5) on Guarantees. It is known that a *Sukuk* manager is a guarantor of the capital, at its nominal value, in case of his negligent acts or omissions or his non-compliance with the investor's conditions, whether the manager is a *mudarib* (investment manager), *sharik* (partner) or *wakil* (agent) for investments. In case the assets of *sukuk* of *al-musharaka*, *mudarahah*, or *wakalah* for investment are of lesser value than the leased assets of "lease-to-own" contracts (*ijarah muntahia bittamleek*), then it is permissible for the *sukuk* manager to undertake to purchase those assets – at the time the *sukuk* are extinguished – for the remaining rental value of the remaining assets; since it actually represents its net value."

times. The analysis was based on the premise that all investors have equal co-ownership interests and, furthermore, that each investor is entitled to do whatever they wish with their interests. On this basis they were entitled to give instructions (through agreeing to the terms and conditions of the issue) that amounts due to be paid to them arising from their co-ownership interest could be paid to other investors in priority to them and/or that all or part of any amounts due to them could be paid to other investors.

Based on this Shari'a analysis and advice, it was then possible to structure the issue and the documentation such that there were different classes, which had different payment priority rights and different payment returns. The result of this structuring was that the requirements of the customer and the investors were met in a manner that was held to be Shari'a compliant.

### **Liquidity facility**

While there are certain differences in opinion as to whether a liquidity facility can be provided in a Shari'a-compliant manner, the structuring of the issue required that if there was, for example, an administrative delay in the collection of rentals under the *ijaras* which constituted the pool of assets, such that on a payment date, there were insufficient funds available to pay the investors, the shortfall would be paid under a liquidity facility. Amounts drawn under the liquidity facility would be repaid from subsequent *ijara* proceeds.

In structuring this part of the offering, it was not possible for any loan facility to be conventional as the entire structure had to be Shari'a-compliant. Accordingly the facility was structured as being a *qard al-hassan*. This is a loan that is acceptable under the Shari'a but one where there is no interest or other return based on the mere provision of the funds (as this would amount to *riba* which is prohibited). To deal with the requirement of the lender that it needed some recompense, the Shari'a advisers agreed that certain payments could be made for administrative services that were being performed in making available and monitoring the provision of the *qard al-hassan* financing. Based on this conclusion, therefore, it was possible to structure such a facility that met the requirements of the various parties.<sup>1</sup>

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<sup>1</sup> Since the Tamweel issue, the AAOFI standard on *sukuk* was issued (in February 2008) and which considered liquidity facilities. The third paragraph states, in part, as follows: "It is not permissible for the manager of *sukuk*, whether the manager acts as a *mudarib* (investment manager), or a *sharik* (partner), or a *wakil* (agent), to undertake to offer loans to *sukuk* holders, when actual earnings fall short of expected earnings." It is permissible, however, to establish reserves or to provide for the distribution of expected earnings on account.

### ***Currency exchange mechanism***

The investors purchased assets that constituted real estate interests which were subject to *ijara* (leasing) contracts for residential buildings. The rental payments were in UAE dirhams. However, the investors wished to be paid in US dollars. While the UAE dirham is pegged to the US dollar, there was a concern about what would happen if the peg were broken. Therefore, there had to be arrangements whereby, if the exchange peg was broken, a financial institution would agree to exchange UAE dirhams in the future for US dollars at the pegged rate.

In order to structure and draft the documentation, it was first necessary to obtain guidance from the Shari'a advisers. The exchange of money does cause some Shari'a-related issues. However, the principle of there being an undertaking from a bank to purchase UAE dirhams in return for US dollars was found to be acceptable provided that:

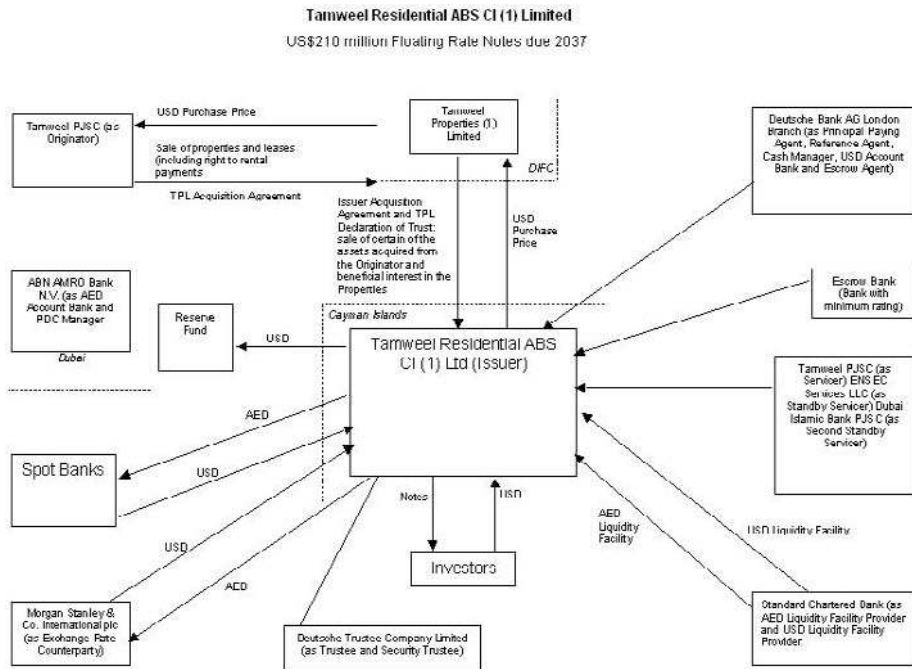
- There was merely an undertaking from the exchange bank to exchange if called upon by the issuer (rather than a binding two party agreement);
- If the issuer wished to exchange it would need to send a notice to the exchange bank providing full details as to the amount and the date of the exchange;
- There would then be an agreement entered into by both parties to reflect that particular sale; and
- The sale/exchange should take place on the same day as the agreement to sell/purchase.

However, there were some practical concerns that had to be addressed. Having a separate sale and purchase agreement signed by both parties each time that there was an exchange was going to cause operational difficulties. After discussions with the Shari'a advisers, it was accepted that when the notice of exercise was sent by the issuer, the exchange bank would only have to sign and return the notice, which would contain language that, as a matter of English law, would constitute a concluded sale and purchase agreement.

The other commercial issue was that it would not always be possible to exchange the currencies on the same day as the signed and returned notice but, in this instance, the Shari'a advisers were willing to approve the exchange if it occurred no later than two business days from the date of the notice. This approval was given on the Shari'a ground of necessity because, within the international banking system, the movement of funds might require two business days for the exchange to be completed. In this way, through an exchange of views between the financial institutions and the Shari'a advisers, it was possible to structure an exchange mechanism that met all parties' concerns.

## Summary

As can be seen from the issues that have been highlighted, in structuring Islamically compliant products it is necessary to ascertain early on what are the commercial aims of the parties and then tailor those aims to reflect the requirements of the Shari'a as well as applicable secular law but in a manner that still means that the commercial aims are being met. While this process can take time, there are usually solutions that can be found.





## 2.8

# Investment Banking

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## Introduction

The term “investment banking” does not have a precise description. In general terms, it can be said to encompass the activities of investment banks and finance institutions in the following areas:

- Assisting companies and governments raising finance through the issue and sale of securities in the capital markets (equity and debt);
- Providing advisory services in areas such as mergers and acquisitions and in relation to the issue and placement of stocks and securities;
- Derivatives, fixed income, foreign exchange and commodity and equity securities; and
- Acting as agents or underwriters in the issue of securities.

As a general principle, Islamic financial institutions can provide all of the usual services offered by conventional investment banks, provided that the services and products are Shari’a-compliant.

The activities and services considered below are not intended to be exhaustive in terms of the range of services and activities that an Islamic investment bank can offer.

## Capital markets

Islamic financial institutions are only able to be involved in capital market issues that are in compliance with the Shari’a. Accordingly, they are not able to be involved in conventional bonds, which merely represent a debt obligation of the issuer.

The Islamic equivalent of conventional bonds are *sukuk*. However, it is important to recognize that there are significant differences. *Sukuk* are supposed to be asset based and the investors must own a pool of assets supporting the issue (in other words the rights and the obligations relating to those assets) and not just the right to a debt or a revenue stream divorced from ownership of the actual assets themselves.

Typically, the structure will involve a special purpose company formed in a jurisdiction such as the Cayman Islands, which will be owned by a widows



and orphans trust. This is done so that the issuer is not a subsidiary of the originator in order, primarily, to ensure total independence from the originator. The funds made available by the investors will be paid to the originator in return for the purchase of the pool of assets. A trustee will usually hold title to the assets on behalf of the investors (and other persons who are entitled, for example, to be paid fees and other amounts in connection with the issue). Those trust arrangements will usually be under English law.

In practice while there has been a sale of assets, the investors have really been looking to the credit risk associated with the originator. This is because, in most of the *sukuk* structures to date, the originator has given a purchase undertaking to the trustee for the benefit of the investors that if there were an event of default or the term of the *sukuk* ended, the originator would be obliged to re-purchase the assets for a price that would equal the initial amount of the investment (less any principal payments made before the exercise of the purchase undertaking) and any other outstanding amounts.

This approach has, therefore, meant that most *sukuk* have been asset backed and not asset based. *Sukuk* should arguably be structured so that they are in effect the same as a conventional securitization in that the investors (who own the assets under the *sukuk*) should only be looking to those assets to obtain the returns that they seek and the recovery of their initial investments. To date, very few *sukuk* have followed this structure.

An Islamic investment bank can structure *sukuk* in a variety of ways and the types of structures are likely to continue to expand and evolve. Current examples include *sukuk* structured as *ijara* (lease), *mudaraba* (investment trust), *musharaka* (joint venture or co-ownership) and salam (forward sale).

What this means is that investors' funds are utilized in a manner which adopts a Shari'a-compliant structure in their deployment and the Islamic investment banker will need to consider the circumstances of the client, the requirements of the investors, the views of the Shari'a scholar and applicable legal, regulatory and tax issues. Examples of structures used for *sukuk al-ijara*, *sukuk al-mudaraba* and *sukuk al-musharaka* are to be found in the exhibits to this chapter. The key aspects that are found in different types of *sukuk* are as follows.

## Sukuk al-ijara

The originator has various assets that it is able to sell to the investors. It sells them for an amount which represents the investment funds being made available by the investors. The investors then lease the assets to the originator. Under the Shari'a, a lessor must remain responsible for structural and major maintenance, property insurance and ownership taxes. It appoints the lessee as its service agent to perform these functions and to pay such amounts on its behalf. The lessor is obliged to reimburse amounts expended by an agent. However, in order to pass the economic cost of these functions

to the lessee, the rent is increased by an equivalent amount. The reimbursement obligation is set off against the additional rent so that there is no flow of funds, resulting in the lessee (originator) bearing these costs. The rent is usually divided into fixed rent (being the amount of the initial purchase price) and variable rent (which will be fixed by reference to the aggregate fixed rent that has yet to be paid using a conventional interest rate as a benchmark for the calculation of the variable rent).<sup>1</sup>

In many of these *sukuk*, the originator has given an undertaking to purchase back the assets if there is an event of default for the balance of all fixed rent that has not yet been paid together with all other amounts that may be owing under the *ijara*.

## Sukuk al-musharaka

This structure can be a *sharikat al-aqt* (partnership or joint-venture) or a *sharikat ul-melk* (co-ownership). With a *sharikat al-aqt*, the originator introduces assets as its share of the partnership or joint venture capital. The proceeds of the *sukuk* issue will represent the investors' capital in the joint venture or partnership.

The originator would normally be appointed as the manager (*mudarib*) of the partnership or joint venture and would undertake activities in accordance with a business plan that would be part of the partnership or joint venture agreement. Profits would be payable to the two partners, although the manager would usually be paid an incentive fee (in effect to reduce the profit entitlement to the investors so that they would receive what would be, in effect, a fixed income return). There would also be a purchase undertaking from the originator to purchase the investors' share if there were an event of default or at the end of the specified period of the *sukuk*. Depending on the jurisdiction, the transfer of assets into and out of the partnership or joint venture can lead to difficult tax and value added tax issues.

## Sukuk al-mudaraba

This structure is of interest to originators who do not have assets that they can easily make available for a *sukuk al ijara* or *sukuk al-musharaka*, but which needs finance for additional business investments or activities. A *mudaraba* involves investors (called *rabb al maal*) providing funds to a

<sup>1</sup> The variable rent will be calculated usually by reference to a conventional interest rate such as LIBOR. The arguments that are currently put forward to support this practice are usually twofold: The first is a very technical argument which is that it is possible to use any benchmark as part of a mathematical calculation to produce the return on an Islamically compliant product. The position taken by most Shari'a Supervisory Boards is that, provided the relevant clause is carefully drafted to provide that a return is calculated by reference to a formula that includes an interest rate benchmark but does not say that the return is interest, such an approach is Shari'a compliant. The better position is that the reference to an interest rate is acceptable based on the Shari'a grounds of necessity or public need because, at present, there is no viable Shari'a compliant alternative.

*mudarib* (an investment manager) to invest on their behalf pursuant to a business plan and feasibility study. It is critical for Shari'a compliance that the *mudarib* is entitled to a share in the profits rather than a flat fee. A *mudarib* can also be paid an incentive fee.

Any losses would be borne by the *rabb al-maal*, unless they were caused by the negligence or default of the *mudarib*. A *mudarib* should produce a business plan and a feasibility study and these are likely to be important if any losses were suffered because, while the *mudarib* cannot be required to guarantee profits or a return, if the business plan and/or the feasibility study were negligently prepared and losses subsequently suffered, they could be used in evidence against the *mudarib*.

In the context of *sukuk*, therefore, the investors acquiring *sukuk* certificates would pass their funds over to the *mudarib*, which would likely be the originator or a group company. The business plan would call for the funds to be invested in projects which would in fact be the projects/buildings/assets that the originator required to be financed.

The return to the *sukuk* certificate holders would be based on the profits and revenue stream generated by the assets that are being acquired and funded as part of the *mudarib's* business plan. In the structures to date there have also been undertakings from the *mudarib* to purchase the investment of the *sukuk* certificate holders for an amount that enables them to recover the balance of their outstanding investments.

## Recent issues arising out of the AAOIFI statement on Sukuk<sup>1</sup>

AAOIFI (Accounting and Auditing Organization for Islamic Financial Institutions) is not a statutory industry-wide body, but is an organization based in Bahrain in which leading Shari'a scholars participate in order to resolve issues and try and reach agreed settled positions.<sup>2</sup> AAOIFI's statement on *sukuk* was issued due to various concerns being expressed about some techniques that had been used in the structuring of *sukuk*. These concerns related in particular to:

- The use of liquidity facilities in order to ensure that *sukuk* certificate holders received timely payments, even if the assets were not generating sufficient income to pay them<sup>3</sup>; and

<sup>1</sup> AAOIFI is based in Bahrain. It has issued numerous standards relating to Islamic financial products, including a statement in relation to *sukuk* that was issued in February 2008.

<sup>2</sup> In Bahrain, however, where AAOIFI is based, it does have a statutory standing. The Central Bank of Bahrain Rulebook has various relevant provisions. Rulebook HC-1.3.15 provides that there should be an independent Shari'a Supervision Committee for a regulated Islamic financial institution complying with AAOIFI's governance standards for Islamic Financial Institutions No. 1 and No.2 and Rulebook HC-1.3.16 provides that all Islamic banks must comply with all AAOIFI issued accounting standards as well as the Shari'a pronouncements issued by the Shari'a Board of AAOIFI.

- The use of purchase undertakings to buy back the interests of the investors using a pre-agreed formula such that investors would neither face any loss to their initial investment, nor receive any gains on that investment.<sup>1</sup>

The statement has allowed (subject to certain conditions) the use of purchase undertakings where the *sukuk* assets are “lease-to-own” contracts where the exercise price equals the balance of rentals not yet paid, on the basis that they can be treated as representing net value. However, it will be interesting to see how this statement is interpreted by the Shari’a scholars and the extent to which they feel bound to follow its provisions. It is likely that Islamic investment bankers will need to carefully monitor the implementation of this statement and will need to modify *sukuk* structures accordingly.

## Selling of securities and packaging of securities into Islamically-compliant products

To the extent that an Islamic investment bank becomes involved in selling securities or wants to create, for example, a Shari’a-compliant equity fund, it must satisfy itself that the securities are Shari’a-compliant. At a primary level, therefore, the securities must not be involved in activities or relate to products which are prohibited under the Shari’a. As such, holding shares in companies that are involved in gambling, hotels (to the extent that they have bars), pubs, pig farming and defence industries would not be allowed.

It is also necessary to consider the revenue and assets of a company, to see if they are Shari’a-compliant. The process of checking the Shari’a compliance or otherwise of securities is usually referred to as “screening”

<sup>1</sup> The third paragraph provides, in part, as follows: “it is not permissible for the manager of the *sukuk*, whether the manager acts as *mudarib* (investment manager), or *sharik* (partner), or *wakil* (agent) for investment, to undertake to offer loans to *sukuk* holders, when actual earnings fall short of expected earnings.” It is, however, permissible to set up reserves or to provide for the distribution of expected earnings on account and also to obtain project financing on account of the *sukuk* holders.

<sup>2</sup> The fourth paragraph states: “it is not permissible for the *mudarib* (investment manager), *sharik* (partner), or *wakil* (agent) to undertake (now) to re-purchase the assets from *sukuk* holders or from one who holds them for its nominal value, when the *sukuk* are extinguished at the end of its maturity. It is, however, permissible to undertake the purchase on the basis of the net value of assets, its market value, fair value, or a price to be agreed at the time of their actual purchase, in accordance with Article (3/1/6/2) of AAOIFI Shari’a Standard (12) on Sharikah (Musharaka) and Modern Corporations, and Articles (2/2/1) and (2/2/2) of the AAOIFI Shari’a Standard (5) on Guarantees. It is known that a *sukuk* manager is a guarantor of the capital, at its nominal value, in case of his negligent acts or omissions or his non-compliance with the investor’s conditions, whether the manager is a *mudarib* (investment manager), *sharik* (partner) or *wakil* (agent) for investments. In case the assets of *sukuk al-musharaka*, *mudarah*, or *wakalah* for investment are of lesser value than the leased assets of “lease-to-own” contracts (*ijarah muntahia bittamleek*), then it is permissible for the *sukuk* manager to undertake to purchase those assets – at the time the *sukuk* are extinguished – for the remaining rental value of the remaining assets; since it actually represents its net value.”

and there are now various software programmes that have been developed that can aid in this process. There are different accounting-based screens that are adopted.

The Dow Jones Islamic Index, which is often used as a respected benchmark, excludes companies whose:

- total debt, divided by trailing 12-month average market capitalization is 33 per cent, or more;
- cash-plus-interest bearing securities divided by trailing 12-month average market capitalization is 33 per cent, or more; and
- accounts receivables divided by 12-month average market capitalization is 33 per cent, or more.

AAOFI has issued Standard No. 21 dealing with financial paper (shares and bonds), which sets out various parameters in relation to the participation or trading of shares in companies whose primary activity is lawful, but which make deposits or borrow on the basis of interest. The conditions are that:

- the constitutive documents do not state that one of its objects is to deal in interest or *haram* goods;
- the aggregate amount of interest bearing debt does not exceed 30 per cent of the market capitalization of the company;
- the total amount of interest bearing deposits does not exceed 30 per cent of the market capitalization of the total equity; and
- the amount of income generated from a prohibited component does not exceed 5 per cent of the total income of the corporation.

In determining these percentages, recourse is to be had to the last budget or verified financial position. In addition, the companies must know that the use of conventional interest-based financing is prohibited.

There are on-going discussions about refining screening ratios and the methodology used in calculating the ratios.

The requirement to ensure Shari'a compliance is an ongoing process in that it is not sufficient that the shares are Shari'a-compliant when they are first acquired, but must continue to be so compliant. For example, it might be that the company which issued the shares is Shari'a-compliant initially but then forms a subsidiary that engages in non-Shari'a activity. In this instance, the security may have to be disposed of or, depending on the level of non-Shari'a compliance, a relevant amount of dividend payments passed over to charity.

## Mergers and acquisitions

Investment banks routinely are involved in mergers and acquisitions. In relation to arranging Islamically-compliant financing for use in these

transactions, it is possible to structure Islamic finance solutions, although these can be sometimes very difficult to achieve, especially in more developed jurisdictions where there are complex tax laws. If the Islamic investment bank wanted to extend finance it could do so using various techniques such as *musharaka*, *mudaraba*, *ijara* and others.

If a direct equity interest is to be taken by an Islamic investment bank or a Shari'a-compliant customer, then the same concerns about the activities of the target and the screening techniques described above would also be applicable.

## Derivatives style transactions

In structuring Shari'a-compliant derivatives, an Islamic investment banker will need to consider certain issues such as:

- the prohibition on *riba*. This term is commonly held to mean interest and, while it is true that interest is covered, *riba* covers any return that arises merely through the passage of time by reference to the use of money itself;
- there should be no *gharar* (roughly translated as “uncertainty”). This restriction covers the general prohibition on the sale of an asset which does not exist at the time when an agreement is entered into. There are exceptions to this rule, such as *salam* or *istisna'a*. *Salam* has been used as the basis of certain Shari'a-compliant derivative transactions; and
- there should be no *maisir* (speculation).

Behind these issues is the exhortation under the Shari'a that money should be properly utilized through its use and investment in real goods and real transactions when a person shares in the return (such as rent, profit or other economic benefit) by virtue of sharing in risk.

Derivative style contracts by their nature raise serious issues in relation to some of these key Shari'a issues. Islamic investment bankers are trying to create new Shari'a-compliant products to match those being offered to conventional customers and some of the Shari'a-compliant derivative products have used the following structures.

## Currency exchange agreements

Currencies can be exchanged or sold but provided strict conditions are complied with. A recent transaction was structured around the following parameters prescribed by the Shari'a advisers:

- There was merely an undertaking from the exchange bank to exchange if called upon by the issuer (rather than a binding two-party agreement);

- If the issuer wished to exchange it would need to send a notice to the exchange bank providing full details as to the amount and the date of the exchange;
- An agreement was then to be entered into by both parties to reflect that particular sale; and
- The sale/exchange should take place on the same day as the agreement to sell/purchase.

However, there were some practical concerns that had to be addressed. Having a separate sale and purchase agreement signed by both parties each time that there was an exchange would cause operational difficulties. After discussions with the Shari'a advisors, it was accepted that when the notice of exercise was sent by the issuer, the exchange bank would only have to sign and return the notice, which would contain language that, as a matter of English law, would constitute a concluded sale and purchase agreement.

The other commercial issue was that it would not always be possible to exchange the currencies on the same day as the signed and returned notice but, in this instance, the Shari'a advisers were willing to approve the exchange if it occurred no later than two business days from the date of the notice. This approval was given on the Shari'a ground of necessity because, within the international banking system, the movement of funds might require two business days for the exchange to be completed.

## Salam-based contracts

Historically, *salam* has been used for financing agricultural products but has been adapted to create Shari'a-compliant derivative transactions mimicking conventional options. A *salam* requires the sale price to be paid immediately and with ownership of the *salam* goods also being transferred at the same time, but generally subject to a restriction that the purchaser cannot dispose of the goods until they are delivered to it.

The *salam* goods will not be in existence when the *salam* contract is entered into. The general rule is that the description of the *salam* goods cannot mention a specific asset on the basis that, as the asset does not exist, it is only possible to refer to goods in a general manner. However, the specifications of the goods, their quality, quantity and other relevant details must be clearly stated.

It is up to the seller to source goods that meet the specific requirements. Using an agricultural example, if the *salam* contract was to describe 100 kilograms of wheat from a particular field, there is the potential for the contract to become void if the wheat in the field was destroyed. It is for this reason that the goods must be described in enough detail for the seller to deliver the required goods to the purchaser but must not describe a specific source.

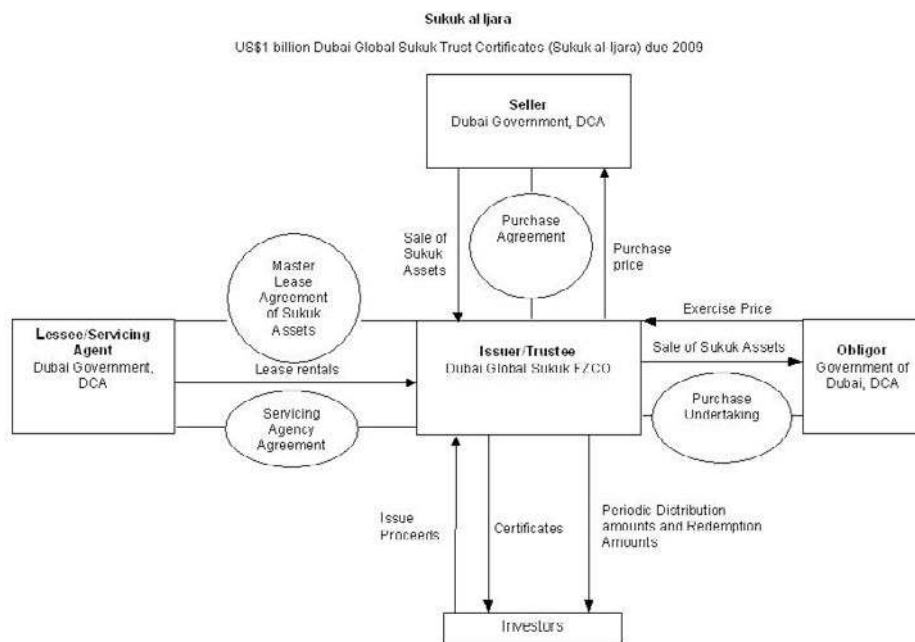
It is not permitted, however, to sell the *salam* goods before delivery has been made; this is because the *salam* contract could be rescinded if the seller



reneged on delivering the *salam* goods. The Islamic financier will not want to retain the goods. A back-to-back *salam* can be used but the date of delivery to the onward purchaser must be after when the Islamic financier’s customer has delivered the goods to it. In addition, this back-to-back *salam* must also specify the goods in general terms (as in the first *salam*) and must not make specific reference to the goods being purchased by it in the first *salam*. The structuring of Shari’a-compliant derivative style agreements using *salam* has been based on the use of back-to-back *salam*.

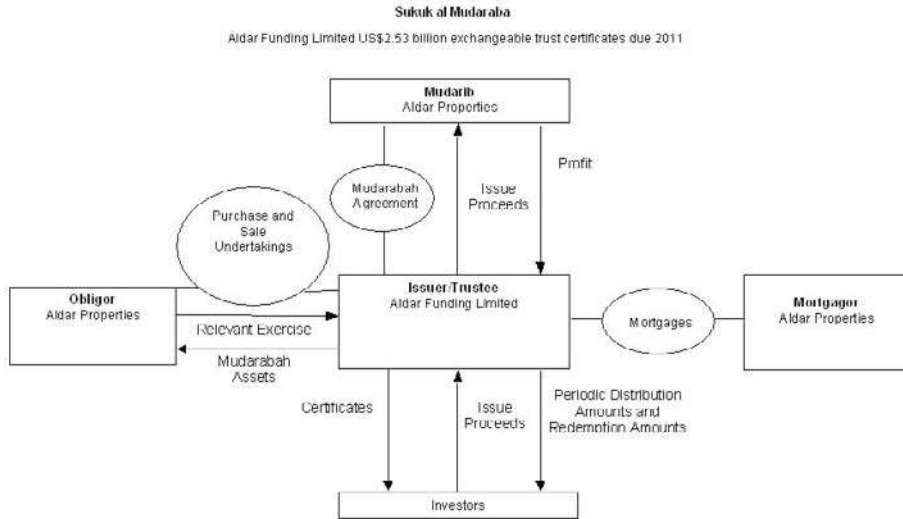
There is, however, a current debate amongst the Shari’a scholars on some of the structures and rationale that has been used in the structuring of some products that has been generated by, in particular, the issues raised by Sheikh Yusuf Talal DeLorenzo in his paper titled “The Total Returns Swap and The Shari’a Conversion Technology Stratagem.”

All this has merely reinforced the view that the creation of Shari’a-compliant derivatives is one of the most challenging areas for Islamic finance practitioners.

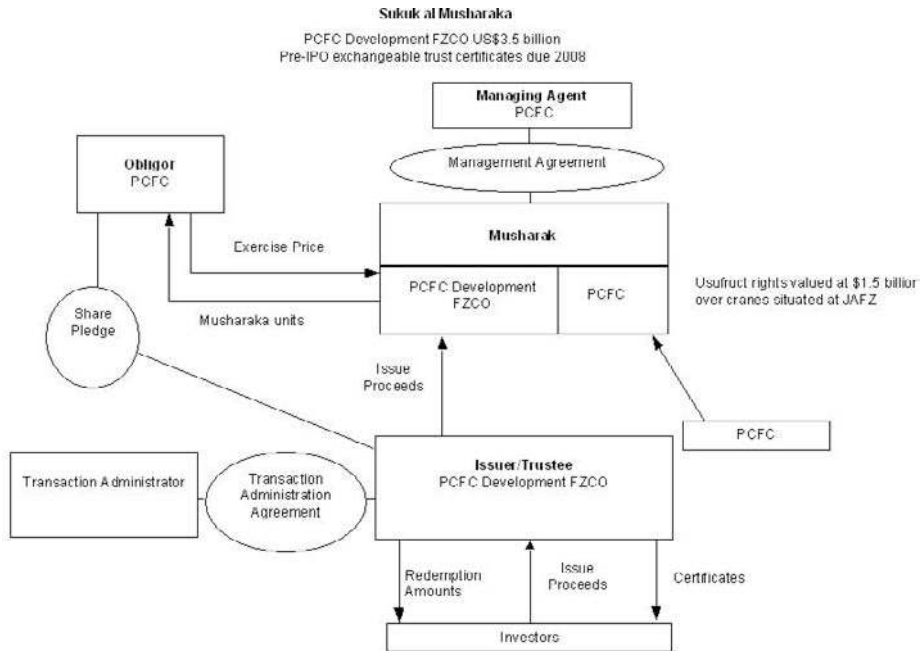


*Sukuk al Ijara* – Department of Civil Aviation, Dubai, UAE





*Sukuk al Mudaraba – Aldar Properties*



*Sukuk al Musharaka – Ports, Customs and Freezones Company*

## 2.9

# Islamic Capital Markets

*Mansur Mannan, Credit Suisse*

### Introduction

The growth of Islamic finance in its modern form has, by all accounts, been impressive. This growth was further accelerated at the turn of the century by developments in the Islamic capital market. Bilateral and syndicated financing techniques had been developed and extensively used in the 1980's and 1990's, both by the Islamic financial institutions as well as Islamic windows of conventional financial institutions. Such techniques were nonetheless limited. Funds successfully mobilized by Islamic financial institutions were invested in a limited number of financial instruments, dominated by short-term trade financing. Such instruments mainly included purchase finance using cost-plus-margin (*murabaha*), leasing (*ijara*), financing and, to a small extent, investment management (*mudaraba*) and partnership (*musharaka*) models. Such status remained fairly static with a significant portion of Islamic institutions' assets comprising short-term commodity *murabaha*-based placements. This was partly due to market conditions, but also lack of liquid assets and other constraints.

By the late 1990s, regulators and industry leaders called for the introduction of new products and the promotion of financial engineering. Their main areas of concern were the lack of liquidity, a lack of portfolio and risk management tools, and the absence of derivative instruments. One of the impediments to growth was the lack of understanding of the fast changing landscape of modern financial markets, as well as the intricacies of rules demanded by the Shari'a.

The task was further complicated by the different schools of Islamic thought in various parts of the globe. Nevertheless, by the turn of the century, Islamic financial institutions had realized that the development of capital markets was essential for their survival and further growth. Meanwhile, deregulation and liberalization of capital movements in several countries led to close cooperation between Islamic financial institutions and conventional financial institutions in order to find solutions for liquidity and portfolio management. This resulted in two distinct developments:

1. The introduction of equity funds that were compatible with Shari'a; and
2. The launch of Islamic asset-backed securities, more commonly known as *sukuk*.

Whereas Islamic equity funds became popular with investors who had a “risk appetite” for equity investment, Islamic financial institutions, driven by the nature of their intermediation, kept demanding securities which could behave like conventional fixed-income debt securities, but also comply with Shari’a. In addition, Islamic financial institutions wanted to extend the maturity structure of their assets beyond the typical short-term maturities provided by trade finance instruments. The result is that within a short span since the start of the new millennium, the market for *sukuk* has reached an impressive size with growth doubling almost each year.

Central banks in several Islamic countries also played a key role in setting the stage for development of the capital market. They were keen to introduce instruments that provided liquidity in the market place. Such countries included Malaysia, Bahrain, Kuwait, Sudan, Iran, Jordan and Pakistan. Some of these countries had tried to introduce a legal framework for *sukuk* issuance, but the first successful issuance was initiated by the Malaysian government in 1983, with the issuance of the Government Investment Issue (GII), formerly known as the Government Investment Certificate. The main objective of this instrument was to facilitate the management of assets in the Islamic banking system, which, by this time, was fairly mature.

The issuance of GII was based on the Islamic concept of *qard al-hasan* (benevolent non-interest bearing loan). However, GII was not a tradable instrument since it only represented outstanding debt that cannot be traded under Shari’a principles. Recently, the underlying concept of GII was changed to *bai al-inah* to allow it to be traded in the secondary market.

Similarly, the Central Bank of Kuwait issued interest-free certificates to finance the purchase of properties held by nationals other than Gulf Cooperation Council (GCC) states. Iran has also introduced the concept of participation bonds on a *mudaraba* basis. The Central Bank of Bahrain, however, pioneered the *ijara* and *salam sukuk*s as medium to short-term monetary instruments that have continued to be well received by institutional investors. Thus, the success of numerous *sukuk* issuances worldwide opened up an alternative source of funding and diversification for investors, which is now tapped by many countries and corporations.

This increase in demand, together with the work that is underway to standardize *sukuk* issuance, is expected to provide further momentum to the growth of the market. The World Bank issued its first local-currency dominated 760 million Malaysian Ringgits (\$200 million) *sukuk* in 2005. In the same manner, hedge funds and conventional institutional investors have been keen to take up a significant portion of *sukuk* certificates as they search for yield pick-up and diversification. This has resulted in a large number of *sukuk*s being issued, both public and private with the result that the issuance of *sukuk*s quadrupled to \$27 billion in 2006, and \$39 billion in October 2007, from \$7.2 billion in 2004, as per McKinsey and Company’s World Islamic Banking Competitiveness report.

## Sukuk

The idea behind a *sukuk* (popularly known as an Islamic or Shari'a-compliant "bond") is simple. Prohibition of interest virtually closes the door for a pure debt security, but an obligation which is linked to the performance of a real asset is acceptable. Shari'a prohibits earning returns from loan contracts upon which returns are based on interest. For instance, conventional bonds and other derivative instruments that rely on profiting holders by providing returns based on interest are unavailable to Muslims. In other words, a financial instrument that derives its returns from the performance of a tangible or even intangible asset is acceptable under Shari'a.

The word *sukuk* is derived from the Arabic word *sak*, which is literally translated as "written document", or a more common meaning of "certificate", and reflects participation rights in underlying assets. In Islamic finance the concept of securitization is what is known in Arabic as "*taskeek*", that is the process of dividing ownership of tangible assets, usufructs or both into units of equal value and issuing securities as per their value.

The creation of Islamic financial securities can be done in two distinct ways:

1. Direct structuring of securities; and
2. The process of asset securitization.

Direct structuring involves the initial issuance of securities, and the funds raised will be used to fund certain assets/projects with the client company. The profits generated from these assets/ projects are then distributed amongst security holders. The opposite to direct structuring is asset securitization, where existing assets of the client company are identified, pooled, and then securities are issued against them.

There are many structures that can generate the revenue paid to *sukuk* holders. Most *sukuk* issuances to date have been wholly asset-based rather than asset-backed; this has an impact on their ratings. In an asset-based *sukuk*, *sukuk* holders rely for payment on the company seeking to raise finance (the originator), in the same way as they would under a corporate bond issue. In an asset-backed *sukuk*, *sukuk* holders rely on the assets of the *sukuk* for security. More importantly, in an asset-based *sukuk*, the market value of the underlying assets has no bearing on the redemption amount as this is fixed at the outset when the relevant undertakings are agreed. More recently, the market has seen issuances with a mix of cash and assets, and in several cases, *sukuks* have been issued for a new business with no tangible assets. The issuances of convertible and exchangeable *sukuks* are more recent developments.

The modern form of *sukuk* is an asset-backed trust certificate. In its simplest form, *sukuk* is a trust instrument with the *sukuk* holder having beneficial or legal ownership of the trust asset or its usufruct. The Accounting

and Auditing Organization for Islamic Financial Institutions (AAOIFI) Standard 17 defines “investment *sukuk*” as being:

Certificates of equal value representing after closing subscription, receipt of the value of the certificates and putting it to use as planned, common title to shares and rights in tangible assets, usufructs and services, or equity of a given project or equity of a special investment activity.

*Sukuk* should not be confused with conventional shares or bonds. Shares are issued by a stock company that has been granted independent juristic personality. In the case of bonds, the bond holder enters into a debtor-lender relationship with the bond issuer. In its simplest form, a bond is a contractual debt obligation whereby the issuer is contractually obliged to pay to bondholders, on certain specified dates, interest and principal. In comparison, the design of the *sukuk* is derived from the conventional securitization process in which a special purpose vehicle is set-up to acquire assets and to issue financial claims on the asset. Such financial claims represent a proportionate beneficial ownership for a defined period when the risk and the return associated with cash flows generated by an underlying asset is passed to *sukuk* holders (investors). Hence *sukuk* holders are entitled to share in the revenues generated by the *sukuk* assets as well as being entitled to share in the proceeds of the realization of those assets.

On the other hand, there are a number of similarities between a conventional bond and a *sukuk*. These include:

- Marketability – *sukuk* are monetized real assets that are liquid, easily transferred and traded in the financial markets;
- Ratability – *sukuk* can be rated;
- Enhanceability – different *sukuk* structures may allow for credit enhancements; and
- Versatility – the variety of *sukuk* structures defined in the AAOIFI standards allow for structuring across legal and fiscal domains, fixed and variable income options, etc.

Recently there has been a claim that *sukuks* are asset backed rather than asset based. In an asset-based *sukuk*, *sukuk* holders rely for payment on the company seeking to raise finance (the originator), in the same way as they would under a corporate bond issue. In an asset-backed *sukuk*, *sukuk* holders rely on the assets of the *sukuk* for security. In the case of asset-based *sukuk*, the market value of the underlying assets has no bearing on the redemption amount as this is fixed at the outset when the relevant undertakings are agreed. As will be shown below, *sukuk* structures are essentially asset-based, but the modern structuring techniques have tended to retain the major risk of the asset with the originator of the *sukuk*.

## Types of sukuk

All *sukuks* are not the same type; AAOIFI lays down 14 different types of *sukuk*. The most popular structure is the *sukuk al-ijara*, based on an Islamic leasing transaction as described further below.

A critical consideration for the *sukuk* is that the issuer must invest the proceeds in a Shari'a-compliant manner using one or more of the Shari'a modes of financing. Some of the common forms of *sukuks* are also described below.

### Sukuk al-ijara

*Ijara* (lease) is a contract according to which a party purchases and leases out equipment required by the client for periodic rental payment. The duration of the rental and the amount payable are agreed in advance, and ownership of the asset remains with the lessor.

*Sukuk al-ijara* is securities representing the ownership of well-defined existing and known assets, that are tied up to a lease contract. This means that *sukuk al-ijara* can be traded in the market at a price determined by market forces.

Steps involved in the structure:

- (a) The obligator sells certain assets to the special purpose vehicle (SPV) at an agreed pre-determined purchase price;
- (b) The SPV raises financing by issuing *sukuk* certificates in an amount equal to the purchase price and this is passed on to the obligator (as seller);
- (c) A lease agreement is signed between SPV and the obligator for a fixed period of time, where the obligator leases back the assets as lessee;
- (d) The SPV receives periodic rentals from the obligator. These are distributed among the investors – the *sukuk* holders; and
- (e) At maturity, or on a dissolution event, the SPV sells the assets back to the seller at a predetermined value. That value should be equal to any amounts still owed under the terms of the *sukuk al-ijara*.

Other characteristics of *sukuk al-ijara* are as follows:

- The rentals can be re-priced using an agreed basis and hence provide a variable return in line with changes in market rates. This allows for issuance of a negotiable instrument that can be traded in the secondary market;
- Although under Shari'a the lessor is responsible for the maintenance and insurance, the costs can be structured into and recovered through the periodic rental payments; and
- There is considerable flexibility in repayment of the principal amount of

the issuance used to purchase the assets. The amount could be amortized with or without grace period and included in the periodic rentals or replicate a bullet repayment on maturity date.

An example of *sukuk al-ijara* is as follows:

The Central bank of Bahrain issued a \$250 million *sukuk* Trust Certificate through BMA International Sukuk Company. The Kingdom of Bahrain, acting through the ministry of finance and national economy (in such capacity, the head lessor), leased by way of head lease for a term of 100 years a certain land parcel to the issuer pursuant to the *al-ijara* head lease agreement, and (in such capacity, the sub-lessee), leased by way of sublease from the issuer the land parcel on the terms set out in an *al-ijara* sub-lease agreement for a period of five years. The sublease is subject to earlier termination if the trust is dissolved early.

## Sukuk al-mudaraba

*Mudaraba* means an agreement between two parties according to which one of the two parties provides the capital (capital provider) for the other (*mudarib*) to work with on the condition that the profit is to be shared between them according to a pre-agreed ratio. These types of *sukuks* play a vital role in the process of development financing, because these are related to the profitability of the projects.

The issuer of these certificates is the *mudarib*, the subscribers are the capital providers, and the *sukuk* proceeds are the *mudaraba* capital. The certificate holders own the assets of *mudaraba* and the agreed upon share of the profits; losses, if any, are borne by capital providers only.

*Mudaraba sukuk* gives its owner the right to receive his capital at the time the *sukuk* are surrendered, and an annual proportion of the profits as agreed. *Mudaraba sukuk* neither yield interest nor entitle owners to make claims for any definite annual interest. This shows that *mudaraba sukuk* is like shares with regard to varying returns, which are accrued according to the profits made by the project.

*Mudaraba sukuk* must represent a common ownership and entitle their holder to shares in a specific project for which the *sukuk* have been issued to fund. A *sukuk* holder is entitled to all rights, which have been determined by Shari'a upon his proportionate ownership of the *mudaraba* assets.

Steps involved in the structure:

- (a) The *sukuk* issuer enters into a *mudaraba* agreement with the project manager (*mudarib*) for construction/commissioning of a project;
- (b) The SPV issues *sukuk* to raise funds, the proceeds of which are given to the *mudarib*;
- (c) The *mudarib* undertakes the project and collects regular profit payments from the activity for onward distribution to investors; and



- (d) Upon completion, the *mudarib*, in its capacity as obligator, purchases the assets of the project from the issuer.

An example of *sukuk al-mudaraba* is as follows:

Aldar Properties PJSC, an Abu Dhabi real estate development company, issued a 4.75-year *sukuk* convertible into its ordinary shares. Proceeds from the transaction were used to fund Aldar's ambitious real estate development programme with Aldar acting as the *mudarib*. The deal was enthusiastically received by investors and was heavily oversubscribed at the initial transaction size. The deal was increased from \$1,300 million to \$2,530 million, highlighting the substantial interest for the issue. The strong demand also allowed improved terms for Aldar; periodic profit distribution was set below the initial price guidance and conversion premium was set at the top end of the range. Aldar, in its corporate capacity, also provided an undertaking to purchase the assets of the *mudaraba* should the *sukuk* certificate holders not convert their holdings into Aldar's shares by the maturity date (2011).

Aldar's *sukuk* convertible broke many records. It was the:

- largest real estate convertible offering globally;
- largest *sukuk* convertible offering globally;
- longest-dated *sukuk* convertible from the Middle East;
- lowest funding rate of all precedent transactions; and
- secured highest conversion premium of all precedents.

## Sukuk al-musharaka

*Musharaka* means a relationship established under a contract by the mutual consent of the parties for sharing of profits and losses in the joint business. All providers of capital are entitled to participate in management but not necessarily required to do so. The profit is distributed among the partners in pre-agreed ratios, while the loss is borne by every partner strictly in proportion to respective capital contributions.

*Sukuk al-musharaka* are certificates of equal value issued with the aim of using the proceeds for establishing a new project, developing an existing one or financing acquisition of a business activity on the basis of a partnership contract. The certificate holders become the beneficial owners of the assets of the partnership as per their respective shares. Normally the party issuing the *sukuk* acts as the managing partner, with the *sukuk* issuing vehicle on behalf of the *sukuk* holders as silent partner. These *musharaka* certificates can be treated as negotiable instruments and can be bought and sold in the secondary market.

Steps involved in the structure:

- (a) The corporate and SPV enter into a *musharaka* arrangement for a fixed



- period and an agreed profit-sharing ratio. The corporate (as *musharik*) contributes land or other physical assets to the *musharaka*;
- (b) The SPV (as *musharik*) contributes cash, that is the *sukuk* issue proceeds received from the investors to the *musharaka*;
  - (c) The *musharaka* appoints the corporate as a managing partner to develop the land (or other physical assets) with the cash injected into the *musharaka* with a view to earning a return on the developed assets. In return, the corporate will get a specified profit share. It is also usual to provide an incentive to the managing partner should the returns exceed a target return;
  - (d) The *sukuk* holders share of profits are distributed to them on periodic basis; and
  - (e) The corporate irrevocably undertakes to buy at a pre-agreed price the *musharaka* shares of the SPV or the assets of the *musharaka* on maturity. The arrangements could also provide for the corporate to purchase the shares of the SPV on say semi-annual basis so that at the end of the fixed period, the SPV would no longer have any shares in the *musharaka*. This would provide for an amortizing *sukuk* issuance that redeemed the *sukuk* certificate over a period of time.

An example of *sukuk al-musharaka* is as follows:

Emirates, Dubai's national airline, issued a \$550 million *sukuk* transaction for seven years. The deal was structured on a *musharaka* basis. The *musharaka*, or joint venture, was set up to develop a new engineering centre and a new headquarters building on land situated near Dubai's airport which was ultimately leased to Emirates. Profit, in the form of lease returns, generated from the *musharaka* were used to pay the periodic distribution on the trust certificates. Emirates then purchased the leased assets on maturity of the transaction.

## Sukuk al-istisna'a

*Istisna'a* is a contractual agreement for construction, manufacturing goods and commodities, allowing cash payment by the financier in advance and delivery of the subject asset at a future date. The goods or building are then sold in a parallel *istisna'a* to the client, who on delivery pays the sale price on a deferred basis. The suitability of *istisna'a* for financial intermediation is based on the permissibility for the contractor in *istisna'a* to enter into a parallel *istisna'a* contract with a subcontractor. Thus, a financial institution may undertake the construction of a facility for a deferred price, and subcontract the actual construction to a specialized firm. Normally the contractor would be appointed as an agent to supervise the construction. Such arrangements can be used for providing the facility of financing the manufacture or construction of houses, plants, projects, and building of bridges, roads and highways.

*Sukuk al-istisna'a* are certificates that carry equal value and are issued with the aim of mobilizing the funds required for producing products that are owned by the certificate holders. The issuer of these certificates is the manufacturer (supplier/seller); the subscribers are the buyers of the intended product, while the funds realized from subscription are the cost of the product. The certificate holders own the product and are entitled to the sale price of the certificates or the sale price of the product sold on the basis of a parallel *istisna'a*, if any.

Shari'a prohibition of *riba* precludes the sale of these debt certificates to a third party at any price other than their face value. Clearly such certificates, which may be cashed only on maturity, cannot have a secondary market.

Steps involved in the structure:

- (a) The SPV issues *sukuk* certificates to raise funds for the project;
- (b) *Sukuk* issue proceeds are used to pay the contractor/builder to build and deliver the future project;
- (c) Title to assets is transferred to the SPV;
- (d) Property/project is leased or sold to the end buyer. The end buyer pays monthly installments to the SPV; and
- (e) The returns are distributed among the *sukuk* holders.

An example of *sukuk al-istisna'a* is as follows:

The Durrat Al Bahrain, a \$1 billion world-class residential and leisure destination situated in the Kingdom of Bahrain, issued the Durrat *sukuk* to finance the reclamation and infrastructure for the initial stage of the project. The *sukuk* was structured to provide quarterly returns with an overall tenure of five years and an option for early redemption. The proceeds of the issue (cash) were used by the issuer to finance the reclamation of the land and the development of base infrastructure through multiple project finance (*istisna'a*) agreements. As the works carried out under each *istisna'a* were completed by the contractor and delivered to the issuer, the issuer gives notice to the project company under a Master Ijara Agreement to lease such infrastructure on the basis of a lease to own transaction. During the *istisna'a* period, the *istisna'a* receivable (amounts held as cash) was only subject to trading at par value. Later, upon completion of the *istisna'a* period and when lease agreements were put in place, the *sukuk* became tradable.

## Hybrid sukuk

Because *sukuk* issuance and trading are important means of investment, and taking into account the various demands of investors, a more diversified type of *sukuk* – hybrid or mixed asset *sukuk* – has emerged in this market.

In a hybrid *sukuk*, the underlying pool of assets can comprise of *istisna'a*, *murabaha* receivables as well as *ijara*. Having a portfolio of assets comprising of different classes allows for a greater mobilization of funds. However, as

*murabaha* and *istisna'a* contracts cannot be traded on secondary markets as securitized instruments, at least 51 per cent of the pool in a hybrid *sukuk* must comprise of *sukuk* tradable in the market, such as an *ijara sukuk*. Due to the fact the *murabaha* and *istisna'a* receivables are part of the pool, the return on these certificates can only be a pre-determined fixed rate of return.

Steps involved in the structure:

- (a) The Islamic finance originator transfers tangible assets as well as *murabaha* deals to the SPV;
- (b) The SPV issues certificates of participation to the *sukuk* holders and receive funds. The funds are used by the Islamic finance originator;
- (c) Islamic finance originator purchase these assets from the SPV over an agreed period of time; and
- (d) Investors receive fixed payment of return on the assets.

An example of a hybrid *sukuk* is as follows:

The Islamic Development Bank (IDB) issued the first hybrid *sukuk* of assets comprising 65.8 per cent *ijara* assets, 30.73 per cent of *murabaha* receivables and 3.4 per cent *istisna'a* assets. This issuance required the IDB's guarantee in order to secure a rating and international marketability. The \$400 million Islamic *sukuk* was issued by Solidarity Trust Services Limited (STSL), a special purpose company incorporated in Jersey Channel Islands. The Islamic Corporation for the Development of Private Sector played an intermediary role by purchasing the asset from IDB and selling it to STSL at the consolidated net asset value.

## Tradability of sukuk

As noted earlier, some of the structures do not easily support tradability of the *sukuk* certificates at market prices. Depending upon the nature of underlying assets and the school of thought, the tradability and negotiability of issued certificates is determined. The majority of *sukuk* issued to date are based on two classes of assets. The first class of assets fall into financial claims created from:

- spot sale and deferred payment (*murabaha*); and
- spot payment with deferred delivery (*salam/istisna'a*) contract.

As these structures result in *sukuk* certificates somewhat de-linked from the risk/return of the underlying assets, these are treated as pure debt securities. Consequently, many investors, including those in the GCC countries cannot trade these *sukuk* in the secondary market, either at a discount, or at a premium. Trading can be undertaken at par but any reference to market value would introduce a mechanism to indulge in *riba* or interest in the transaction. Such structures have been used but mainly

for short-term securities such as the Salam-based quarterly *sukuks* issued by government of Bahrain.

The second class of assets are those that generate periodic returns. *Sukuk*-based structure provide longer term maturity, tradability and negotiability to investors. For instance, as noted above, *sukuk al-ijara* is based on leasing transaction and bears the closest resemblance to a conventional lease contract and offers flexibility of both fixed and floating-rate payoffs. The cash flows of the lease including rental payments and principal repayments are passed through to investors in the form of coupon and principal payments. Since the asset that is the subject matter of the *ijara* can be traded at market value, the *sukuk* certificate representing a beneficial interest in such asset can also be traded at market value. The premium or discount that is given for the *sukuk* certificate therefore represents the changes in the value of the underlying asset. Similarly the structure of *mudaraba* and *musharaka sukuks* allow for tradability as well as fixed or floating coupon payments.

## Rating of sukuks

Most of the *sukuks* issued have not been rated, other than the larger issues in the last few years and many of the sovereign issues. This has been due to the cost both in terms of time and expense as well as the fact that technology to rate the *sukuks* have taken time to develop. A key issue that has now been understood is that *sukuks* do not represent entire new asset class and are similar to existing securities that employ the existing legal and financial tools to create securitization structures that are also Shari'a-compliant. In general rating agencies do not take into consideration the extent to which the *sukuk* is Shari'a-compliant as long as adequate disclosure is made in the offering circular. For instance in certain *sukuks* based on the *mudaraba* or *musharaka* models, Shari'a scholars have insisted that periodic review be undertaken of the *sukuks* to ensure that the funds are being used in Shari'a-compliant manner. This requirement adds a risk that during the period of the *sukuk*, the Shari'a scholars may declare that the *sukuk* is no longer compliant. Such a declaration would not result in a default and hence lead to early redemption unless stated in the terms of the issue. Only the Islamic investors would be affected in that the income generated from non-Shari'a-compliant investment has to be given over to charity.

International rating agencies, such as Moody's, tend to look through the Shari'a structure and categorize the *sukuks* into:

- asset-backed *sukuk*, for which the ratings are primarily dependent on a risk analysis of the assets; and
- unsecured (repurchase) *sukuk*, for which ratings are primarily dependent on the risk-rating of the borrower.

In the first case, key securitization elements need to be present in the structure to ensure that the *sukuk* holders have beneficial title to the assets and in case of default enforce their security over such assets. Although the originator of the *sukuk* is responsible for the periodic payments and the redemption price, default situations would provide senior security over the underlying assets. The rating agencies would look at the legal enforceability of the title to the asset and the liquidation procedures in the jurisdictions where the assets are placed. Even if the original borrower becomes insolvent, the *sukuk* does not default. The rating for such *sukuks* is normally higher with corresponding lower costs although the legal structures are often more complex.

In the second case, the title to the underlying assets may not be enforceable since these will not be in the name of the Issuer but in the name of the managing agent or partner. The *sukuk* holders are primarily reliant on the credit worthiness of the originator to perform under the agency/ partnership agreements and the obligations entered into under the purchase undertakings. The asset performance does not affect the *sukuk* performance but rather the borrower's undertaking to repurchase the assets at maturity at a redemption price that is equivalent to the face value of the certificates outstanding. The fact that such an undertaking is provided alters the credit risk of the *sukuk* structure. The *sukuk* holders in such situations rank *pari passu* with senior unsecured creditors of the borrower. The rating assigned is therefore that of the borrower.

## Current issues with the *sukuk* structures

There has been considerable publicity as to non-Shari'a compliance of the *sukuk* structures. This controversy arose as a result of a discussion paper issued by an eminent Shari'a scholar – Justice (retired) Mohammed Taqi Usmani, the chairman of the AAOIFI Shari'a board. In his discussion paper, he highlighted the fact that Shari'a-compliant structures such as *mudaraba* and *musharaka* are essentially used for equity investments and not for raising debts. Debts can be raised by use of *ijara*, *murabahah*, *salam* and *istisna'a* modes of financing. In the case of *mudaraba* and *musharaka*, the investor takes the full performance risk of the investment. He questioned the widespread use of the purchase undertakings in the *mudaraba* and *musharaka*-based *sukuks* to redeem the *sukuk* certificates at face value by the borrower. This effect resulted in the investors being guaranteed the return of their capital. Any purchase undertakings in such structures should provide for the assets being purchased at their market value, and hence any gain or loss on the redemption date being for the account of the *sukuk* holders.

Scholars who have allowed the use of purchase undertakings have not viewed such undertakings as providing a guarantee to the investors. The purchase undertakings have been related to the purchase of the underlying

assets and not the *mudaraba* or the *musharaka* units. In this respect the basis for determining the price for the purchase of the assets could be agreed at the time of entering into the purchase undertakings.

AAOIFI is in the process of resolving the differences and providing guidance on the *sukuk* structures.

## Equity markets

Other than debt instruments, another significant development of the Islamic capital market was the establishment of clear guidance on the types of equities that comply with Shari'a requirements. Given the popularity of investing in equities, much debate took place as to which equities were available for Muslim investors. Initial efforts were made in Malaysia in 1983 when Bank Islam Malaysia Bhd published its first list of Shari'a-compliant equities. This was later followed by the introduction of a list of eligible equities in June 1997 by the Securities Commission of Malaysia.

As the Shari'a guidance for screening stocks became acceptable, this facilitated the establishment of Islamic indices. The first Islamic equity index was introduced in Malaysia by RHB Unit Trust Management in May 1996. This was followed by the launching of the Dow Jones Islamic Market (DJIM) Index by Dow Jones & Company in February 1999, the Kuala Lumpur Shari'a Index by Bursa Malaysia in April 1999, and the FTSE Global Islamic Index Series by the FTSE Group in October 1999. In the last few years Standard & Poors have followed suit with their own Shari'a-compliant index.

Another asset class that benefited from the Shari'a screening guidance was the Islamic investment funds. The Amana Income Fund, the first Islamic equity fund to be established in the US, was formed in June 1986 by members of the North American Islamic Trust – an organization in Indiana, which oversees the funding of mosques in the country. In 1987, Dallah AlBaraka Group established two companies, namely Al-Tawfeek and Al-Amin, which were specifically dedicated to the development of Islamic equity funds. These companies have successfully launched a number of Islamic funds focusing on such diverse sectors such as real estate as well as international equities. Later, the entry of international banks in the Islamic market led to a proliferation of structured products, ranging from capital protected certificates to long-term investment certificates.

The Shari'a screening process of equities is based on a number of filters:

- *Haram* or non-Shari'a-compliant business activities. These include financial institutions that derive their income from interest-based products, businesses engaged in alcohol, pork, entertainment such as pornography, hotels, casinos and other related sectors that infringe Islamic principles as well as some sectors of the defence industry that are engaged in offensive weaponry. Normally, the tobacco sector is also

- excluded;
- Highly leveraged companies that are burdened with conventional debt. Only companies that have a ratio of debt to 12 months trailing market capitalization of less than a third are allowed;
  - Companies that derive a high proportion of income from interest. Companies that have total cash and securities in excess of one third of their 12 months trailing market capitalization are excluded; and
  - Companies having a significant portion of non-income generating assets. Hence companies that have accounts receivables higher than one third of 12 months trailing market capitalization are also excluded.

The above screening is mainly for DJIM indexes. The FTSE Islamic index base its ratios on the total assets of the company, whereas Standard & Poors generally follow the guidance of the DJIM index.

## Future developments

Today, the Islamic capital market has grown to form a critical mass that some claim can support a well functioning and efficient market. The growth that has been fuelled by demand from oil rich states as well as developing counties of the Far East is set to continue. Recent studies, however, indicate that penetration rates are still as low as 20 per cent of the financial markets in the mainly Muslim states. As Islamic products and services become more competitive, such penetration would increase. Some additional 60 per cent of the users of financial services in those countries have indicated their preferences for Islamic banking services if the products and services are competitive.

The continuing trend in high oil and commodity prices, the significant need for infrastructure investment together with growing awareness of compliance with faith in countries comprising the organization of Islamic countries will ensure that demand remains high for Islamic capital markets.



## 2.10

# Secondary Markets in Islamic Finance

*Majid Dawood, Yasaar Ltd*

## Introduction

Secondary markets, in the financial sense, are defined as enabling the trading of securities that have been issued already to the market by means of an initial private or public offering, or to put it in the vernacular a market for the trading of "used goods". Once issued and listed on a stock exchange, goods, stocks or other financial instruments/products can be traded by investors through bids and offers provided by the market-makers in those securities. A requirement for the secondary market is that it be highly liquid. The secondary market is extremely important for liquidity and efficiency purposes in modern capital markets. The need to be able to trade issued securities has been the driver behind the emergence of stock exchanges.

## Islamic finance secondary markets

Where are the secondary markets in Islamic finance? We now have a securitization market worth an estimated \$2 trillion+ in the overall Islamic finance sector. The sector is very young and needs to have critical mass. The current liquidity being generated by the oil price boom is pushing the recipient nations in the Middle East to develop their infrastructure, industry and services to create sustainable environments. These developments are being leveraged to ensure larger and more encompassing projects, which will in turn help to create a critical mass of financial issues and instruments to support development.

However, a potential issue will always be that there will be wealth, but the populations will be so small that their industrial base will need to be export-oriented. There were some Islamic equity funds in the early days, and these were managed funds and therefore had the element of a secondary market.

As debt is not tradable under Shari'a, this restricts the development of a secondary market in tradable debt, which in turn mitigates the potential for



events such as the sub-prime crisis being experienced. The regulators tend to be reactive rather than proactive. These derivative products and their like should be scrutinized now rather than later.

On the other hand, mortgage market defaults in the US have urged conventional banks and institutions to seek access to the booming Arabian Gulf economies, and they have become the largest investors of *sukuk*, preferring to be able to trade. Geert Bossuyt, the head of Middle East structuring at Deutsche Bank, stated the following:

Now we have more Western investors, not necessarily Islamic investors. They tend to have a more active view in terms of trading in the market and are more driven by arbitrage opportunities than interest environments.

Although a number of *sukuk* are listed on exchanges in the Middle East, Europe (London) and Asia (Bursa Malaysia), they are not liquid, due to factors such as a lack of availability of stock with most of the issue being bought and held by investors to maturity due to high cash liquidity and shortage of investable issues, a lack of a diverse pool of investors, and standardization and regulatory issues.

London has made an effort to develop a *sukuk* secondary market to take the lead among the established financial centers to become the world's leading financial center and also the main Islamic finance hub away from the Middle East and South East Asia. Malaysia has a roster of more than 40 *sukuks* listed and averaging around 100 trades weekly, though the typical transactions are around the \$5 million mark.

## Critical mass

For the success of any initiative of the nature of Islamic finance, it needs to have a secondary market otherwise growth will be constrained. We have a "catch-22" situation in that the secondary market is essential, but requires a critical mass. However, as the sector is relatively young, we have excess liquidity and not enough product thereby creating a mismatch that needs to be addressed to ensure smooth development of the sector.

A Shari'a board's involvement maintains fairness in the products and the elements of Shari'a are very risk averse; therefore you have a stable and robust initiative that as it grows will become more and more attractive to non-Muslims as well, thus prompting growth of the sector. The Ethical and Social Responsible Investment markets are also likely to participate in the Islamic finance sector. As the sector develops, it will be a bigger market, as it is open to all whereas the conventional market excludes Muslim investors and financial market participants.

Lately, it seems that the appetites of non-Middle Eastern investors has been targeted towards the booming emerging markets of the Middle East

and Arabian Gulf countries, and corporate issues with their massive infrastructure projects has led to their taking up nearly 80 per cent of *sukuk* issues. The record was set in 2006 of \$9 billion issued, and by July 2007, London had listed 15 *sukuk* raising nearly \$10 billion. There are now four Islamic banks operating in the UK, and 20 conventional ones also offer Islamic finance services. France is somewhat trailing behind with only four providers and none of them Islamic.

The growth is dramatic and as the Islamic mortgage or home finance market in the UK alone has grown to £500 billion – more than a 50 per cent increase over the previous year – and with the rest of the world, especially the Islamic countries, driving the demand for Shari'a-compliant products, critical mass will develop.

Demand is outstripping supply and few global investment banks or investors can get sufficient exposure to the *sukuk* issues due to issuance sizes and the demand from local Islamic institutions for Shari'a-compliant products, as they need to park the massive liquidity being caused by the oil price surge. Most issues are well oversubscribed, but there has been a lull in issues after the controversy set off by the statement of a senior Shari'a scholar who commented that a lot of the *sukuk* were non-compliant mainly due to the purchase undertaking in some of the *sukuk* structures. Ahmed Abbas, CEO of Liquidity Management Centre (LMC) in Bahrain recently had the following comments:

Illiquidity here is not your typical illiquidity as in the conventional markets. If you look at the size of the market *vis-à-vis* assets, there are around \$500 billion of Islamic assets and currently only around \$11 billion in *sukuk* in the Middle East. When you say it is illiquid, normally it means you have stuff you cannot dump or dispose of. But here, it means you want stuff and you cannot locate it.

According to Moody's, assets of banks in the United Arab Emirates (UAE) are more than 144 per cent of gross domestic product (GDP) at \$150 billion, while in Bahrain, that ratio climbs to 908 per cent of GDP at \$109 billion. This can only mean that investors in *sukuk* are unlikely to trade on the secondary market – cash is something they do not need.

## Standardization and harmonization

Of course, another limiting factor in the global roll-out of Islamic finance is the variance between the schools of Islamic jurisprudence and the lack of standardization in the sector. One can appreciate the market jurisdictional issues and the tax regimes, but the need to have standard products and level playing fields is paramount.

The existence of the Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI), the Islamic Financial Services Board (IFSB), and the Islamic Ratings Agency are all positive steps required to build a robust industry platform, and the standards being developed by AAOIFI for example cover both accounting and Shari'a standards that are becoming acceptable in more and more jurisdictions, which will engender the acceptability of Islamic finance as an alternative form of finance.

There have been some controversies recently in terms of the Shari'a compliance of some of the *sukuks* that have been issued relating to the "purchase undertaking" aspects in the structures. Also some scholars have opposing views on the structure of *tawarruq*. These have become issues, but that is to be expected as the sector is in its infancy, enhanced by the fact that Shari'a is subject to interpretation and opinion. But institutions such as AAOIFI have through their Shari'a board addressed these issues.

The implementation of standardization of structures and documentation will take the development of the secondary market a long way. In the case of Malaysia, the *sukuk* market is larger, better standardized and with one regulatory body based on one school of Islamic jurisprudence, thus the functionality of the market is a lot easier than in the Gulf nations. Even the tax regime is friendlier in terms of claiming back *sukuk* issuance expenses. Whereas in the Gulf area, each new *sukuk* issue has to comply with the different school of Islamic jurisprudence's interpretation of that territory, hence the abundance of different *sukuk* structures. Thankfully, this is changing as increasing numbers of Shari'a boards of scholars from different schools of jurisprudence are working together, and their pronouncements are becoming more encompassing. Even the Shari'a board of AAOIFI is large and varied and they are setting standards that are becoming more acceptable over many jurisdictions.

## Product ranges

As the sector has grown and its liquidity put to productive use, there has been considerable development of products; we have seen the introduction of more structured products, including capital protection, hedge funds and *sukuks*.

More is on the way as investors' appetites for more sophisticated products increases, and international banks in their desire not to lose clients are actively developing and marketing these products for Islamic markets. Furthermore, the sub-prime crisis has created liquidity issues in international markets and these international banks are turning their gaze to the Middle Eastern markets for their funding.

The requirements in these markets are also now geared to investing in a Shari'a-compliant way. Many of these product vendors are finding that when they trawl the Gulf and Islamic markets with their products, invariably

they are asked if they have a Shari'a version of their product as they would prefer to invest in a Shari'a-compliant manner.

## Innovation

Demands by Muslim investors are pushing the international financial institutions to be more creative and work closely with lawyers and Shari'a scholars to develop Shari'a-compliant products that will be acceptable in most jurisdictions. More and more financial institutions are creating Shari'a boards that cover multi-regions and schools of Islamic jurisprudence to enable the product to be acceptable across many of the jurisdictions.

There have been developments in capital-protected products, such as the replication of short sale benefits to motor the infant Islamic hedge fund industry through prime brokerage avenues, "variations of a theme" using *arbouns*, *wa'ad*, etc. A lot of these developments produce tangent products and innovative means to achieve conventional equivalent Shari'a-compliant offerings.

Convertible *sukuk* have been particularly attractive for investors, and the ability to convert to the issuer's equity has encouraged trading in the secondary market due to performance of that underlying equity. There has also been the development of Shari'a-compliant repurchase agreements and the presence of a sustainable and robust repo-market will enable holders of *sukuks* to free-up capital from their balance sheets for periods of time as may be necessary to take advantage of opportunities as they arise or to meet regulatory requirements. This would allow smaller investors to take exposure to the *sukuk* market at prevailing market rates.

## Market-makers and exchanges

As with any secondary market, there is a need for a developed and efficient market-making process or exchange. Exchanges such as the Dubai International Financial Exchange (DIFX) are making efforts to provide electronic exchange services for Islamic products by means of listing *sukuks*, etc. Smaller market-makers are active in trading *sukuks* in London, Hong Kong, etc. The issue for them is the dearth of sellers due to the number of listed *sukuks* and lack of a depth of products and volumes. As the number of *sukuks*, exchange-traded funds, and other products get launched and listed, the market will achieve critical mass for the trading of these issues and to better manage the liquidity in the market. Presently, most issues are held to maturity due to the shortage of alternative opportunities to invest and get a return on that investment, while the pool of liquidity is ever increasing.

Among the secondary market-makers, Barclays Capital apparently trades *sukuk* daily to the amount of \$20 million, and Dubai Islamic Bank reportedly trades between \$100-250 million worth of *sukuk* on a monthly basis. It was

London that set up the first secondary market for trading *sukuk* in 2006. GFI Group – a brokerage company – established an inter-dealer market for *sukuk* trading in the same year, and the London Stock Exchange listed its first *sukuk* issuance – the \$200 million offering by National Central Cooling Company (Tabreed). The sale in November of the \$3.52 billion *sukuk* bond issue by Nakheel Group – a Dubai property developer – spurred trading in London, and volumes rose to about \$2 billion by the beginning of 2007.

To further develop this nascent market, London-based International Capital Markets Association and the International Islamic Financial Market have joined forces to enable the expansion of international Islamic financial markets by means of establishing standard contracts and documentation, as well as market practices for *sukuk*.

In the Gulf region, LMC together with a handful of regional banks, is offering two-way pricing for numerous *sukuk* on its website. Generally, the number of market-makers offering bids and offers has been low; nevertheless LMC executed \$78 million of secondary trades in the first seven months of 2006 – well up on the \$60.9 million of trades for the whole of 2005.

## Hubs of Islamic finance

The rapid growth of Islamic finance has encouraged many existing and new financial centres to establish themselves as an Islamic finance centre or hub. London has been active in this respect for many years, as the law firms there and banks have been active in conducting Islamic finance products or transactions, and it the first “western” nation to amend its laws to enable financial institutions to offer Islamic finance products. The UK authorities are now also in the process of enabling changes so that *sukuks* can be issued. Others among the conventional centres vying for this “crown” are Hong Kong and Singapore. In the Middle East, Dubai has taken the lead from Bahrain in some ways, but the result is still to be determined. Saudi Arabia and Qatar are also in the equation for the role of “Islamic finance hub.” Just as in the conventional market, there will be room for more than one centre. Dubai and London are predicted to be the leading centres, with Bahrain and Kuala Lumpur as other hubs.

The UK authorities, via the Chancellor of the Exchequer’s 2008 Budget, announced the following to enable the operations of an active *sukuk* issuance market, by amending laws to create a level playing field:

- Legislate (following consultation) in the Finance Bill, 2009 to provide relief from stamp duty land tax for *sukuk* (referred to as alternative finance investment bonds);
- Amend the law to classify *sukuk* as a tax-exempt loan capital for stamp duty and stamp duty reserve tax;
- Adjust legislation to allow existing corporation tax and income tax rules on Islamic finance arrangements (referred to as alternative finance

arrangements) to be amended by regulation, and work with the UK banking regulator (the Financial Services Authority) and stakeholders to clarify the regulatory treatment of *sukuk*; and

- Continue to examine the feasibility of a sovereign *sukuk* issue, and in the Finance Bill, 2008, take legal powers to facilitate any future sovereign issuance, and provide a full response to the recently closed public consultation on *sukuk* issuance in the summer of 2008.

## Conclusion

Shari'a finance is based primarily on equity, whereas conventional finance is based on debt. The following comments have been made regarding the growing Islamic finance sector:

Rami Falah, senior relationship manager at BNP Paribas in Bahrain:

"Many banks are flush with liquidity and are desperate for assets, so they would rather keep them in their portfolio instead of trading them".

Steve McMillan, chief executive officer at GFI Group in London:

"These banks have committees that decide to invest in those kinds of bonds and they buy them, put them away, end of story. So if you actually want to go and buy a bond from that bank, it has to go back to the committee process and those committees meet once a month".

Luma Saqqaf, head of Islamic finance at law firm Linklaters in Dubai:

"Tabreed went into the international markets with the hope that it would see more trading and it hopes there will be. Actually, it was oversubscribed and Tabreed didn't want to put out an extra amount because it wanted to encourage a secondary market. Maybe in a year or two, there will be enough *sukuk* out there for a secondary market".

Recently, post the *sukuk* issues raised by some scholars, there have been some deferred issues and some oversubscriptions. The Saudi Basic Industries Corporation \$5 billion issue was oversubscribed, and 90 per cent of it was allocated to Saudi investors, while the 10 per cent balance was allocated to other Gulf Cooperation Council (GCC) nationals. This means that the appetite for products is strong and therefore we can expect to see more issues and hopefully a robust secondary market. The huge infrastructure and property development projects that require funding and *sukuk* offer exceptional Shari'a-compliant means to do just that. Ernst & Young have

stated that the issuance of *sukuk* is to double to \$100 billion this year. The market size is now estimated at \$900 billion, and by 2010 the market size is expected to reach \$2 trillion.

However, it goes without saying that an increase in issuance is essential to the establishment of a robust secondary market and it appears that many issuers are keen to incorporate tradability within the structures.

## 2.11

# Screening and Purification Criteria: Shari'a Application to Investments

*Iqbal Asaria, Yasaar Ltd*

## Introduction

With the current growth in Shari'a-compliant investments, the need for a screened universe of stocks is increasing. These screens typically opine on the permissibility or otherwise of investment in stocks and securities from an investor's point of view. Investors and/or their fund managers are thus able to offer Shari'a-compliant investment channels.

Traditionally, these screened universes have been used by long equity fund managers. Now, increasingly such universes are used by Index providers, like FTSE and Dow Jones, to provide benchmarks for funds. They are also used by providers of exchange traded funds and other index-based instruments. Lately, alternative investment funds have also started to use them.

Given their increasing and varied usage, it is important to have a robust methodology in place, which is transparent and verifiable. In addition, there is a need to bear in mind that the universe of investable stocks needs to be as large as possible, so as not to detract from the risk mitigating advantages of portfolio diversification. Thus, the screening of stocks for Shari'a compliance is beginning to be a critical task that demands thoroughness and professionalism.

It is interesting to look at the rationale behind the Shari'a screens and methodologies of the various providers for these services. Essentially, the process involves looking at business compliance and financial compliance.

## Business compliance

With regards to business compliance, one needs to determine if a corporation is engaged in the provision of prohibited activities like alcohol, gambling, armaments, tobacco, pornography, interest-based finance or pork. Most Shari'a scholars have put a tolerance level of 5 per cent for such activities.



The basic methodology of ensuring business and financial compliance may seem simple at first glance. However, on closer examination, several critical issues crop up. The first issue is of business classification. The broad category of prohibited categories is clear. However, corporations are complex entities and engage in a diverse variety of activities. For this purpose there are two classification systems that can be used. One is the standard industry classification (SIC) codes, the other one is the international business classification (IBC) code.

SIC codes are much more detailed and delve into several layers of corporations' activities. Thus, an individual company may have up to eight SIC codes associated with its activities. IBC codes are much more general and focus on the core businesses of corporations.

With the help of some examples it is possible to outline the complex process that needs to be in place to keep the screens current and up-to-date. For the purposes of determining whether the proportion of unacceptable activities is under 5 per cent, SIC codes seem to provide greater robustness. However, aggregation of activities by their associated SIC codes are not free of issues. As an example, a SIC code could be assigned to livestock production, but it would be difficult to determine whether this includes pig farming or other disallowed activity. This would have to be determined by actual contact with the corporation concerned. Similarly, production of beverages presents a host of issues, including the possible production or otherwise of alcoholic drinks.

At another level, business compliance also involves some decisions to be made by principles. Thus, a company specializing in conventional financial industry publications is a case in point. Does this activity constitute a part of the conventional finance category or the more neutral category of publishing? If we adopt the latter option, then what classification would we give to a company manufacturing gaming machines? As one ploughs through the possible investable stock universe, a multitude of such issues needs to be addressed. In many cases, detailed discussions with Shari'a scholars are needed to come to a decision.

Even after these deliberations, it may not be possible to verify if over 95 per cent of any corporations' revenue comes from compliant activities. In many cases, data is simply not available. In others, data may be available, but not from published sources. In either case, a direct engagement with the corporation is called for. For a large universe, this activity can be quite expensive. However, principle companies are excluded from screened universes if satisfactory data is not available. They are only screened back in once satisfactory data becomes available.

## Financial compliance

For financial ratios, gearing levels, receivables and interest income are material. Typically, gearing would have to be less than 33 per cent; cash and

cash receivables less than 45-50 per cent and interest income less than 5 per cent. Many scholars are now requiring any interest income to be included in the 5 per cent overall tolerance level. One can either base the calculation of these parameters as a proportion of total assets, or of market capitalization of the corporation.

Presently, Dow Jones and lately Standard & Poors use market capitalization. All other providers, such as Morgan Stanley Capital International, FTSE, Ratings Intelligence, Amiri S3, etc use total assets. The rationale of the ratios, and the pros and cons of the total asset/market capital debate can be debated at length.

In general, market capitalization as a base is more volatile than a total assets base. This is very important for index providers as frequent changes in constituents without any underlying change in the nature of the business is likely to distort the index and its utility for benchmarking purposes. Secondly, many Islamic financial institutions finance both listed and private companies. For them to have a consistent yardstick, a total assets base provides a more robust measure, as no market capitalization indicator for unlisted companies is likely to be satisfactory.

Only in the exceptional case of companies that have very large intellectual property content can a case be made to modify judgements based on total assets criteria. This can be done on a case-by-case basis without resorting to a wholesale move to a market capitalization base.

Anecdotal evidence suggests that in the bull market phase, a market capitalization base may yield more Shari'a-compliant companies than a total asset based methodology. Whilst a larger universe is desirable from a portfolio investment perspective, it is unlikely to carry much weight with Shari'a scholars. Recent research done by several students and scholars has tended to confirm these findings. The global universes are not that different, and the overall portfolio performance of those based on total assets or market capitalization is not divergent enough to allow screening arbitrage of any magnitude. Given these findings, it is likely that institutions such as the Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI) will issue standards which allow either methodology or a combination of the two.

With regards to financial compliance, the issues are somewhat straightforward once the definition of terms and their composition are agreed. However, even in this area, one can encounter difficult issues. For example, if a corporation is generally compliant but the gearing ratio shoots just over the prescribed limit in a particular year, should its status be changed to "fail?" This could just be an aberration due to the arbitrary cut-off balance sheet date. One thus needs to determine whether it is long-term change in the corporation's operating profile or a mere blip in its activities. If the latter is the case, then Shari'a scholars would need to be consulted if the current "pass" status is to be retained for the next period. This could be quite an issue for large "index" constituents as frequent changes of status create instability and unsuitability for use as benchmarks.

## Future outlook

Finally, some light needs to be shed on the involvement and role of the Shari'a scholars in managing a Shari'a-screened universe of stocks. Their involvement is deeper than appears at first sight. They have played a key role in classifying the multitude of business activity codes and specifying areas of further investigation.

There is now a greater exchange of scholars between Malaysia and the Gulf Cooperation Council countries, and so Shari'a standards are converging rapidly. As an example, the Bursa Malaysia has recently launched a Bursa Malaysia Hijrah Index in collaboration with FTSE. The screening criteria are based on the FTSE methodology, rather than the Malaysian Securities Commissions methodology, to enable global investors to use this as a possible benchmark.

Shari'a scholars have also been amenable to arguments for incorporating some sustainability criteria in the screening process. The exclusion of tobacco and armaments are a case in point. It is quite possible to see Shari'a scholars looking at more of the socially responsible investment criteria in the very near future. The main driver for this development is expected to come from investors who are increasingly becoming conscious of these issues. Just like the growth of the ethical investment movement in developed markets, the rise in institutional investors representing public funds, will drive this expected evolution in the Shari'a criteria. This, in turn, opens up the area of affinity with ethical screening, and the possibility of having a unified Shari'a/ethical screened universe in time. The target investor market is expected to grow considerably as a result.

## 2.12

# Takaful

*Mohammed Khan, PricewaterhouseCoopers*

## Introduction

The word “*takaful*” literally translates to “guaranteeing each other”. The concept of *takaful*, or Islamic insurance, has been around for centuries and was practised by the Muhajin of Mecca and the Ansar of Medina, following the *hijra* of the Prophet Mohammed over 1400 years ago. The main concept of *takaful* is to pool resources to pay for events/losses that individually none of the members of the pool could afford; for example, a group of people collectively use their combined money to pay for events and large expenses such as births or marriages, or if a financial loss occurs to a member of the group. It is a form of mutual insurance and is not dissimilar to the mutual cooperative schemes that exist in Europe and the US.

Broadly, the main differences between *takaful* and conventional insurance are:

- The customers (policyholders) of the *takaful* business agree to pool their contributions and share the liability of each policyholder. So if one policyholder has to be paid a claim, this is paid out of the combined pool of the policyholder contributions. This eliminates the principle of *gharar* (uncertainty) which is not allowed within Islam;
- As with mutual insurance, the policyholders share in the profit and loss of the *takaful* business – that is, the policyholders all share the insurance risk. They do not give the risk to the *takaful* company (as occurs in a conventional shareholder insurance company). Consequently, if at the end of a financial year, the *takaful* business makes a surplus, this is shared between the *takaful* policyholders;
- The assets of the *takaful* business have to be invested in Shari’a-compliant assets. For example, investments cannot be made in gambling institutions, businesses that make alcohol, businesses that sell weapons or assets that pay interest (*riba*); and
- The operators of the business are paid explicit fees for setting up and running the company on behalf of the policyholder. These fees should cover all the setting up costs, running costs and profit loading of the shareholders and are the only way that the shareholders are remunerated. After the fees are deducted, any surplus arising from the *takaful* business

is shared amongst the policyholders only. These explicit fees are in the *takaful* contract that each policyholder signs with the *takaful* company, and are fully transparent.

The *takaful* market is currently concentrated in Malaysia and in the Middle East and has been experiencing significant growth rates. Some estimates are that the global *takaful* industry is growing at 10-20 per cent per annum, compared to forecasts for the growth of conventional insurance of around 9 per cent per annum in emerging markets, and 5 per cent per annum in Organization for Economic Cooperation and Development (OECD) countries. Moody's has predicted that total *takaful* premiums will rise to \$7 billion by 2015. Furthermore, some of the world's largest *takaful* companies envisages that about one-third of their premiums will come from the West by 2020, and the first pure *takaful* company (Principle Insurance Company Limited) has just been authorized by the Financial Services Authority (FSA) in the UK.

One of the key characteristics of *takaful* is that its products are price competitive with conventional insurance products, and so in Malaysia – which is the most developed *takaful* market – many of the customers of the *takaful* companies are owned by non-Muslims. Furthermore, *takaful* business is, by its nature, ethical; it is structured to benefit the policyholder, the funds are invested in ethically compliant funds and an independent group of advisors (Shari'a committee) opines that all of the ethical considerations have been met. In the UK, Europe and the US where consumers are increasingly spending a greater proportion of their disposable income on ethical products (eg, organic food), a competitively-priced ethical insurance has the potential to be just as successful with non-Muslim customers as it does with Muslim customers.

## Development of takaful

The first modern *takaful* company is generally acknowledged to have been the Islamic Insurance Company of Sudan, founded in Sudan by Faisal Islamic bank in January, 1979.

The Islamic Insurance Company, which also established a branch in Saudi Arabia, was a pure mutual *takaful* business – it was an Islamically-compliant insurance company, where the policyholders also owned the company (there were no shareholders).

In 1985, the Council of Islamic Scholars in Mecca approved *takaful* as a Shari'a-approved alternative to the conventional insurance system. This led to mutual *takaful* companies being established in different Muslim countries, including Dubai, Bahrain and Malaysia. There was also a concerted effort by insurance professionals and appropriately trained Shari'a scholars to develop a Shari'a-compliant *takaful* business model that allowed for a shareholder structure.

At around the same time, Malaysia developed the Takaful Act, 1984 leading to the establishment of Syarikat Takaful Malaysia Berhad as the first *takaful* company in Malaysia and the Far East region.

Currently Malaysia has the most mature Islamic financial system with many established Shari'a-compliant banks and *takaful* businesses operating alongside conventional banking and insurers. Its Shari'a-compliant financial companies offer price-competitive products and due to this have a market appeal to non-Muslim as well as the Muslim population.

## Key stakeholders

The key stakeholders in a modern *takaful* operation are the:

1. Policyholders – the customers of the *takaful* business. They pay contributions to obtain a Shari'a-compliant insurance policy;
2. Shareholders – the people who operate the business on behalf of the policyholders and provide the initial money to start running the business; and
3. Shari'a board – the Islamic scholars who opine on whether the products and operations of the *takaful* business are Shari'a-compliant

## Policyholders

The policyholders pay contributions to cover them for a Shari'a-compliant insurable loss (eg. damage to their car in an accident). As in a mutual insurance company, the policyholders pool their contributions in a “policyholder fund” and use these pooled contributions to pay all the insurance claims of the company, as well as brokerage fees and reinsurance fees.

The policyholders also share in the profit and the loss of the *takaful* business. For example, if at the end of a financial year the policyholder fund makes a surplus after deducting all expenses, claims (including setting up reserves to pay potential future claims), this surplus is shared amongst the policyholders.

If at the end of the financial year the participant fund makes a loss, this deficit is funded by a *qard al-hassan* (a benevolent loan, one where interest is not charged and repayment is not implicit) from the shareholders. The shareholders are then repaid the loan from any future surpluses of the policyholders fund. The shareholders cannot access the capital from the policyholders fund, except when the *qard al-hasan* is being repaid.

The distribution of surpluses to policyholders can occur in several ways:

- It can be distributed to all the participants, depending on the percentage of their contribution to the total contributions received;
- It can be distributed to whomever did not make any claim during their

contract, depending on the percentage of their contributions to the total contributions;

- It can be distributed to all the participants, but in the case that a policyholder made a claim then the policyholder will get a share of the surplus if the claim amount is less than the contributions; and
- It can be distributed through another methodology approved by the Shari'a board and the company's board of directors.

The surplus distribution can either be paid directly to the policyholder or be deducted from the policyholders next contribution (ie. if they renew their *takaful* contract). Commonly both the shareholders fund and the policyholders fund are within the *takaful* business.

## Shareholders

The shareholders set up the *takaful* company for the purpose of managing the insurance risk of policyholders. They are paid explicit fees by the policyholders to operate the *takaful* business on behalf of the policyholders. These explicit fees cover the expenses of running the company, plus an allowance for profit for the shareholders. Examples of expenses include the costs of recruiting and employing staff, the costs of providing information technology systems, rent for buildings for the staff to work in, and so on.

There are three major models for the shareholders to be paid by these fees, and they are described in more detail below.

## Shari'a board

The Shari'a board ensures that the operation of the *takaful* business complies with Shari'a – the board opines on whether the business is *takaful*, or whether it is acting in a way that would not be permissible within the Shari'a rules. The Shari'a board consists of a minimum of three Shari'a scholars educated in economics. Their main duties are to:

- ensure that all the *takaful* products are compliant with Shari'a rules;
- approve the Shari'a compliance of technical operations of the company;
- approve that the structure of the *takaful* business is compliant with Shari'a;
- advise the company on Shari'a compliance and provide any *fatwa*, if needed;
- check the company's files on an *ad-hoc* basis to ensure Shari'a compliance; and
- publish a report at the end of each financial year to confirm the Shari'a compliance of the company's activities.

## Main takaful models/structures

When the Grand Counsel of Islamic scholars in Saudi Arabia approved the *takaful* system in 1985 as a Shari'a-compliant form of insurance, they did not specify the exact structure that should be used. Consequently, several models have been developed around the world to allow shareholders and policyholders to set up *takaful* businesses in an Islamically-compliant manner.

All four models described below allow the shareholders to be paid explicit fees by policyholders. These fees generally cover two areas:

1. Fees paid to shareholders for setting up and running the company on behalf of policyholders; and
2. Fees paid to shareholders for investing policyholders' funds on their behalf.

### Mudaraba model

This is known as the profit sharing model as the shareholders share in the profit or loss with the policyholder. In this model, the shareholders are paid:

- A pre-agreed proportion of any surplus generated by the policyholders' funds in return for running the insurance operations of the *takaful* business. If the policyholders' funds make a loss, the operator does not share the losses, though it will provide the *qard al-hasan* to cover this loss; and
- A pre-agreed proportion of any investment income from investing the policyholders' funds assets on behalf of the policyholder.

The pre-agreed proportions are agreed at the beginning of each financial year. Figure 1 gives an overview of this model.



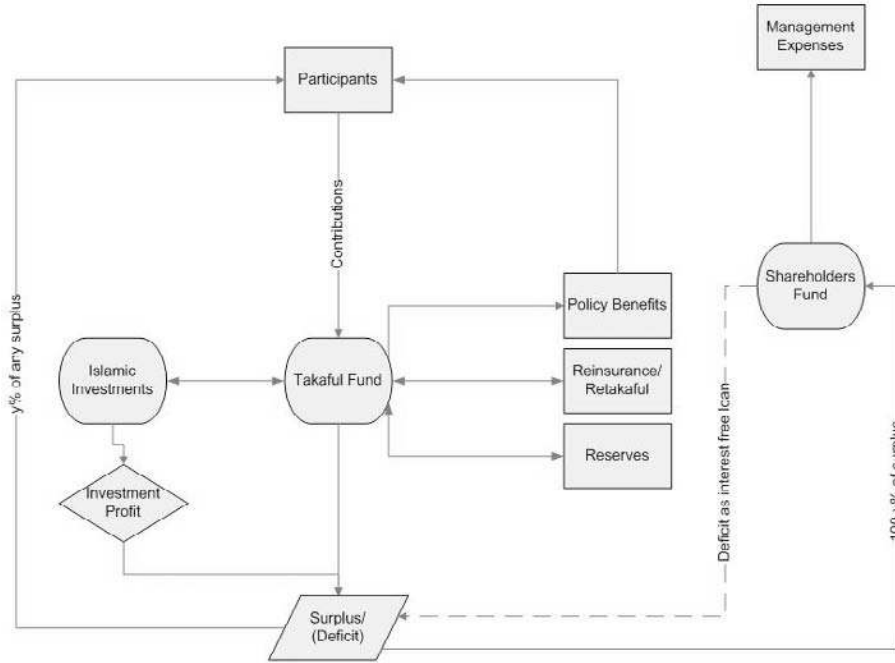


Figure 1. *Mudaraba* model

## Wakala model

In the *wakala* model, the shareholders act as an agent (*wakil*) to the policyholders. In this model, shareholders are paid:

- A pre-agreed proportion of the contributions paid by the policyholders in return for running the insurance operations of the *takaful* business. As with the *mudaraba* model, if the policyholders' funds make a loss, the operator does not share the losses, though it will provide the *qard al-hasan* to cover this loss; and
- A pre-agreed proportion of the policyholders' investment funds in return for running the investment of the policyholders' investment funds.

Figure 2 gives an overview of this model.

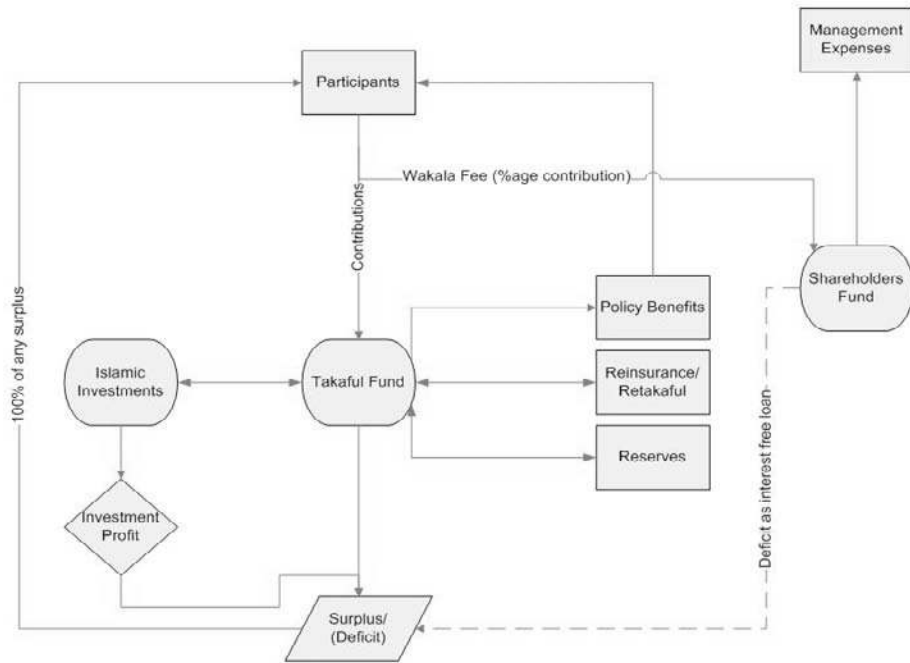


Figure 2. *Wakala* model

## Hybrid model

This is a mix between the *wakala* and *mudaraba* model, and is widely used in the Middle East countries (excluding Saudi Arabia). In this model, shareholders are paid:

- A pre-agreed proportion of the contributions paid by the policyholders in return for running the insurance operations of the *takaful* business – that is *wakala* model for the contributions; and
- A pre-agreed proportion of any investment income from investing the policyholders' funds assets – that is *mudaraba* model for the investments.

## Waqf model

There was considerable debate within Pakistan amongst Islamic Scholars as to whether “contributions” were really charitable donations. In response to this, the Shari’a scholars in Pakistan developed a model called *wakala-waqf* model (known as the *waqf* model).

In the *waqf* model, policyholders' funds are replaced with a charitable trust fund – a *waqf* fund. Under the *waqf* model, part of the capital of the

shareholders fund is donated to create the *waqf* fund. In all other respects, the *waqf* model works in the same way as the hybrid model.

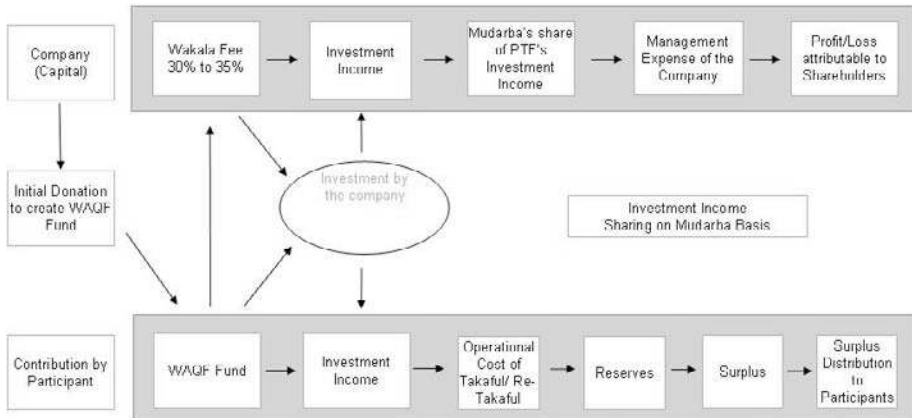


Figure 3. *Wakala-waqf* model

The *waqf* fund works to achieve the following objectives:

- To extend financial assistance to its members in the event of losses;
- To extend benefits to its members strictly in accordance with the *waqf* “trust” deed; and
- To donate to charities approved by the Shari’a Supervisory Board.

As per the hybrid model, the shareholders fund is remunerated through the *wakala* and *mudaraba* fees, and a *qard al-hasan* is payable in cases where the *waqf* fund is in deficit, which is unlikely to happen given the initial donation paid by the shareholders fund.

The *waqf* model is only used in Pakistan and South Africa.

## Practical considerations

### Incentives for shareholders

The takaful structures described above are theoretical structures. In practice, there are often variations to these models to incentivize the shareholders of the company to generate increased surpluses for policyholders. For example, shareholders can often be paid “incentivization fees,” which can take the form of:

- bonus pre-agreed shares of any surplus generated, if the surplus is greater than a certain proportion of the policyholders fund; or

- bonus pre-agreed shares of any investment income, if the investment income return is greater than a pre-agreed percentage.

Furthermore, in some companies, the *wakala* and *mudaraba* fees are defined as being to cover shareholders' profit expectations – that is, the expenses incurred by shareholders in running the company and in running the investment of the policyholders fund are paid by policyholders, and additional fees are paid to the shareholders. This was used by some companies to stop shareholders running the risk of being paid fees that did not cover the expenses of running the company.

## Qard al-hasan

In all of these variations, the *qard al-hasan* is still paid if the policyholders fund makes a deficit in one financial year.

There is at least one *takaful* company where the policyholders fund is not paid a *qard al-hasan* if the policyholders fund makes a deficit in one financial year. In this scenario, the policyholders fund will contain some of the money from the shareholders "contingency fund" to cover the possibility of the policyholder fund going into deficit. Essentially, the shareholders have made a *qard al-hasan* at the beginning of the life of the *takaful* business. As the policyholders' funds make surpluses, it will replace the shareholders contingency funds with some of this surplus money, and repay the shareholders for putting their money in the policyholders' funds.

## Retakaful

As with conventional insurance, often the *takaful* business may need to Islamically insure itself, in case it suffers a lot of unexpected losses at the same time (eg. floods in an area where many policyholders have personal household *takaful* policies) or one very large unexpected loss takes place (eg. if the *takaful* business insured an oil rig offshore and this oil rig sank). This Islamic insurance of the *takaful* business is known as *retakaful*.

Currently there is a dearth of strongly rated insurance *retakaful* companies. A strong insurance rating is important as the *takaful* company would only Islamically insure itself if it knew that the big loss(es) that may impact the *takaful* company adversely would not impact the *retakaful* company, and they may look to the insurance rating as a proxy for this insurance strength. At the time of writing, there are only three *retakaful* companies and *retakaful* windows that have a rating of A- or above, and there are less than 20 *retakaful* entities in the world.

This lack of *retakaful* capacity and strongly rated *retakaful* capacity presents *takaful* companies with a quandary, as they need to buy *retakaful* but there isn't the capacity. Shari'a boards have recognized this problem

and have allowed *takaful* companies to reinsure their business with conventional reinsurers.

## Investment compliance

As part of Shari'a compliance, *takaful* businesses should invest their assets within Shari'a-compliant assets. However, given the rapid growth of *takaful* entities, it may not be possible to invest all assets within Shari'a-compliant assets and also meet local regulatory rules on asset investment, which are designed to protect policyholders by ensuring that companies do not invest within risky investments or have too great a reliance on one asset.

Many of these investments that are allowable under local regulatory requirements (eg. bonds) are not Shari'a-compliant. Even if there are suitable Shari'a investments, there may not be enough of them; for example, if there is only one *sukuk* bond available for a *takaful* company to invest in, the company may fall foul of local regulations concerning "concentration risk" – the local regulator may want its companies to be invested in at least three *sukuk* bonds, not just one.

Currently there is a shortage in Shari'a-compliant investments that *takaful* business can invest in. The only option for *takaful* businesses in the short term is for their Shari'a boards to allow them to invest in non-Shari'a-compliant but ethically allowable investments.

## Takaful principles

### Tabarru' (contribution/donation)

The participants pay contributions to the *takaful* business to secure protection. The amount of contribution is fixed, based on the risk assumed and duration of participation defined under the *takaful* contract. For Shari'a purposes, the contributions are treated as donations from the policyholders to the *takaful* business. In theory, protection is provided under the principles of joint indemnity (ie. each policyholder jointly protects other policyholders, so in theory if a loss occurs that is bigger than the contributions that the policyholders have put in, they could be asked to put more money into the *takaful* entity). However, this does not occur in practice.

### Mutual cooperation

The *takaful* industry is based on the concept of mutual cooperation, where the insured is also the insurer, and therefore shares in the profit or loss of the institution they are paying the contribution to.

## 2.13

# Takaful vs. Conventional Insurance

*Mohammed Khan, PricewaterhouseCoopers*

## What is conventional insurance?

A normal insurance contract can be defined as an agreement whereby an insurer undertakes (in return for the agreed premium) to pay a policyholder a sum of money (or its equivalent) on the occurrence of a specified event. The specified event must have some element of uncertainty about it; the uncertainty may be either the fact that although the event is bound to happen in the ordinary course of nature, the timing of its occurrence is uncertain; or the fact that the occurrence of the event depends upon accidental causes, and the event, therefore, may never happen at all.

Essentially, insurance contracts include five elements:

1. Two parties – the insured and the insurer;
2. An agreed premium;
3. An amount to be paid to cover a specified loss or losses;
4. The specified loss or losses should have a remote chance of occurring; and
5. The policyholder who is taking out the insurance should have an interest in what is being insured (eg. they could own the item they are insuring).

## Differences between takaful and conventional insurance

### Shari'a vs. "man-made" laws

The first *fatwa* that explicitly prohibited commercial insurance in its modern application and its related activities was made by Ibn Abdeen (a Syrian Scholar) in 1834. While opinions vary among Muslim scholars, the overwhelming majority of them have concluded that modern conventional insurance contracts are unacceptable to Islam. In particular, life insurance

involves the use of certain elements that directly contradict the rules of Shari'a. These elements are:

- *Al-maisir* – this is also known as gambling. The policyholder loses the premium paid if he/she does not claim or the loss does not occur. On the other hand, the policyholder may be entitled to receive a bigger amount than what he/she deserves compared to the premium. In other words, the insurance company promises to pay a certain amount of money (indemnity) to the insured if the risk occurs and the insured agrees to pay another amount of money (premium) if the risk does not occur. This is not the case in a *takaful* business, where the policyholders are deemed to donate a sum of money to help each other in case anyone of them suffers a loss;
- *Gharar* – This is also known as uncertainty. It is against Shari'a rules to sell any contract involving uncertainty, doubt and probability. In Islam, uncertainty is prohibited in business contracts. In conventional insurance, neither the insured nor the insurer knows when the loss will occur or what will be the amount, or whether it will occur in first place. Alternatively, in *takaful* the policyholders fund is structured so that policyholders aid each other if a loss occurs. There is no guarantee from the company to the policyholder. The policyholders are grouped in a mutual assistance contract; there is no probability or uncertainty factor involved as they donate their contributions to the fund and they could receive a surplus from the principle of sharing the losses and profits. In fact there is no risk transfer (as the policyholder retain the risk), but there is risk sharing amongst the policyholders;
- *Riba* – This is also known as “interest” and defined as making money on money. Shari'a rules prohibit any activity involving interest. Most conventional insurers invest in interest-bearing assets (for example, the government or company bonds). *Takaful* businesses are restricted to an interest-free system. In theory, this means that a *takaful* entity must ensure that both its policyholder and shareholder funds must be invested in assets which do not have *riba* and that any bank that the *takaful* entity deals with should not be involved with the practice of *riba*.

## Investments

*Takaful* businesses can only invest in Shari'a-compliant assets subject to local regulatory restraints (eg. in certain countries, there are restrictions on the percentage of assets one can invest in equities due to solvency restrictions). Conventional insurance businesses are only restricted by local regulatory restraints.

In Islam, the basic principle of investment is that reward must be accompanied by risk. On this basis, it is permissible to invest in Shari'a-approved stocks, as prices of equities and dividends from equities command no certainty in value. However, *takaful* businesses cannot invest in any investments that are:

- debt based (eg. bonds), as this violates the *riba* principle;
- have a guaranteed or minimum return on the investment, as this violates the risk/reward sharing principle; or
- based on *haram* practices (eg. casinos and gambling companies).

With the recent growing interest in Islamic finance, there are, however, innovative Shari'a-compliant investments, such as:

- Commodity *murabaha* – the Islamic equivalent of money market instruments that are based on the underlying value of commodities; and
- *Sukuks* – the Islamic equivalent of conventional bonds that are asset based rather than debt based.

The investment decisions are, however, the same for *takaful* and conventional assets, and involve consideration of the same questions. For example, which investments will enable the business to match the cash flows to the liability cash flows of the insurance/*takaful* business? What are the local regulatory restrictions?

The income from the investment of the policyholders fund is returned to the policyholders fund after the deduction of any "*mudaraba* fee". If the *takaful* structure includes a *mudaraba* fee, this is returned to the shareholders' fund.

## Conclusion

*Takaful* is not a new concept – it has been around for centuries. *Takaful* business allows policyholders to enjoy the benefits of a mutual structure within a shareholder wrapper. *Takaful* business also has an explicit ethical structure which can be marketed to both Muslims and non-Muslims. Although both conventional and *takaful* businesses generate profits for the shareholders, in *takaful* business the expenses paid to the shareholders are explicitly transparent – in conventional insurance they are not necessarily so.

The following table summarizes the main differences between both systems.



	<b>Takaful</b>	<b>Conventional</b>
Benefits	Paid from the related participants' funds under mutual assistance.	Paid from the company reserves.
Investments	The funds shall be invested in any interest-free Shari'a-approved assets and also meet any required national insurance regulations and laws.	The funds may be invested in any assets so long as they meet required national insurance regulations and laws.
Operations	Operational mechanisms shall be in line with the Shari'a rules.	Operational mechanisms shall be in line with the national insurance regulations and laws.
Profit	Underwriting profit is distributed to the policyholders. Shareholders' profit is generated from the return on the investments of the shareholder capital and expenses paid to the shareholders by the policyholders for (i) managing the company on behalf of the policyholders; and (ii) managing the policyholders' investment funds on behalf of the policyholders.	Policyholders do not get any share of the underwriting profit (except in mutual companies); shareholders' profit is generated from the company's underwriting profit plus any investment returns.
Premiums	Paid premium is treated as both donation ( <i>tabarru'</i> ) and saving ( <i>mudaraba</i> ).	Paid premium creates an obligation against the insurer on a sale and purchase relation.
Company	Company is better known as an operator, which acts as a trustee, manager and also entrepreneur.	Relationship between the company and the policyholders is on one to one basis.
Shari'a	<i>Takaful</i> practices are free from the elements of <i>riba</i> and other prohibited elements, and is evolved around the elements of <i>mudaraba</i> , <i>tabarru</i> and other Shari'a-justified elements.	Conventional insurance (including mutual insurers) may involve <i>riba</i> and some other elements, which may not be justified by Shari'a principles.
Policyholder Fund	The policyholder fund belongs to the policyholders on collective basis and is managed by the shareholders.	All (ie. both policyholder and shareholder) funds belong to the company, though separation of assets may be maintained between shareholders and policyholders for specific insurances (eg. with profits).
Regulations	The operational mechanisms and products must be Shari'a-compliant and be in accordance with required national laws and insurance regulations.	Operational mechanisms and products have to be in accordance with the required national laws and insurance regulations.

## 2.14

# Human Resources and Training for Islamic Financial Activities

*Mohammad Shafique, Institute of Islamic Banking and Insurance*

## Introduction

Developing over the past three decades, Islamic banking has become a viable financial approach that is seen as a rapidly growing interest for both Muslim clients and non-Muslim investors. With its value-orientated system, Islamic finance stands apart from conventional banking. For Muslims, it is a question of moral conscience and religious obligation. For non-Muslims, its attractiveness lies in its ethical foundations and its potential for lucrative returns on investments. Today, more than 300 Islamic banks and financial institutions are operating in the Middle East, Asia, Europe, America and Africa. The rapid growth of the *sukuk* (Islamic bonds) market and the increasing demand for investments according to Islamic principles are addressing the liquidity management problems of Islamic financial institutions (IFIs). This is also attracting the resources and attention of the financial world to develop Islamic financial instruments, thus promoting the Islamic finance industry at a macro level in the overall framework of the global financial system.

The availability of well-informed and trained human resources at all levels to cater the needs of the emerging Islamic finance industry has, however, lagged behind the pace of its development. One major problem that IFIs are facing in almost all parts of the world has been the lack of availability of staff possessing adequate competence in procedures and expertise in Shari'a-related banking functions – a prerequisite to run the asset-backed and value-oriented financial system. As a result, many IFIs are headed and staffed by people who have moved from the conventional financial system, and this includes just as many personnel involved in structuring and sales of Shari'a-compliant products. The conventional mindset does, to some extent, limit the approach of structuring and executing transactions in the Shari'a-compliant financial system, particularly in innovative products, to compete with conventional financial instruments.

In order for IFIs to operate within the parameters defined by the Shari'a, they have to be supervised by scholars who are well versed in Shari'a and its approach to economic and financial issues. However, such scholars are also in short supply. As a result, their services are overstretched, and many sit on the Shari'a Supervisory Board of different banks. With the exception of a small number of scholars, a key factor in the prevailing shortage is that they may be well versed in Shari'a rulings, but they are not sufficiently well versed in the complexities of present day banking and financial issues.

Against this backdrop, the principles that guide all financial dealings within the ambit of the Shari'a, as well as continuing training for implementation of these principles, cannot be overemphasized in building professionals and Shari'a scholars, who are committed to developing an alternative financial system. To fill this human resource gap, there are only a few well-established organizations in the world that are dedicated to providing education and training for professional development in the emerging field. Among the well known are:

- the Islamic Research and Training Institute of the Islamic Development Bank based in Jeddah, Saudi Arabia;
- the Institute of Islamic Banking and Insurance (IIBI), UK;
- the Bahrain Institute of Banking and Finance, Bahrain;
- the Islamic Banking and Finance Institute, Malaysia;
- the International Centre for Education in Islamic Finance, Malaysia;
- the Securities and Investment Institute;
- the Association of Business Executives;
- CASS Business School; and
- the Chartered Institute of Management Accountants in the UK.

These are some of the institutions offering courses internationally in Islamic finance.

The Islamic Finance Project, a part of the Islamic Legal Studies Programme at Harvard Law School in the US, aims to study the field of Islamic finance from a legal and Shari'a point of view, and to therefore increase the interaction between theory and practice in Islamic finance.

There are also many local organizations providing courses and training, and some of the leading Islamic banks also offer their own in-house training. In addition, there are also a growing number of academic institutions in the UK that are offering qualifications in Islamic finance, for example:

- Durham University;
- Markfield Institute of Higher Education;
- University of Reading; and
- Bangor University.

Outside the UK, the two well-known educational institutions are the

International Islamic University of Malaysia, and the International Islamic University in Islamabad, Pakistan.

Academic institutions are providing a valuable service; however, the organizations that are developing practical education and training programmes often provide the best platform to promote professional development for the Islamic finance industry. While it was necessary to import talent from the conventional sector for running the IFIs at the formative stage, it cannot be relied upon for a long term and has many associated problems. Key is the reputation risk for the IFIs, as many of these personnel, well trained in the conventional sector, cannot be expected to look deep down for alternatives, which comply with the letter as well as the spirit of Shari'a principles.

The continuing education of all stakeholders – customers, Shari'a scholars, management, regulators, ratings agencies and shareholders and the public at large – is required to make Islamic finance a viable alternative. Though the Islamic Financial Services Board in Malaysia, the Accounting and Auditing Organization of Islamic Financial Institutions and the International Islamic Financial Market based in Bahrain are doing commendable work in developing international standards for the Islamic finance industry, this still requires personnel with an understanding and ability to implement these standards.

## Human resource development

While every IFI already has a department for human resource management, these departments need to place the same level of importance on professional education and training as their conventional counterparts and, to that extent, also allocate sufficient financial resources to this important area. Human resource development may be defined as an organized learning process to optimize the growth and productivity of the members of an organization for achieving the organizational goals. It is a continuous learning process to enable the staff to transfer new knowledge to the workplace, and to improve their performance and growth, thus leading to an improvement in productivity, which in turn leads to the growth and success of the organization.

When an organization develops and trains its staff, a sense of belonging is implanted in them, which is indeed very important for the success of the organization. When the staffs feel that they belong to an organization, they go out of their way to improve it. A sense of belonging is developed among employees when the organization cares about their well-being, professional growth and development of their employees. In organizations where a sense of belonging is absent, the employees are demoralized and are bound to decline in terms of productivity relative to their competitors.

In pursuing this vision, many IFIs are no doubt carrying out training internally; however, there is also a need to work with the external service

providers who can provide a wider base of knowledge and also practical learning experiences that reflect the developments around the world.

In IFIs, the human resource management function needs to also take a more formal approach in developing staff at all levels and providing sustainable programmes for career progression and self-development, and for improving the quality of operations. If the IFIs do not invest in upgrading the skills of their staff, they may not be able to convince their potential customers and fully exploit market opportunities.

## Management

Executives and senior managers in management are required to give the highest priority to governance issues, because they are also responsible for implementing the Shari'a rules, policy and processes that affect the way in which the business of an IFI is conducted. These relate to leadership, risk management, transparency, accountability, effectiveness and coherence in ensuring Shari'a-compliance. Management must always be reminded that while there will always be pressure to compete with conventional interest-bearing products, the alternatives offered by Islamic finance through participatory modes such as *musharaka* or *mudaraba* are considered the ideal modes of Islamic finance as they comply in substance as well as in form with Shari'a principles.

## Operations, marketing and sales

The performance of operations in IFIs, focusing on the quality of their operations personnel, must have an important place in the corporate strategy with the purpose of gaining competitive advantage. Focused training in this area can groom new, as well as existing staff to be assets for IFIs, and the closer IFIs get to this goal, the higher the efficiency and employee satisfaction.

Customer satisfaction is the key to success for any business enterprise. It is therefore imperative that the front-line staff in an IFI interacting with customers and the market place is competent and knowledgeable about the Shari'a-compliance of products and services on offer, and able to provide information about these products and service delivery systems. At the same time, front-line staff can provide valuable feedback to the management on customer satisfaction as well as their other views that are important in formulating product development and marketing strategies.

## Product development, legal issues and documentation

Products must increasingly be structured and implemented in a way that stands up to scrutiny from Shari'a advisory boards. With increasing liquidity

of IFIs, lending, treasury and fund management require appropriate financial instruments to undertake large and complex transactions. This opens up a huge new challenge for those involved in structuring and marketing such instruments, whether they are retail, corporate, capital raising or investment products. With a significant number of people working on structuring such complex transactions having conventional banking background and not enough experience and practice of Shari'a essentials and desire to compete for returns, management invariably places enormous demands on the structuring team to come up with innovative Islamic financial instruments that can compete with conventional financial products that are permissible under Shari'a. For this to successfully take place, the relevant staff must always have a very clear understanding of the characteristics and strict parameters underlying Islamic financing structures as well as a detailed analysis of the various points of contention over Shari'a documentation and legal requirements, and how these issues can be addressed.

## Technology

In today's environment, the operations of financial institutions are supported by a complex network of computer systems and software applications. With the growing complexities of banking regulation and supervision and the additional layer of Shari'a compliance, systems adopted by IFIs must be structured to conform to legal and regulatory as well as strict Shari'a requirements. Staff using information technology systems should be properly trained as part of the implementing processes and self-regulating the products and services offered by IFIs, as well as building clients' confidence in the institutions.

## Shari'a scholars

In order to widen the base of Shari'a scholars, there is a need for setting up separate courses tailored to produce scholars who have a thorough grounding in Shari'a and its approach to financial issues, and by making existing *fatwas* available to all financial institutions. With a view to giving access to the *fatwas* issued by various Shari'a scholars, the IIBI collected the available *fatwas* relating to financial issues and compiled these in three volumes, titled "Compendium of Legal Opinions on the Operations of Islamic Banks", which covers the key contracts in Islamic finance and their applications.

While there are already steps taken in this direction in Malaysia, the UK and other jurisdictions, these are few and patchy, and there is a need to coordinate these initiatives to bring wider participation from Shari'a scholars. Furthermore, Shari'a scholars on the advisory boards of IFIs are required to undergo regular training to engage in continuous interactions

with the management of IFIs in building and implementing broad, coherent policies, at a domestic and international level.

## Conclusion

There should be an increasing level of interaction between the industry and organizations providing Islamic finance education and training. Current professional education and training providers also need to coordinate to establish standards and to ensure they work towards a common agenda. They should also consider making strategic alliances with each other, which will create synergies and possibly better value to the potential learners of Islamic finance. Needless to say, this will require separate efforts to “train the trainers” to produce more trainers capable of delivering dedicated quality Islamic finance training.

Both governments and regulators need to be conversant with the demands of the Islamic financial system and should facilitate Shari’a-compliant transactions within their overall regulatory and legal framework. Ensuring that all personnel, whether they are Shari’a scholars, industry practitioners or regulators, have closer interaction in key markets, learn from each others’ experience and familiarize themselves with key issues and trends in the Islamic financial services industry will certainly be helpful for sustainable growth of the industry.

The late founder and chairman of the IIBI, Muazzam Ali, strongly believed that embedding a learning culture that is imperative in every IFI is the only way to compete in the global market place and keep up with competition from the conventional financial institutions in a fast changing world. However, to do this successfully, it requires more than just another round of restructuring the training function and also requires a holistic and systematic approach to learning. The industry as a whole needs to implement initiatives that will allow a more sustainable environment for training, development and growth of new talent into the system, which may include creation of a variety of human resource development programmes. Unbiased education and training from independent organizations supported by professionals, the industry and regulators is the formula for successful promotion and implementation of Islamic finance and its sustainable growth in the future.

## 2.15

# Taxation

*Mohammed Amin, PricewaterhouseCoopers*

## Introduction

Tax law varies between countries, reflecting each country's legal and political systems and economic history. In the context of Islamic finance, the key requirements are that a tax system should provide a "level playing field" between conventional and Islamic finance, so that extra costs are not imposed upon Shari'a-compliant transactions.

Countries where Islamic finance has been conducted for many decades (in some cases many centuries) generally have tax systems which give parity of treatment to conventional and Islamic finance. However, Islamic finance can pose challenges for the tax systems of countries where it is new.

## Summary of the generic issues involved

The issues are most easily explained using the following hypothetical example:

A company wishes to purchase a machine, to be delivered immediately, with a manufacturer's price of \$1,000. The machine will be useable for five years. If purchased with conventional finance, the customer will pay for this machine immediately, financed by a bank loan of \$1,000, carrying simple interest at 5 per cent per year, with all of the interest to be paid in full when the loan is repaid after two years (as demonstrated in Diagram 1).



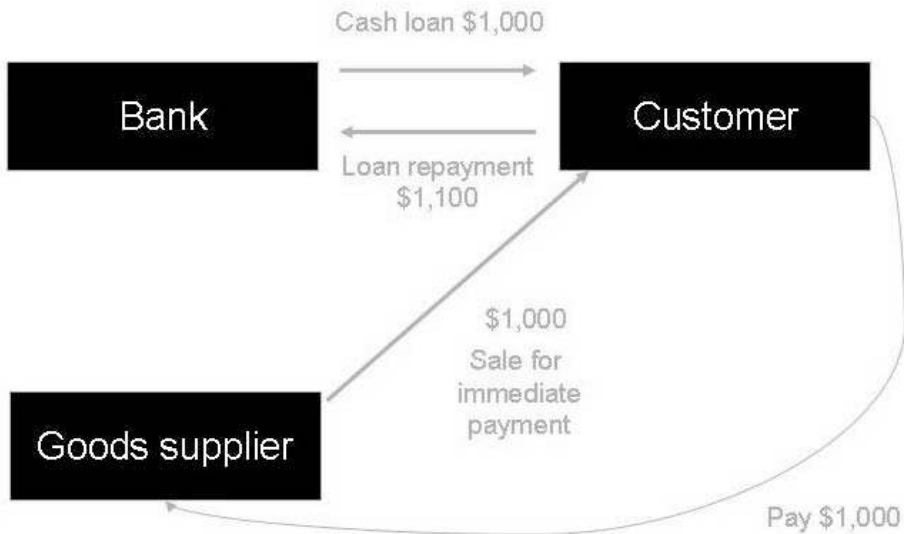


Diagram 1. Conventional purchase

If acquired with Islamic finance, the bank will purchase the machine from the manufacturer for \$1,000 and resell it to the customer for \$1,100 with immediate delivery, permitting the customer to only pay the bank the price after two years (as demonstrated in Diagram 2).



Diagram 2. Islamic purchase

In both scenarios, the customer has the same cash flows, obtaining the machine for immediate use and paying out \$1,100 after two years.

## Tax analysis

Tax law is specific to each country, and varies in complexity. For simplicity, assume a hypothetical tax system under which capital equipment, such as this machine, can be amortized for tax purposes, on a straight line basis, commencing only after the machine has been paid for. Tax relief for finance costs is given on an accruals basis over the life of the debt.

### Conventional finance tax analysis

The hypothetical tax system, developed in an environment of conventional finance, has no problems computing the tax deductions the customer is entitled to as shown in Table 1 below. The key principles underlying the tax treatment are that the customer has paid for the machine on delivery (even though financed by a bank loan) so the tax amortization starts immediately, and the customer will be paying \$100 interest to the bank, spread evenly over the two-year life of the loan.

Table 1. Conventional purchase tax deductions

Year	Amortization	Interest	Total
1	\$200	\$50	\$250
2	\$200	\$50	\$250
3	\$200	–	\$200
4	\$200	–	\$200
5	\$200	–	\$200
Total	\$1,100	–	\$1,100

### Islamic finance tax analysis

When the customer acquires the machine under Islamic finance, it is not paid for until after two years, and the legal contracts record no cost of finance. Instead there is the purchase of a machine costing \$1,100, which is only paid for two years after delivery. There are two fundamentally different ways for the hypothetical tax system under consideration to look at this Islamic finance transaction.

#### ***Follow the legal form***

If the tax treatment follows the legal form of the contract, there is no cost of finance. There is simply the purchase of a machine costing \$1,100, paid for two years after delivery. Under the assumed tax system, tax amortization only commences upon payment, and the tax deductions are shown in Table 2.

Table 2. Tax deductions with Islamic finance following legal form

Year	Amortization	Interest	Total
1	\$0	\$0	\$0
2	\$0	\$0	\$0
3	\$366	–	\$366
4	\$366	–	\$366
5	\$367	–	\$367
Total	\$1,100	–	\$1,100

The total tax deductions that arise are \$1,100, as with the conventional finance purchase. However, the key difference is that no tax deductions arise in the first two years since the machine has not been paid for. The deductions only arise in years three, four and five.

A basic principle of financial economics is that where two cash flow patterns have the same total, but one set of cash flow arises earlier than the other, then it is more valuable. Here the tax deductions with conventional finance are more valuable than the tax deductions that arise with Islamic finance. This difference illustrates why a tax system that follows the legal form fails to properly accommodate Islamic finance without specific adaptations.

### ***Follow the transaction economics***

The other way that the hypothetical tax system could look at the Islamic finance purchase transaction is to consider its underlying economics; the machine which the customer receives is worth only \$1,000, despite the customer agreeing to pay the bank \$1,100 for the machine. \$1,000 is the price at which the manufacturer sells the machine to the bank and is also the price at which the manufacturer would sell the machine to the customer if the customer could pay for it immediately.

Accordingly, the only reason the customer is willing to pay the bank \$1,100, which is \$100 more than the manufacturer would charge, is because the customer is going to pay the bank two years after delivery. Paying a larger amount for the privilege of paying later is the essence of what a finance cost is. Accordingly in economic terms there is a finance cost of \$100, and since this relates to the two-year period the annual finance cost must be \$50.

If the tax system follows the above economic analysis, then it will recognize this finance cost. Furthermore, since the customer is bearing this finance cost, then tax amortization should be given from delivery just as it is where payment is made on delivery financed with a conventional bank loan. The tax deductions with this analysis are shown in Table 3 and are of course identical to those with conventional finance.

Table 3. Tax deductions with Islamic finance following economic analysis

Year	Amortization	Finance cost	Total
1	\$200	\$50	\$250
2	\$200	\$50	\$250
3	\$200	–	\$200
4	\$200	–	\$200
5	\$200	–	\$200
Total	\$1,000	–	\$1,100

## The tax systems of some major Western countries

The author has previously surveyed a number of tax systems to consider how well they dealt with some common Islamic finance transactions. It showed that there is a spectrum, illustrated in Diagram 3.



Diagram 3. Tax systems classified

Some tax systems, such as in the UK, have long established principles of following the legal form of transactions in most cases. Such systems do not accommodate Islamic finance well unless specific legislation is enacted for it, as the UK has done. Other tax systems, such as in the Netherlands, find little difficulty with Islamic finance, as they primarily look to the economic consequences of the transaction to determine the tax treatment.

However, even where a tax system follows the economic substance of the transaction for computing business profits, there remains the possibility of it failing to provide a “level playing field” for Islamic finance due to transaction taxes.

In the example discussed above, in the conventional finance transaction, the machine is sold once, by the manufacturer to the customer who is the

end user. In the Islamic finance transaction, the machine is sold twice, once by the manufacturer to the bank, and again by the bank to the customer. This creates the risk of two applications of sales taxes or value added taxes. While many tax systems contain reliefs which apply in the case of such successive sales, in every case one needs to consider whether such reliefs will apply, or whether the Islamic finance transaction will suffer higher transaction taxes than a conventional finance transaction. Tax administrators considering changes to their tax systems to facilitate Islamic finance need to consider transaction taxes as closely as the tax law governing the calculation of business income and expenses.

## The UK's approach to the taxation of Islamic finance

### *Stamp duty land tax changes*

The first changes made to the UK tax system to facilitate Islamic finance addressed the question of residential mortgages. Islamic house finance in the UK typically involves a bank purchasing a property and then selling it to the customer. This can be an immediate sale at a higher price with deferral of payment such as the machine purchase illustrated above, ie. a *murabaha* transaction.

Alternatively diminishing *musharaka* can be used with the householder and the bank purchasing the property together. The bank rents its share of the property to the householder, and sells its share to him or her in tranches over the life of the arrangement. Under either the *murabaha* or the diminishing *musharaka* structure, the property is being sold twice, whereas in the case of a conventional mortgage there is a single sale from the vendor to the householder. Each sale would be subject to stamp duty land tax (SDLT) – the UK's real estate transfer tax – charging the Islamic transaction twice.

Accordingly, in the Finance Act (FA), 2003, the UK legislated to eliminate the double charge to SDLT where a property is sold to a financial institution (as defined) and then sold on to an individual. The key provision is found in section 71A, of which a portion is set out below:

1. This section applies where arrangements are entered into between a person and a financial institution under which:
  - (a) the institution purchases a major interest in land or an undivided share of a major interest in land (“the first transaction”);
  - (b) where the interest purchased is an undivided share, the major interest is held on trust for the institution and the person as beneficial tenants in common;
  - (c) the institution (or the person holding the land on trust as mentioned in paragraph (b)) grants to the person out of the major interest a lease (if the major interest is freehold) or a sub-lease (if the major interest is leasehold) (“the second transaction”); and

- (d) the institution and the person enter into an agreement under which the person has a right to require the institution or its successor in title to transfer to the person (in one transaction or a series of transactions) the whole interest purchased by the institution under the first transaction.
- 2. The first transaction is exempt from charge if the vendor is:
  - (e) the person; or
  - (f) another financial institution by whom the interest was acquired under arrangements of the kind mentioned in subsection (1) entered into between it and the person.
- 3. The second transaction is exempt from charge if the provisions of this Part relating to the first transaction are complied with (including the payment of any tax chargeable).

When first legislated, this relief applied only where the end customer was an individual, but it has since been extended to acquisitions by partnerships and companies. The section originally had its own free-standing definition of financial institution, but this has now been harmonized with the definitions used below for computing income and expense.

### ***Computation of income and expense***

The tax law changes were introduced by the FA, 2005, with subsequent expansion of the range of transactions covered in the FA, 2006 and the FA, 2007. A review of the legislation enables one to “reverse engineer” the design considerations that underlie it. There are four significant features:

1. Tax law must apply equally to all taxpayers;
2. Tax law changes should not impact upon transactions not intended to be covered;
3. Legislation should not be longer than is necessary; and
4. Addressing specific obstacles to Islamic finance.

### ***Tax law should apply equally to all taxpayers***

Strictly speaking, the UK has not enacted any Islamic finance legislation. A search of FA, 2005 will fail to find words such as Islamic, Shari’a, *tawarruq* or any other term used specifically in Islamic finance. The reason is that the tax treatment of a transaction cannot be allowed to depend upon whether it is Shari’a-compliant. As well as introducing significant uncertainty into the UK tax system, introducing Shari’a considerations would create a situation where all taxpayers were not receiving identical tax treatment.

Instead, the UK identified certain types of transaction widely used in Islamic finance, and ensured that those types of transaction received appropriate tax treatment. This is illustrated by FA, 2005 section 47: “Alternative Finance Arrangements”, reproduced here in full as originally legislated:

1. Subject to subsection (3) and section 52, arrangements fall within this section if they are arrangements entered into between two persons under which:
  - (a) a person (“X”) purchases an asset and sells it, either immediately or in circumstances in which the conditions in subsection (2) are met to the other person (“Y”);
  - (b) the amount payable by Y in respect of the sale (“the sale price”) is greater than the amount paid by X in respect of the purchase (“the purchase price”);
  - (c) all or part of the sale price is not required to be paid until a date later than that of the sale; and
  - (d) the difference between the sale price and the purchase price equates, in substance, to the return on an investment of money at interest.
2. The conditions referred to in subsection (1)(a) are:
  - (e) that X is a financial institution; and
  - (f) that the asset referred to in that provision was purchased by X for the purpose of entering into arrangements falling within this section.
3. Arrangements do not fall within this section unless at least one of the parties is a financial institution;
4. For the purposes of this section “the effective return” is so much of the sale price as exceeds the purchase price;
5. In this chapter references to “alternative finance return” are to be read in accordance with subsections (6) and (7);
6. If under arrangements falling within this section the whole of the sale price is paid on one day, that sale price is to be taken to include alternative finance return equal to the effective return;
7. If under arrangements falling within this section the sale price is paid by instalments, each instalment is to be taken to include alternative finance return equal to the appropriate amount;
8. The appropriate amount, in relation to any instalment, is an amount equal to the interest that would have been included in the instalment if:
  - (g) the effective return were the total interest payable on a loan by X to Y of an amount equal to the purchase price;
  - (h) the instalment were a part repayment of the principal with interest; and
  - (i) the loan were made on arm’s length terms and accounted for under generally accepted accounting practice.

Reading section 47, it is clear that it was designed to facilitate *murabaha* and *tawarruq* transactions. However, it nowhere uses those terms and nothing in section 47 limits its application to Islamic finance. If a transaction falls within section 47, the tax treatment follows automatically, regardless of whether the transaction is (or was intended to be) Shari’a-compliant.

*Tax law changes should not impact upon transactions not intended to be covered*

Commercial sales of goods often involve a credit period for the customer. It would unduly complicate UK tax law if every sale of goods with deferred payment required identification of the price that would have prevailed if no credit were given, and then giving separate tax treatment for the implied cost of the credit. Consider for example a food manufacturer selling hundreds of thousands of tins of food to retailers with 30 days credit allowed for the payment of each sales invoice.

Section 47 limits its impact by requiring the involvement of a financial institution in subsection (3). This ensures that only transactions where finance is provided by or to a financial institution fall within the new rules. Accordingly, the food manufacturer and its customers should not be impacted by these new rules. (One drawback of this approach is that it is currently impossible for two non-financial companies to transact Islamic finance with each other and receive the tax treatment given by the new legislation.)

Financial institution is defined in section 46(2) as:

- (a) a bank as defined by section 840A of Income and Corporation Taxes Act (ICTA), 1988;
- (b) a building society within the meaning of the Building Societies Act, 1986;
- (c) a wholly-owned subsidiary of a bank within paragraph (a) or a building society within paragraph (b);
- (d) a person authorised by a licence under Part 3 of the Consumer Credit Act, 1974 to carry on a consumer credit business or consumer hire business within the meaning of that act; or
- (e) a person authorised in a jurisdiction outside the UK to receive deposits or other repayable funds from the public and to grant credits for its own account.

Tracing through the definitions establishes that they cover all banks licensed in the European Economic Area, and also persons licensed to take deposits in other countries, which is the key practical definition of a bank. However many other bodies engaged in financial activities, such as hedge funds, fall outside these definitions.

*Legislation should not be longer than it is necessary*

Section 47 (reproduced above) demonstrates how complex it can be to legislate for an apparently straightforward transaction. Drafting the new legislation would have been very arduous if it was then necessary to legislate specifically for all the tax consequences flowing from *murabaha* or *tawarruq* transactions.

The legislation avoids this burden by assimilating the tax consequences of Islamic finance transactions into the existing tax legislation. For example,



where a company undertakes a *murabaha* or *tawarruq* transaction, the tax consequences are governed by FA, 2005 section 50 (1): Where a company is a party to arrangements falling within section 47, Chapter 2 of Part 4 of FA, 1996 (loan relationships) has effect in relation to the arrangements as if:

- (a) the arrangements were a loan relationship to which the company is a party;
- (b) any amount which is the purchase price for the purposes of section 47(1)(b) were the amount of a loan made (as the case requires) to the company by, or by the company to, the other party to the arrangements; and
- (c) alternative finance return payable to or by the company under the arrangements were interest payable under that loan relationship.

The FA, 1996, which governs loan relationships, contains a very extensive and complex set of provisions which apply to companies engaging in the lending or borrowing of money and paying interest or other finance costs. Section 50 (1) is not saying that section 47 involves the making of a loan; instead it taxes the company as if a loan had been made and as if the alternative finance return (the profit or loss under the *murabaha* or *tawarruq* transaction) were interest.

### *Addressing specific obstacles to Islamic finance*

Tax legislation in the UK has grown steadily since income tax became a permanent feature of the tax system in 1842, and was of course developed long before Islamic finance was contemplated in the UK. Not surprisingly, it happened to contain specific provisions which would impact upon Islamic transactions, even though the equivalent conventional transaction was not affected. These were addressed by specific legislation.

For example, the UK has long had a provision to counter companies disguising equity finance in the form of debt, in order to obtain tax relief for payments that are economically equivalent to dividends to risk bearing shareholders. This can be found in the ICTA, 1988, section 209 (2) (e) (iii).<sup>1</sup> This provision would preclude Islamic banks offering investment accounts to their customers, since the profit share paid to the customer would be treated as a distribution. This means that the payment would not be tax deductible for the bank.

This problem is addressed specifically by FA, 2005, section 54, which states: “profit share return (*defined in FA, 2005, section 49 in a form that corresponds to profit share return on investment account deposits of Islamic*

<sup>1</sup> In the Corporation Tax Acts, “distribution,” in relation to any company, means ... (e) any interest or other distribution out of assets of the company in respect of securities of the company (except so much, if any, of any such distribution as represents the principal thereby secured and except so much of any distribution as falls within paragraph (d) above), where the securities are ... (iii) securities under which the consideration given by the company for the use of the principal secured is to any extent dependent on the results of the company’s business or any part of it.

*banks*) is not to be treated by virtue of section 209(2)(e)(iii) of ICTA as being a distribution for the purposes of the Corporation Tax Acts.

## **Conclusion**

The approach taken by the UK has been a success in enabling Islamic banks to set up and operate while maintaining a tax system that applies equally to all taxpayers irrespective of their religious practices. As a pioneer, the UK has been closely watched by other countries considering how to develop Islamic finance in their own territory.