INSOL INTERNATIONAL

GUIDE TO ISLAMIC FINANCE

INSOL INTERNATIONAL

International Association of Restructuring, Insolvency & Bankruptcy Professionals

Guide to Islamic Finance

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International Association of Restructuring, Insolvency & Bankruptcy Professionals

On behalf of INSOL International, I am pleased to introduce this “Guide to Islamic Finance”. Thanks to the contributions from leading restructuring and insolvency professionals, this guide offers a detailed and thorough overview of many aspects of Islamic finance.

The world of Islamic finance represents both a challenge and opportunity to the global-minded business. With globalization strengthening business and legal ties around the world, more companies than ever have adopted a cross-border focus. This is particularly true of many businesses and investors in the Middle East and North Africa (or “MENA”), whose more global reach has helped drive interest in Islamic finance in MENA and other Muslim-majority countries. As a result, Islamic finance in practice has become more sophisticated and more relevant to professionals and firms around the world.

Like most areas of the world, the MENA region has been affected by global and regional financial downturns in recent years. Not surprisingly, as Islamic finance has become more sophisticated and prevalent, and as the MENA region has been hit by market distress, there has been a rise in business distress and a growing need for restructuring and insolvency solutions which are tailored for the unique dynamics of Islamic finance. Our profession has already witnessed more and more restructurings of firms in countries where Islamic finance is the norm and I expect that trend to continue, especially as recent reform efforts in the Middle East, North African, and Southeast Asian regions continue to update and revise local insolvency and restructuring systems.

Our Guide to Islamic Finance is a great tool to learn about critical aspects of Islamic finance. This book addresses fundamental topics including: basic Shari’ah-law finance concepts; common financing arrangements (such as prevalent murabaha, ijara, and mudarba / musharka facilities); the markets for Islamic financing; and restructuring Islamic syndicated bank facilities and public issuances. It also includes a helpful case study and a glossary of Islamic finance terminology.

We are very grateful to the project leader Mr. Qudeer Latif of Clifford Chance and all the contributors who have made this useful resource possible. Enjoy!

James H.M. Sprayregen
President
INSOL International

Foreword

Whilst the rate of growth of Islamic finance has been unprecedented in recent years the idea that led to this publication was the number of Islamic finance restructurings that resurfaced in late 2009/early 2010 and a consequential appreciation from the world of Insolvency Practitioners on the limitations of their practical understanding of Islamic finance principles and techniques. This publication, while focusing on practical aspects of Islamic finance across different asset classes from a global perspective that takes into account the two largest regional markets (the Gulf and South East Asia), also offers views into the technical aspects of Islamic Finance. The world of Islamic finance is too varied with different Schools of thought prevalent in different jurisdictions to be able to provide an exhaustive list of issues but it certainly, I hope, provides a useful starting and reference point.

I would like to extend my sincere appreciation and thanks to all the authors who presented their valuable contributions and have invested their time. I would also like to thank Shauaib Mirza and Hajar Barbach as part of my team who helped to review and edit some of the chapters. Finally I would like to express many thanks to the team at INSOL International who have managed this project for their support and encouragement.

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CHAPTER 1

Introduction to Islamic Finance

1. Introduction

The current unprecedented level of interest in Islamic finance has been generated by a growth in the wealth of a number of Islamic states, together with a change in the socio-political climate over the last few years.

The global Islamic financial services market is now estimated to be worth almost US$1.35 trillion and the continued potential for growth of Islamic finance means that investors are increasingly looking to tap into the opportunities offered by *Shari'a* compliant products and services.

Islamic banking transactions are based on Islamic principles and jurisprudence (together, the *Shari'a*) which are derived from a number of sources, including the primary sources of the *Qu'ran* and the *Sunna*. Islamic finance structures have developed in accordance with *Shari'a* principles and these principles must be kept in mind when trying to determine the Islamic acceptability of proposed financing techniques. Some of the key principles are discussed below.

2. Speculation (*maisir*)

Under *Shari'a*, contracts which involve speculation are not permissible (*haram*) and are considered void. *Shari'a* does not however prohibit general commercial speculation (which is evident in most commercial transactions). Rather the concern is to prohibit forms of speculation which are regarded as akin to gambling. The test is whether a gain is the result of chance rather than productive effort. However, the distinction between commercial speculation and speculation akin to gambling can be difficult to establish. As a result, in each case the commercial substance of the transaction must be analysed to evaluate whether or not it is permissible under *Shari'a*.

3. Unjust enrichment / unfair exploitation

Contracts where one party is regarded as having gained unjustly at the expense of another are also considered void. Again, it is not clear exactly what would amount to unjust enrichment and each contract must be considered on a case-by-case basis. It should be noted that the *Shari'a* principle of unjust enrichment applies to an enrichment of one party at the expense of another which cannot be justified but also to the enrichment of one party who exercises undue influence or duress over another and is therefore wider in its scope than the principle as applied under certain legal systems including English law.

4. Interest (*riba*)

Under *Shari'a*, money is regarded as not having any intrinsic value or time value and is seen merely as a means of exchange. As noted above, *Shari'a* requires that any return on funds provided by the financier be earned by way of profit derived from a commercial risk taken by the financier. Therefore, the payment and receipt of interest (*riba*) is prohibited and any obligation to pay interest is considered void.

5. Uncertainty (*gharrar*)

Contracts which contain uncertainty (*gharrar*), particularly any uncertainty as to one of the fundamental terms of the contract, such as the subject matter, price or time for delivery, are, again, considered void. As with unjust enrichment, the Shari'a principle of *gharrar* is wider than the English common law principle of uncertainty. Whereas case law such as *G.Scammel & Nephew Ltd v Ouston* ([1941] A.C. 251) has established that an agreement may not be binding if a definite meaning cannot be given due to the vagueness or uncertainty of certain of its terms, the *Shari'a* principle is wider in two main ways. Firstly, whereas English common law will permit some vagueness provided that it can be resolved by interpretation, or by examining the intention and/or conduct of the parties, *Shari'a* requires absolute certainty on all fundamental terms on its face. Secondly, *Shari'a* does not permit a contract where uncertainty may arise out of the actual subject matter or substance of a contract. For example a conventional insurance arrangement is not permitted (*haram*) on the basis of, amongst other things, uncertainty (*gharrar*) as to whether the insured event will occur or not.

6. *Shari'a* board / committee

To ensure adherence to these underlying *Shari'a* principles, most Islamic financial institutions or conventional financial institutions that have an Islamic 'window' have a board which scrutinises proposed transactions to ensure compliance with Islamic precepts. This board may be referred to as the bank's *Shari'a* board or *Shari'a* committee. The board will comprise a number of eminent Islamic scholars, who meet at regular intervals to discuss policy and / or specific transactions. Although a single issue may give rise to differing views held by different *Shari'a* boards as a result of the various schools of thought within Islamic jurisprudence, this is partly mitigated by the fact that the four main schools of thought within Islamic jurisprudence share mutual agreement on the majority of issues and that many modern day scholars sit on the *Shari'a* boards of a number of different Islamic institutions.

7. Islamic financing structures

In order to comply with *Shari'a* principles a number of financing techniques have been developed. A description of some of the most common structures, which will be explored in greater detail in further chapters of this publication, are as follows:

7.1 Murabaha (cost plus financing)

This popular method of Islamic financing is frequently used in trade financing arrangements. The financier will buy the asset in question from the supplier (either directly or through an agent) and will then on-sell the asset to the customer at an agreed marked-up price. The financier may hold title to the asset for only a brief period, perhaps just a few seconds, but the profit generated by the financier on the marked-up sale price is nevertheless regarded as a profit derived from a sale of goods transaction and is not therefore prohibited as interest paid on monies lent (*riba*). The marked up sale price may be payable immediately or deferred for payment at a later date. The mark-up charged by the financier will be an aggregate of the commodity risk borne by the financier in the asset, the credit risk of the customer as well as an amount equal to the conventional cost of funds for raising the finance for undertaking the initial purchase.

7.2 Tawarruq / commodity murabaha

Under a *tawarruq* / commodity *murabaha*, the financier (either directly or indirectly) purchases commodities (usually metals other than gold or silver) at market value for spot delivery and spot payment and immediately sells the commodities at an agreed mark-up price to the customer on a spot delivery and deferred payment basis. The customer then immediately sells the commodities at market value to a third party for spot delivery and spot payment. The end result is that the customer has received an amount of money and has a deferred payment obligation for the marked-up price to the financier. Although certain commentators have raised the suggestion that this transaction appears to be a disguised loan agreement, the counter argument is that the risk profile of the transaction is very different for the financier than the risk profile he would be expected to assume under a conventional loan facility. Under a conventional facility, the primary risk is that of the borrowing entity whereas under the *tawarruq* structure, the financier also takes commodity risk and risk on the third party supplier, in addition to customer risk. The *tawarruq* facility therefore enables Islamic banks to provide funding for customers who require a sum of money to be advanced to them.

7.3 *Ijara* (lease)

This is the Islamic finance equivalent of leasing and may be seen as a hybrid between conventional operational and finance leases. Rental payments under an *ijara* reflect an agreed profit element and comparisons with rentals on conventional leases (where interest considerations would often be relevant) can readily be made. However, unlike a conventional lease, the obligation to insure and undertake any major maintenance to the leased asset remains with the lessor. In addition, the lessee is only responsible for payment of rent whilst the use of the asset continues. Therefore if, for example, the lessee is no longer able to use the leased asset, for example, due to its total destruction, then the rental payments will cease. If the intention is to provide the lessee with title to the goods at the end of the lease this can be achieved through a variant of *ijara* called *ijara wa-iktina*.

7.4 *Istisna'a* (construction financing)

Istisna'a is an arrangement whereby a financier funds the production of goods or the realisation of a project in accordance with pre-agreed specifications, for a fixed price and a fixed date of delivery. *istisna'a* is particularly useful in providing an Islamic element in the construction phase of a project, and is typically used to provide financing for large projects such as the construction of a building, industrial machinery, ships or aircraft. In an *istisna'a* transaction, a financier may undertake to manufacture an asset and sell it on receipt of monetary instalments. As financiers do not normally carry out manufacturing, a parallel contract structure will typically be used. The ultimate buyer of the asset will commission it from the financier, which will institute a parallel contract under which the financier commissions the asset from the manufacturer. The financier charges the buyer the price it pays the manufacturer plus a premium. Under an *istisna'a*, the financier therefore takes the risk of manufacture of the asset.

7.5 *Bai salam* (forward financing)

This technique may be used to provide working capital. *Bai salam* financing is essentially a forward financing transaction where the financier pays in advance for the purchase of specified assets which the seller will supply on a pre-agreed date. As a mode of financing, the financier is able to acquire the assets by advance payment at a discounted price. The financier may sell the asset to be acquired on delivery for an increased price or may enter into a parallel *bai salam* contract. This financing technique can be used for the purposes of providing a pre-export facility.

7.6 *Wakala* (agency)

A *wakala* is an agency relationship between an investor (*muwakkil*), typically a financial institution, and the agent (*wakil*), the entity requiring financing. It is customarily used in interbank arrangements and between group companies. A simple *wakala* structure would operate as follows:

- the *muwakkil* agrees to put up capital for a specified period of time which the *wakil* invests, on behalf of the *muwakkil*, in certain *Shari'a*-compliant investments; and

- any profits generated by the investments are structured in a way that ensures the *muwakkil* receives its agreed profit, with the *wakil* entitled to retain any additional profit in excess of the agreed return of the *muwakkil*.

Although the *wakil* can be any entity, the investments made by the *wakil* have to be *Shari'a*-compliant. In each case the *wakil* will charge a nominal fee for providing its expertise.

7.7 *Sukuk*

A *sukuk* is a type of certificate or note which represents or evidences a proportionate interest in underlying assets and revenues. It is a negotiable instrument which, depending on the underlying asset, can be sold and purchased in the secondary market. It is often used in conjunction with other Islamic financing techniques (e.g. *ijara*, *musharaka* etc.). Although *sukuk* may be considered as the Islamic equivalent of bonds or capital market debt instruments, it is important to distinguish between a *sukuk* and a conventional bond. The *sukuk* is an asset based security where the primary credit risk is that of the originator who is obliged to pay the *sukuk* holder irrespective of the performance of the underlying asset. To the extent that the *sukuk* are rated, the rating cannot exceed the rating given to the entity which is ultimately responsible for providing the funds for the repayment of principal on maturity or early redemption of the *sukuk*. A conventional unsecured bond, although with a similar risk profile, does not give any ownership rights in an underlying asset but rather just a contractual claim against the issuer. It is also important to distinguish the *sukuk* from a traditional securitisation. In a securitisation the bond holder takes credit risk on the cash-flow which is being securitised, the issuer simply being used to pass through the underlying debtor credit risk. Accordingly, to the extent a securitisation is rated, the rating of the issuing entity may be improved by credit enhancement features and may also exceed the rating given to the parent of the issuing entity, which would not be possible for a *sukuk*.

7.8 *Musharaka* (equity financing)

Musharaka is the Arabic word for partnership. In a typical *musharaka* structure, the financier and the customer provide financing for a project in agreed proportion in the form of either cash contributions or contributions in kind. Profits arising from the project are shared in agreed proportions but losses are shared in proportion to their initial investment. In general, the customer will act as manager of the *musharaka* with the responsibility for investing the *musharaka* assets to earn a return for the *musharaka* partners (thereby obtaining access to the cash contribution). Typically the profit sharing arrangement are structured in a way that ensures the financier receives its agreed profit, with the party providing the management charging a fee for providing this service equivalent to the difference between the financier's share of the profit and the amount it actually receives based on the agreed return.

7.9 *Mudaraba* (participation financing)

This is a contractual arrangement between a group of investors (*Rab al Maal*) and a manager (*Mudarib*). The investors put up capital which the manager invests. The arrangement is flexible and may be used in a number of ways, for example, it may be:

- considered akin to a funded participation arrangement in conventional financing where the investors are similar to the participants who provide funds to the grantor or in this case *Mudarib* who in turn has a direct relationship with the customer; or

- used for the establishment of investment funds with the fund manager acting as *Mudarib*. Customers subscribe to the *mudaraba* fund where the *Mudarib* exercises its professional investment skills.

Although the *Mudarib* can be any entity, the *Mudarib's* investments have to be *Shari'a*-compliant. In each case the *Mudarib* will charge a fee for providing its expertise which will customarily be a proportion of the profits generated from the investments. Savings accounts operated by Islamic banks operate on this basis and strive to provide a rate of return which is comparable to conventional savings accounts by investing those funds in *Shari'a*-compliant transactions.

8. Co-financings

There are an increasing number of financings, particularly in project finance, where an Islamic finance tranche is used in conjunction with conventional financing. As in any multi sourced financing, the parties will want to agree how the two financings will operate together and what rights each group of financiers will have. For example, they may want to agree:

- a mechanism to establish the amount of the 'investment' in the project by each financier (which will allow comparison of loans with, for example, purchase or lease payments);

- the agreed 'investment' amount can then be used as a benchmark in relation to a number of issues such as agreeing scheduled payments, voting rights, and allocation of funds if there is a payment shortfall on acceleration and termination of the financings; and

- how to exercise their remedies on default such as the right to sell project assets, how proceeds of the sale will be used and how proceeds of insurance (e.g. if a financial asset is destroyed or lost) will be applied. Islamic financiers and conventional financiers may in theory have very different rights (for example as owner or lessor in possession in the case of the Islamic financier, or as secured party in the case of a conventional lender) but parties would expect assets to be available for the benefit of all the financiers.

The contracts and techniques used in Islamic financing may give rise to additional risks and liabilities for the financier or for the transaction that need to be assessed and, if appropriate, mitigated. The following chapters will explore in greater detail Islamic financing structures and techniques, as well as the pertinent legal and practical implications.

CHAPTER 2

Murabaha

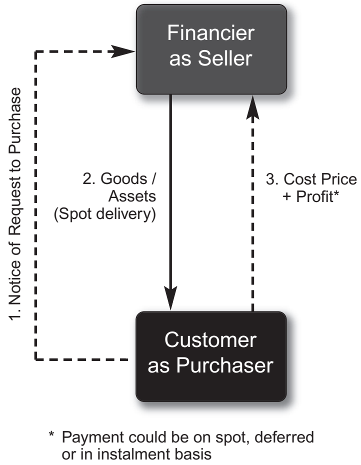
1. Introduction

This chapter will focus on the *murabaha* structure (in both its original and derivative forms) and how it has been used as a financing tool within the Islamic finance industry across the entire spectrum of financing arrangements. It will analyse how the variants of *murabaha* operate, the principal benefits of those structures over other *Shari'a* compliant structures and some of the inherent risks. It will also touch upon some of the concerns raised by scholars and other industry practitioners around the use of the structures.

> *"...Allah has permitted trade...."*[1]
> *"..it is no crime for you to seek the bounty of your Lord."*[2]

The AAOIFI *Shari'a* standard on "*Murabaha to the Purchase Orderer*" cites the above two Qur'anic verses as the primary foundation upon which the legitimacy of the *murabaha* is founded. Although the term "*murabaha*" is used within the Islamic finance industry to largely refer to commodity *murabaha* structures, the *murabaha* itself is in fact a form of sale contract between a buyer and a seller for the sale and purchase of goods (see figure 1). The key differentiating feature of a *murabaha* contract from other sale arrangements permitted under *Shari'a* is that the goods must be sold at cost price plus a profit mark-up. The goods, the cost price and the profit mark-up must be clearly specified and agreed between the parties at the time of concluding the *murabaha* contract. It is not a requirement that payment of the purchase price (i.e. the aggregate of the cost price and the profit mark-up) is deferred until a future date (although in the Islamic finance industry it typically is deferred). The purchase price can be paid at the time of delivery, on a future date or even in instalments provided that the arrangements are agreed at the time of entering into the *murabaha* contract.

Figure 1
Murabaha



Traditional scholars would argue that *murabaha* in its original, pure form is not intended to serve as a tool for financing. Unlike other *Shari'a* structures such as *mudaraba*, *musharaka* and *wakala*, no party provides cash to another party in order to finance a particular purpose. The arrangement is purely a trade arrangement where one party sells goods to another party in exchange for the payment of a price. However, within the Islamic finance industry, *Shari'a* scholars and other practitioners have developed structures around the pure *murabaha* that function as financing tools. This was done in order to allow

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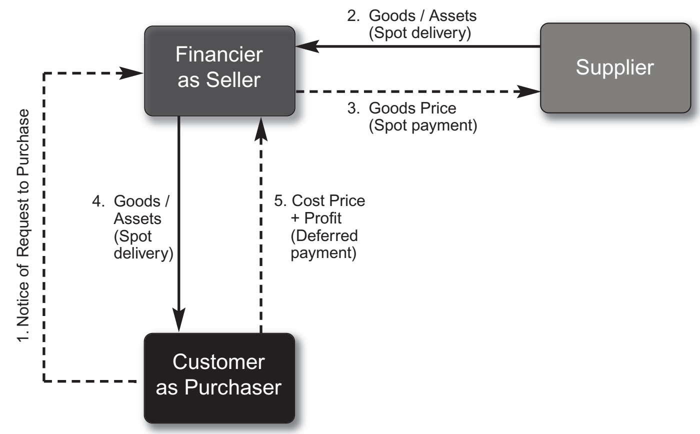
[1] Verse 275 of Surah Al-Baqarah of the Qur'an
[2] Verse 198 of Surah Al-Baqarah of the Qur'an

Islamic banks to provide *Shari'a* compliant alternatives of conventional products on a competitive basis, where to do so using other *Shari'a* compliant structures would have been very challenging and, some argue, may have impeded the growth and development of the Islamic finance industry. The most common structures that have been developed around the pure *murabaha* are what are known as the "trade *murabaha*" and the "commodity *murabaha*".

2. Trade *Murabaha*

The trade *murabaha* is also known as "*murabaha* to the purchase orderer" and the AAOIFI *Shari'a* standard on *murabaha* relates to this type of *murabaha* arrangement. The trade *murabaha* generally operates as follows:

Figure 2
Trade Murabaha



(a) a customer is interested in acquiring a particular good or asset from a supplier but does not have the cash to do so;

(b) the customer approaches a third party financier (an Islamic bank or financial institution) and requests it to purchase the goods or assets on its behalf on immediate payment and immediate delivery terms from the supplier;

(c) at the time of making this request, the customer undertakes / promises to the financier that it will purchase the goods or assets from the financier once they have been purchased from the supplier;

(d) once the financier has acquired the goods or the assets from the supplier, it then offers to sell them to the customer at cost price plus a profit mark-up (i.e. an offer to enter into a *murabaha* is made); and

(e) the customer accepts the financier's offer and acquires the goods or assets on a *murabaha* basis. The goods or assets are delivered immediately but payment of the cost price plus the profit mark-up is deferred to a date in the future.

By implementing the above steps, a customer is able to finance the acquisition of goods or assets which it otherwise would not have been able to purchase. In economic respects, the structure essentially replicates a conventional trade financing arrangement. The profit mark-up would typically be determined by reference to a fixed rate applied against the amount of the financing (i.e. the cost price of the goods or assets) or a floating rate such as LIBOR. The timing for payment would represent the tenor of the financing. The structure can also be supplemented with third party guarantees / letters of credit and security arrangements, much like a conventional trade financing.

Although the general economics of the structure achieve the same outcome as a conventional trade financing arrangement, there are a number of risks that are inherent in the structure[3]. For instance:

(a) the financier must take actual or constructive possession of the goods or assets before it can sell them on to the customer. During the period of ownership, although the period is very brief, the financier is exposed to risks associated with ownership (such as maintenance, total loss, diminution in value etc.);

(b) in the event that the customer fails to comply with its undertaking / promise to purchase the goods or assets from the financier, the financier cannot oblige the customer to conclude the *murabaha*. It can only make a claim for its actual costs, namely the difference between the price paid by it to the supplier and the price obtained from selling the goods or assets to a third party. Crucially, the financier is not able to claim for funding costs or costs associated with a loss of opportunity; and

(c) the goods or assets are being bought and sold on two separate occasions. Each sale could give rise to tax liabilities for the financier and / or the customer.

There are also a number of *Shari'a* requirements that need to be complied with when structuring and documenting these arrangements. For instance (and this is not intended to be an exhaustive list):

(a) the financier cannot make an offer to sell the goods or assets until it has acquired those assets and a sale is not effective under *Shari'a* without the exchange of an offer and acceptance between the buyer and the seller (or vice-versa);

(b) the supplier cannot be the customer itself as that would then constitute a purchase from the customer with a subsequent sale back to the customer (*bai al-inah*), which is forbidden under *Shari'a*;

[3] Please see the AAOIFI Shari'a Standard on "Murabaha to the Purchaser Orderer" for further details

(c) buying agency arrangements are permitted but generally speaking the preference is for the agent to be someone other than the customer (which would often be the preferred choice of the financier);

(d) whilst benchmarks such as LIBOR can be used for the purposes of determining the profit mark-up, any determination must be made prior to concluding the *murabaha* contract such that the exact amount of the profit mark-up can be ascertained at the time;

(e) *Shari'a* scholars do not view this as a loan or a funding arrangement and therefore conventional financing concepts, such as increased costs, mandatory costs, indemnities etc., can be problematic; and

(f) default interest provisions are prohibited under *Shari'a* and would need to be replaced with a more *Shari'a* friendly concept of late payment amounts.

Notwithstanding the above risks and requirements, the trade *murabaha* structure is frequently used to finance the acquisition of goods and / or assets in a *Shari'a* compliant manner. The structure is used by trading companies that seek *Shari'a* compliant financing for their trade financing needs. It is also used in the retail space, for example for providing vehicle financing to customers.

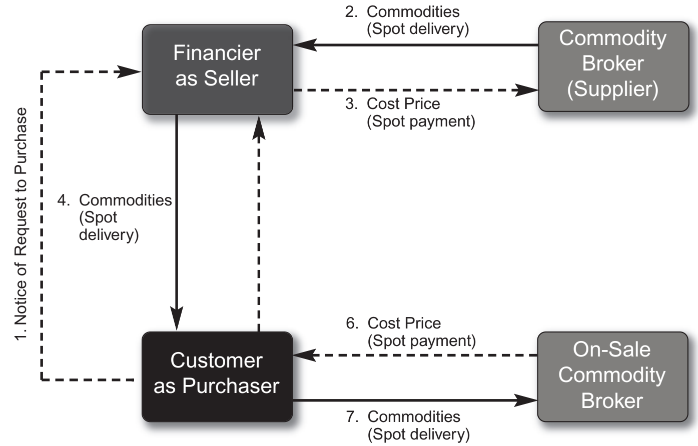
Whilst this structure lends itself very well to trade financing, it does not work in its current form where the customer is not really looking to finance the acquisition of goods or assets but rather simply wants cash (i.e. a corporate financing). Although *Shari'a* does provide for means through which a customer can obtain cash funding, those methods do not allow the financiers to replicate the economics of a conventional loan. For instance, in a *mudaraba* arrangement the financiers cannot be guaranteed a rate of return equal to LIBOR plus a margin, they can only expect their share of profit from the activities of the *mudaraba*. If the *mudaraba* does not make a profit or suffers a loss then this risk is borne by the financiers. A similar position applies in respect of other structures such as *musharaka* and *wakala*. These structures require the financiers to take a risk which is far greater than the simple credit risk of their customer and as such financiers are generally reluctant to use them. Acknowledging this reluctance and with the intention of growing the Islamic finance industry, *Shari'a* scholars and industry practitioners took the trade *murabaha* one step further to develop, what is commonly known as, the commodity *murabaha* structure.

3. Commodity *Murabaha*

The commodity *murabaha* structure is also known as *tawarruq* or reverse *murabaha*. It is similar to the trade *murabaha* structure with three notable differences: (i) as the name suggests, the subject matter of the structure is almost always commodities (usually metals other than gold or silver); (ii) the customer has no interest in acquiring the commodities either for itself of for trading purposes; and (iii) whereas the trade *murabaha* structure ends with the customer acquiring the goods / assets, the commodity *murabaha* structure continues with the customer selling the commodities to a third party.

It generally operates as follows:

Figure 3
Commodity Murabaha



(a) a customer is in need of cash funding. The cash may be required for general corporate purposes or something more specific (such as the acquisition of an asset);

(b) the customer approaches a third party financier (an Islamic bank or financial institution) and requests it to purchase commodities in an amount equal to the amount of funding the customer is seeking (being the cost-price) on immediate payment and immediate delivery terms from a commodity broker (the supplier);

(c) at the time of making this request, the customer undertakes / promises to the financier that it will purchase the commodities from the financier once they have been purchased from the commodity broker;

(d) once the financier has acquired the commodities from the commodity broker, it then offers to sell them to the customer at cost price plus a profit mark-up (i.e. an offer to enter into a *murabaha* is made);

(e) the customer accepts the financier's offer and acquires the commodities on a *murabaha* basis. The commodities are delivered (constructively) immediately but payment of the cost price plus the profit mark-up is deferred to a date in the future; and

(f) once the customer has acquired the commodities from the financier it immediately on-sells them to a commodity broker (the on-sale commodity broker) at cost-price on immediate delivery and immediate payment terms.

The net result of the above arrangements is that the customer obtains a cash sum equal to the amount of the financing it needs and is under an obligation to make a payment to the financier for an amount equal to that cash sum plus a profit mark-up on a future date. This is no different to a conventional loan arrangement where the net outcome of the loan is that a borrower obtains a cash sum equal to the amount of financing it needs and is under an obligation to pay that amount together with an interest mark-up on a future date.

As per the trade *murabaha* structure, whilst the commodity *murabaha* successfully replicates the economics of a conventional loan, there are additional risks inherent in the structure. For instance:

(a) the financier must take actual or constructive possession of the commodities before it can sell them onto the customer. During the period of ownership, albeit the period is very brief, the financier is exposed to risks associated with ownership (such as maintenance, total loss, diminution in value etc.);

(b) the financier not only takes the corporate credit risk of the customer but also takes the risk of the customer refusing to purchase the commodities from the financier. As mentioned earlier in this chapter, the financier cannot enter into a binding agreement to sell the commodities to the customer until (i) it has acquired the commodities and (ii) the parties have exchanged an offer and acceptance for the sale;

(c) the parties will need to identify commodity brokers that can be used to facilitate the structure. The brokers will typically charge a commodity fee for facilitating the structure – this is an additional cost which the customer would need to bear which a borrower under a conventional financing would not be exposed to;

(d) as per *Shari'a* requirements, the customer cannot enter into a binding sale with a commodity broker until (i) the customer has acquired the commodities; and (ii) the parties have exchanged an offer and acceptance for the sale. There is therefore a risk that the commodity broker refuses to purchase the commodities from the customer leaving the customer with a large amount of commodities and no cash;

(e) in addition to the risk set out in paragraph (d) above, the customer is also exposed to the insolvency risk of the commodity broker to which it intends to sell the commodities. The commodity broker may become insolvent and unable to pay the purchase price; and

(f) the commodities are being bought and sold on three occasions. Each sale could give rise to tax liabilities for the financier and / or the customer.

A number of these risks can be, and are typically, addressed within the parameters of *Shari'a*. For instance, all of the commodity trades usually happen within the space of a couple of hours, the commodities are typically located in bonded warehouses in tax friendly jurisdictions and the parties generally adopt cash settlement arrangements between themselves which result in the financier having control over the movement (if any) of funds and it is the financier that will disburse the purchase price, due from the commodity broker to the customer, directly to the customer.

There are also a number of *Shari'a* requirements that need to be complied with when structuring and documenting these arrangements. For instance (and this is not intended to be an exhaustive list):

(a) a party cannot make an offer to sell the goods or assets until it has acquired those assets and a sale is not effective under *Shari'a* without the exchange of an offer and acceptance between the buyer and the seller (or vice-versa);

(b) generally, speaking the commodity broker selling the commodities to the financier and the commodity broker buying the commodities from the customer must be different entities;

(c) buying and selling agency arrangements are permitted but generally speaking the preference is for the agent to be someone other than the customer or financier; and

(d) whilst benchmarks such as LIBOR can be used for the purposes of determining the profit mark-up, any determination must be made prior to concluding the *murabaha* contract such that the exact amount of the profit mark-up can be ascertained at the time;

(e) *Shari'a* scholars do not view this as a loan or a funding arrangement and therefore conventional financing concepts, such as increased costs, mandatory costs, indemnities etc., can be problematic;

(f) default interest provisions are prohibited under *Shari'a* and would need to be replaced with a more *Shari'a* friendly concept of late payment amounts; and

(g) generally (although not always), the scholars do not like to see any mention of the on-sale of the commodities by the customer to a commodity broker in the same document as the *murabaha* agreement.

Notwithstanding the above risks and requirements, the commodity *murabaha* is the most prevalent structure used across the entire ambit of the Islamic finance industry. It is a desirable structure because it allows the economics of a loan to be synthesised without the customer requiring an asset (as would be the case in an *ijara* structure), without the customer and the financier entering into a partnership or loss-sharing relationship (as would be the case in a *mudaraba* or *musharaka* structure) and without the banks being exposed to anything more than credit risk during the tenor of the arrangements.

4. Application of structures

As alluded to earlier in this chapter, the trade *murabaha* structure lends itself very well to trade financing arrangements where one party is seeking financing to acquire certain goods and / or assets. It can be applied across the entire suite of trade financing arrangements, for example, import financing, export financing (pre-shipment), export financing (post-shipment) and forfeiting arrangements. However, beyond this the structure is of limited use in the context of financing. However, the same cannot be said of the commodity *murabaha* structure.

Along with the *wakala* structure, the commodity *murabaha* structure, is commonly used by Islamic financiers to manage their interbank / liquidity management arrangements. It is for this reason that the International Islamic Financial Market's template documentation for treasury placement is based on the commodity *murabaha* arrangement (although the final leg, between the customer and the on-sale commodity broker, is not specifically mentioned or provided for – this is not uncommon but in practice the final leg is completed).

In addition, the commodity *murabaha* is the Islamic financing tool of choice for general and syndicated corporate financings. The structure can be easily adapted to provide for features that are common in the conventional finance space but that would otherwise be very difficult to accommodate using other *Shari'a* structures. For example, commodity *murabaha* facilities can be structured as term or revolving facilities, can have accordion features and can contain amortisation or bullet repayment profiles. The structure also allows banks to create a payment obligation which, once created, is only subject to the credit risk of the customer (much like a conventional loan). The arrangements can be supplemented with credit support and / or security. These features also make it ideal for the purposes of providing working capital facilities in connection with a *Shari'a* complaint project financing or for providing *Shari'a* compliant leverage to fund vehicles.

In the last few years, the commodity *murabaha* structure has been increasingly used in the *sukuk* market. Pure *sukuk al-murabaha* structures are still very rare however, since the *sukuk* certificates become non-tradable due to the absence of underlying tangible assets. However, it is becoming increasingly common to see a more typical *sukuk* structure, such as *sukuk* al-*ijara* or *sukuk* al-*wakala*, complimented by a commodity *murabaha* structure. Whereas more typical *sukuk* structures require underlying assets, and therefore the amount of the *sukuk* issuance is naturally limited to the value of those assets, *sukuk al-murabaha* has no such limitations. By combining the two structures, issuers can upsize the amount of their overall issuance in a *Shari'a* compliant manner whilst retaining the tradability feature of the *sukuk* certificates (which is generally viewed as a key requirement for investors).

5. Concerns

Notwithstanding the perceived benefits outlined above, there are concerns within the Islamic finance industry around the commodity *murabaha* structure. There is an argument that it is nothing more than a disguised loan. Whilst each individual step arguably complies with the requirements of *Shari'a*, collectively the arrangements may be seen as creating the equivalent of a loan with interest, and one could argue that this is indeed the intention of the parties involved. None of the parties involved are interested in the commodities themselves, the commodity risk required to be taken by the financiers is mitigated to such an extent that it is almost non-existent (or placed firmly on the customer) and the commodity brokers are typically affiliated entities such that the commodities generally find their way back to the original commodity broker. For these reasons, some argue that the structure takes the concept of "trade" permitted under *Shari'a* a step too far, and a number of scholars do not permit the use of the commodity *murabaha* structure except in exceptional circumstances.

Another issue with the *murabaha* generally is that once the relevant goods, assets or commodities are sold by the financier, the financier is only entitled to receive a payment, that is to say it is only entitled to a debt in its favour. The trading of debt is prohibited under *Shari'a* except at par. This essentially means that a financier and, in the context of *sukuk*, an investor can only transfer its participation in a *murabaha* arrangement at par. This is not that much of an issue in the syndicated financing space but is more important in the context of *sukuk*, where investors generally want to be able to trade their certificates at a premium or discount.

6. Summary

The *murabaha* structure, in its true form, is a tool for conducting trade and not for providing finance. However, its derivative forms clearly lend themselves well to financing arrangements and for that reason are widely implemented. The derivative forms allow Islamic financiers to compete with conventional financiers by offering their customers an alternative manner of financing which meets their commercial and religious needs whilst retaining an equally competitive rate of return for the banks involved in the financing.

Although there is a difference of opinion between scholars as to the permissibility of the commodity *murabaha* structure, most would agree that it is necessary in order to allow the industry to grow but that it may, at some point, be phased out in favour of the traditional financing structures specifically provided for in *Shari'a*.

CHAPTER 3

Istisna'a and *ijara* Financing: Background and Practical Implementation

1. General background about the principles underpinning *Istisna'a* and *Ijara*

1.1 Ownership of the asset

The basic *Shari'ah* requirement is that the seller of an asset must own it when the seller enters into the sale agreement[1]. As explained in more detail in previous chapters, there are a few *Shari'ah* principles that underlie this position, the main aim being to avoid excessive risk and uncertainty (i.e. *gharar)*. In Islamic jurisprudence *gharar* should be avoided in order to promote unity and social harmony. If no asset exists when a sale agreement is concluded, there is a greater chance for uncertainty which also means a greater chance for discord between the parties. There are however some exceptions to this rule. Contracts of *salam* and *istina'a* are the two main exceptions recognized by early Islamic jurists.

1.2 The exceptions of *Salam* and *Istisna'a*

(a) Contract of *salam*

A *salam* contract is a forward sale contract of fungible goods, such as, grain. Here the buyer pays the purchase price in full when it enters into the contract. The goods can however be delivered on a future agreed date. Historically, *salam* contracts were used in connection with agricultural activities in order to provide funds to farmers so they could buy seeds and pay their labourers. Initially, Prophet Muhammad (SAWS) forbade merchants from selling goods that they did not own, for the reasons mentioned in the introductory paragraph.

(b) Contract of *Istisna'a*

The other principal exception to the general rule relating to sale agreements is the contract of *istina'a*. This chapter considers *istina'a* contracts later in more detail. *Shari'ah* scholars permit this type of contract on the basis that the lawful economic needs of people must be allowed in a way that does not impose unnecessary hardship.

The main differences between a contract of *salam* and a contract of *istina'a* is that *salam* is for the sale of a fungible asset and for a *salam* to be valid the full purchase price must be paid when the contract is signed. An *istina'a* is for the sale of a specific asset, such as a building. In an *istina'a* the purchase price can be paid in advance, on a deferred basis or in installments.

The contract of *istina'a* was initially permitted to deal with specific needs arising out of manual work relating to local products such as carpentry or shoes. However, the scope of this contract has been expanded in modern Islamic finance era to include a wide variety of assets, major infrastructure and industrial projects.

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1 Narrated by Bukhari and Muslim: The Prophet Muhammad said: "Do not sell what you do not possess"

1.3 *Ijara* contracts

There are a range of *ijara* contracts. They include:

(a) An *ijara* – this is a simple lease of an asset against payment of rent, that is an "operating lease".

(b) An *ijara muntahia bi al-tamlik*, which is also sometimes called an *ijara wa iqtina* – this is a lease, but where the structure incorporates various procedures that allow the lessee to own the leased asset ("lease to own"). While the AAOIFI Standards consider an "operating lease" and a "lease to own" to be operating leases, the International Accounting Standards consider "lease to own" arrangements under the Shari'a as "finance leases". Generally, Shari'a scholars do not recognize the concept of finance leases[2].

(c) *ijara musufah fi al-dhimmah* – this is a "forward lease".

(d) *ijara al-ashkhas* – this is a lease relating to the services of people.

(e) *ijara al-ajir al-kahs* – this is a lease in respect of a private employee, such as a private driver.

(f) *ijara al-ajr al-mushtarak* – this is a lease of a shared employee, such as a taxi driver.

The basis for permitting a contract of *ijara* for the hire of a person's services (*ijara al-ashkahs*) is found in the *Sunnah* in which the Prophet Muhammad (SAWS) said "whoever hired a worker must inform him of his wages" and "give a worker his wages before his sweat is dried"[3].

The subject of an *ijara* contract can also be the usufruct of an asset.

While a *salam* contract and an *ijara musufah fi al-dhimmah* (forward lease) contract are similar in that both deal with an asset that is not owned by the seller or lessor at the time of the contract, they differ from each other in two main aspects. A *salam* contract is a sale contract of a fungible asset in which the total sale price must be paid in advance when the contract is signed. By contrast, a forward lease contract is a contract of sale of a usufruct and the rent can be paid at any time agreed between the parties. It can be paid in advance, on account, while the leased asset is under construction.

2. *Istisna'a*

Section 2 explores a contract of *istina'a* in more detail.

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2 See OIC International Fiqh Academy issued the following Resolution (Resolution No. 13 (1/3) concerning the *ijara* question submitted by the Islamic Development Bank (IDB))

3 *al-Sunan al-Kubra, Kitab al-Ijara*

2.1 What is an *istina'a*?

There are some differences amongst the Shari'a schools as to how a contract of *istina'a* should be classified. Is it a sale or a promise to sell or should it be viewed as a form of employment of the constructor? There is general acceptance, however, of the *Hanafi Shari'a* school of opinion, which is that a contract of *istina'a* is a contract for the sale of an asset.

AAOIFI Standard No. 11 defines it as follows:

"*Istisna'a is a contract of sale of specified items to be manufactured or constructed, with an obligation on the part of the manufacturer or builder (contractor) to deliver them to the customer upon completion*"[4].

2.2 Key issues

For an *istina'a* to be valid under Shari'a principles, certain key criteria must be met in order to avoid, in particular, *gharar*. It is necessary to clearly describe:

(a) the type of asset that is being constructed or manufactured;

(b) the quality / quantity of the asset; and

(c) the sale price.

As the completion of the construction of an asset may be affected by external factors, it is not necessary to mention a specific delivery date in the contract. However, the normal practice is to mention a date and then provide in the contract that the manufacturer must produce and deliver the asset within such reasonable time as the nature of the work may permit, in accordance with the accepted practice as recognised by experts.

2.3 The different ways in which *istina'a* is used in Islamic financing

Istisna'a contracts are used by Islamic financial institutions to provide financing for projects or the construction of single or multiple assets. As a financial institution, an Islamic financier is generally not licensed or equipped to construct the asset itself. In almost all situations, the construction is normally carried out by a contractor.

There are three ways in which *istina'a* is usually utilised for financing purposes:

(a) a parallel *istina'a* in which there will be an *istina'a* between the Islamic financier and the contractor, together with a separate *istina'a* between the Islamic financier and its customer;

(b) an *istina'a* between the Islamic financier and the contractor, together with a separate forward lease between the Islamic financier and its customer; and

(c) an *istina'a* between the customer and the contractor, a separate *istina'a* between the customer and the Islamic financier, together with a separate forward lease between the Islamic financier and its customer.

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[4] Appendix C; Definitions to AAOIFI Standard No. 11

2.4 Risks faced by the Islamic financier as the seller / contractor

As it is a party to a sale agreement, the Islamic financier, as the seller, faces various risks. Some risks that the Islamic financial institution must consider include the following:

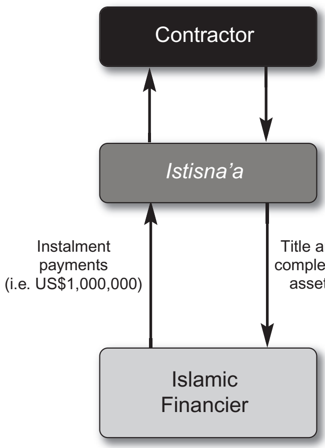
(a) in many jurisdictions it is not possible to exclude all warranties through contractual exculpatory provisions (for example, statutory warranties usually cannot be excluded by contract). Strict liability may also attach to the sale of an asset. Item 2/2/3 of Standard No. 11 on *istina'a* prohibits a builder excluding liabilities arising from a defective manufacturing or construction activity; and

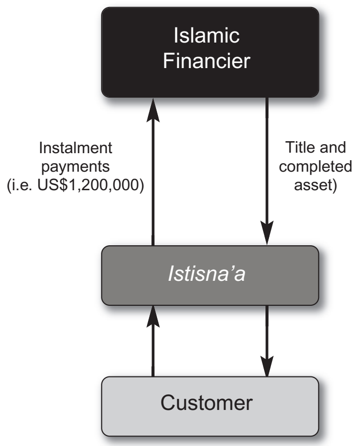
(b) there may be defects liability provisions that are imposed by statute that follow the assets being sold or manufactured.

While the term "as is, where is" is generally allowed in sale contracts, it is often not allowed in *istina'a* contracts. The customer can reject the asset if it does not comply with the contractual provisions relating to specifications or quality.

2.5 Parallel *istina'a* structure

The traditional *istina'a* structure can be presented in the following diagram:





The Islamic financier enters into a contract with the contractor to build the item that the customer wishes to finance, for example a building. The Islamic financier will also enter into a separate *istina'a* with its customer – this is the parallel *istina'a*. Under the first *istina'a*, the contractor will be the seller (*Al Sani'*) and the Islamic financier will be the purchaser (*Al-Mustasni'*). In the parallel *istina'a* the Islamic financier will now be the seller (*Al Sani'*) and the customer will be the purchaser (*Al-Mustasni'*). With the parallel *istina'a* structure, the sale price that the Islamic financier charges its customer will be higher than the price that it pays to the contractor in the first *istina'a*.

It is important to remember that an *istina'a* is a sale agreement where the purchase price is fixed. This means that it is only suitable when an Islamic financier is willing to enter into what, in conventional banking terms, would be called a fixed rate of return financing. Changing the sale price in an *istina'a* is not automatic. If the purchaser changes the specifications, then it would be possible to change the price[5]. The purchaser, however, cannot oblige the contractor to accept modifications or changes to the subject matter of the *istina'a* without the consent of the contractor[6]. However, it is not possible to introduce a formula that varies the purchase price so that it mimics a variable rate of return. It is also not possible to make a direct reference to any increase in the purchase price in the first *istina'a* so that this increase is included in the sale price of the parallel *istina'a*. Shari'a scholars would generally not allow linking two (parallel) *istina'a* contracts.

2.5.1 Combination of an *istina'a* with a forward lease

These types of structure are often used:

(a) for more complex projects where the risks to the Islamic financier are higher, often due to the nature of the asset; or

(b) when the Islamic financier wants to achieve a variable rate of return.

These structures are examined in more detail in Section 4.

3. *ijara* contracts

Section 3 explores a contract of *ijara* in more detail, but focuses on:

(a) *ijara muntahia bi al-tamlik* (sometimes called an *ijara wa iqtina*) – a lease to own; and

(b) *ijara musufah fi al-dhimmah* – a forward lease.

3.1 What is an *ijara*?

AAOIFI defines an *ijara* as:

"leasing of property pursuant to a contract under which a specified permissible benefit in the form of the usufruct is obtained for a specified period in return for a specified permissible consideration"[7].

In an *ijara*, the subject matter of the contract is the usufruct in the asset rather than the asset itself. The lessor therefore remains the owner of the leased asset (absent any other rights of purchase given to the lessee)[8].

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5 See Item 4/1/1 of AAOIFI Standard No.11

6 See item 4/1/2 of AAOIFI Standard No. 11

7 Appendix C: Definitions to AAOIFI Standard No. 9

8 See Chapter 13 (Legality, Cornerstones, and Essence) of "Financial Transactions in Islamic Jurisprudence" (Volume 1) by Dr. Wahbah Al-Zuhayli and translated by Mahmoud A El-Gamal published by Dar Al-Fikr, 2003 (ISBN:1-59239-072-2) for a discussion of the approaches taken by the different *Shari'ah* schools in relation to *Ijara*s

3.2 Specific requirements

The leased asset must conform to the general Shari'a requirements, e.g. they are not assets involved in alcohol production or distribution. The term of the *ijara* must be specified. It can commence either when the contract is signed or on a future date, in which case it will be called a future *ijara* or forward *ijara*. The leased asset must not be perishable through its use. The general principle is that the Islamic financier must have title to the leased assets before it enters into the leasing arrangements. If the assets are new and have been manufactured or constructed, it may be that the Islamic financier will purchase the assets from the manufacturer or contractor. *ijara* arrangements can also be used where the customer requires additional funds for its business and has an unencumbered asset. In this circumstance, it will sell that unencumbered asset to the Islamic financier and the Islamic financier will then lease that asset to the customer, as lessee, under the *ijara*.

It is not possible to ask for an increase in the amount of rent if the lessee does not pay the rent on its due date. This would amount to charging Riba on a debt. However, before its expiration period, the parties may mutually agree to extend the lease period, with additional rent to be paid by the lessee, or to increase the amount of rent.

As under Shari'a principles it is only the usufruct that is being sold and not the asset itself, the lessor (the Islamic financial institution) as the owner of the asset, must remain responsible for the following, which are considered obligations arising from such ownership interest:

(a) performing and paying the cost of major maintenance - the lessee is responsible for ordinary maintenance;

(b) insurance of the property (or its equivalent in relation to assets such as aircraft) and payment of the insurance premia - the lessee is responsible for operating insurance. Shari'a supervisory boards will generally require the use of an Islamic insurance company (Takaful) whenever such insurance is available; and

(c) payment of taxes that are directly related to the ownership of the assets - the lessee pays for all other taxes.

Usually, the commercial reality is that neither the Islamic financial institution as the lessor, nor its customer as the lessee want the Islamic financial institution to be responsible for major maintenance, property insurance and ownership taxes. To accomplish this, the parties enter into a service agency agreement. In this agreement, the lessor appoints the lessee to act as its service agent. The service agent undertakes all of the responsibilities that remain with the lessor. However, the agent is entitled to be reimbursed all amounts that it pays in performing these activities. The commercial understanding between the parties is usually that the customer is to bear the ultimate financial cost for these matters. Accordingly, an additional amount of rent will be added to the rental payment obligations of the lessee (or to the termination amount at the end of the leasing arrangements), which equals the reimbursement obligation of the lessor under this service agency agreement. These two amounts are set-off. This results in the customer bearing the ultimate financial cost for these matters.

3.3 Rental payments

The lessee must pay rent. The rent can be fixed for the entire lease term. It can also be structured so that it can vary. The rent can, therefore, consist of all or some of the following:

(a) fixed rent – this rent will reflect the apportionment of the initial purchase price that the Islamic financier paid to acquire the leased assets. It will usually be payable on stated dates (e.g. every three months) in equal pro rata amounts over the lease term, although the payment method can be whatever the parties agree;

(b) variable rent – when part of the rent is to vary, there will be a variable rent component, which will normally be calculated using a conventional interest rate benchmark by reference to the fixed rental that has not as yet been paid. The AAOIFI Standard[9] provides that the rent for the first lease period should be fixed and any variable rent can be determined in the following lease periods, although, in practice, especially with forward leases, many *ijara*s have mechanisms that allow variable rent to be also charged in the first lease period;

(c) supplementary rent – this is an amount of rent that will equal the reimbursement obligation owed by the lessor, as principal, to the service agent (the customer) under the service agency agreement; and / or

(d) with a forward lease there will also be "advance rent" (which is rent being paid in advance while the leased asset is being built or manufactured) and "additional rent" (which is rent that is usually paid in the second lease period and which equals the amount of the "advance rent'" – see 4.2 paragraph 1 below for a more detailed description.

Normally the lease term is broken down into individual lease periods, such as three monthly periods. At the beginning of each individual lease period, the lessor issues a notice to the lessee informing it of the rent that will become due during the next lease period. This will be done where there is a variable rent obligation. If there is a variable rent component, rent is generally calculated by reference to a conventional benchmark, such as LIBOR.

Individual lease periods are required where there will be a variable rent. This is because, when the lease is signed, it will not be known what the conventional benchmark will be throughout the lease term. By having individual lease periods and payment notices issued beforehand, the rent for each individual lease period will be known and therefore will not be subject to the prohibition on *gharar*.

The AAOIFI Standard[10] states that where the rent is to be a "floating rental" calculated by reference to a benchmark, it "should be subject to a ceiling, on both maximum and minimum levels". However, in many instances this ceiling is not found in *ijara* documents.

[9] See Item 5/2/3 of AAOIFI Standard No. 9
[10] See Item 5/2/3 of AAOIFI Standard No. 9

3.4 Purchase and sale undertakings

The leasing arrangements often involve a purchase undertaking and where it is a "lease to own" (*ijara muntahiyah bi al-tamlik or ijara wa iqtina*), a sale undertaking.

The purchase undertaking is provided by the lessee in favour of the Islamic financier. The Islamic financier can exercise its rights under that purchase undertaking upon the occurrence of specified events e.g. an event of default. In this situation the Islamic financier can oblige the lessee to purchase the leased assets from it. The price that will be paid will be calculated by reference to the fixed rentals that have not as yet become due together with any accrued and outstanding additional or variable rental payments, supplementary rental payments and other amounts due under the transaction documents[11]. Upon the payment being made, the Islamic financier and its customer will enter into a sale and purchase agreement or a bill of sale, which transfers title to the leased assets to the customer.

If the *ijara* is a "lease to own" (*ijara muntahiyah bi al-tamlik or ijara wa iqtina*), there will be a sale undertaking from the Islamic financier to the customer. If all of the rental payments have been made at the end of the lease term, the customer can exercise its rights under the sale undertaking and require the Islamic financier to sell the leased asset to it for a nominal amount. The sale undertaking may also allow the customer to buy the leased asset before the end of the lease term.

4. Forward lease (*ijara musufah fi al-dhimmah*) combined with an *istina'a*

4.1 General considerations

The initial requirement is that the leased asset should exist or be owned by the lessor before it can lease it to the lessee. A forward lease (the sale of the usufruct of an asset yet to be owned by the lessor) is permitted, based on the *salam* contract, which allows the forward sale of a non-existing asset. Some Shari'a scholars are of the view that, as with a *salam* contract that requires the entire purchase price to be paid in advance, the rent in a forward lease contract must also be paid in advance. They also argue that deferring the payment of rent as well as the access to the usufruct in a forward lease contract makes it a contract of the "sale of debt with debt", which is not permitted under the Shari'a. However, AAOIFI has taken the view that there is no mandatory requirement to pay rent in advance (although for commercial reasons this often happens) and a forward lease is allowed if the lease does not mention the words "*salam*" or "*sarf*".[12]

There was in the past some debate amongst the Shari'a scholars as to whether it was possible to have an Islamic financing based on a lease of an intangible asset. However, the position is that it does seem to be possible. An example of an *ijara* financing, where the subject matter of the *ijara* was an intangible right, was the Hajj Terminal expansion project. Here the rights that were being bought by the Islamic financiers and then leased were those arising under a concession agreement.

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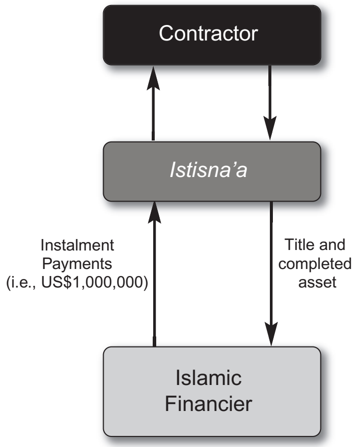
[11] See paragraph 3.18 for a description of the various rental payments.
[12] See Item 3/5 of AAOIFI Standard No. 9

With more complicated financings, especially major project financings or capital asset financings, two combinations involving *istina'a* are seen, which are considered below.

Istisna'a between the Islamic financier as the purchaser (*Al-Mustasni*') and the main contractor combined with a forward lease.

In this model the Islamic financier directly contracts with the contractor or manufacturer that it builds the asset that the customer wants to have financed and to ultimately acquire. The basic structure can be represented by the following diagram:



[lease *Ijarah* with customer]

In reality, the contract will often not be that of an *istina'a*. If it is a major construction contract, it is more likely than not that the Islamic financier will be classified as an employer and that the contract will be seen to be a contract of works, rather than a purchase contract. Regardless of whether the Islamic financier is a purchaser or employer, it will face various risks because of its direct contractual relationship with the contractor. Some of these risks are:

(a) it will have the direct obligation to pay the contractor;

(b) it will have to undertake all of the day-to-day responsibilities associated with meetings with the contractor, perhaps appointing its own engineer, certifying and approving all construction milestones;

(c) if there is a dispute, as there often can be with major projects, it will be a party to any legal proceedings or arbitrations, which can be costly and time-consuming; and

(d) if there are unforeseen circumstances or variation orders, it will be the person that is legally responsible for any additional payments to the contractor.

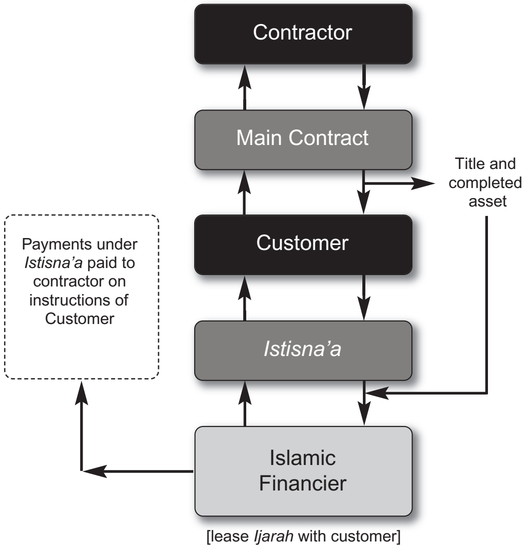
Often with these types of complex financings, the financier appoints its customer as its *Wakil* (agent) to act for it under the construction contract. While the agency appointment can include an indemnity from the customer for any breach of its agency obligations or negligence, this ultimately may not exclude the Islamic financial institution from being primarily responsible for any liabilities or obligations that arise under the main construction contract. If there are any litigation or arbitration proceedings under the main construction contract, the Islamic financial institution may be named as a party to such proceedings.

Particularly with complex construction projects, it is possible that certain liabilities may fall on the Islamic financier (i.e. to make additional payments under the main construction contract) that are not due to the negligence of or the breach of its agency appointment by its customer. For example, there may be unexpected geological conditions or events of force majeure that have caused extra cost to the main contractor entitling it to additional payments and that may not be the result of any negligence by the Islamic financial institution's agent. In these circumstances, the Islamic financier will have to bear these costs without any recourse to the customer as its *wakil*.

The Islamic financier must carefully draft multiple contracts regulating a connected single objective in order to avoid any mismatches between the terms of the forward lease and the agreement that it has entered into with the contractor. For instance, if the leased asset is not delivered by the contractor by the projected leasing date under the lease contract, the lessee (customer) may refuse to accept a delayed delivery date of the leased asset, decide to cancel the leasing and demand the return of any advance rent that it has paid. Conversely, the Islamic financier may still find itself legally obliged to continue to make payments to the contractor and to take delivery at a later date of the asset, which may also have gone down in value. It will be important, therefore, from the Islamic financier's perspective, to have a clear mechanism in each contract to mitigate the risks it may face in these situations, but in a way that does not lead to *gharar*.

4.2 *Istisna'a* between the Islamic financier as the purchaser (*Al-Mustasni*') and the customer combined with a forward lease

Often this structure will be used if the Islamic financier does not find the risks it is taking on in the structure described above are acceptable, when viewed against the return it is achieving under the forward lease arrangements. The following diagram sets out the basic outlines of such a structure.



Under this structure, the *istina'a* is entered into between the customer as the Al-Sani' (the constructor or manufacturer) and the Islamic financier as the purchaser. The customer in turn enters into the main construction contract – which could be in the form of an *istina'a* or a contract for works. Therefore the customer has the sole responsibility and liability for dealing with the main contractor. Under the *istina'a*, the customer agrees to build and sell to the Islamic financier the specified assets. The Islamic financier makes payments under the *istina'a* to the customer. These will be structured so that they are by reference to the construction milestones under the main construction contract, but the manner in which this is described must be carefully carried out to meet the approval of the Shari'a scholars. In a conventional sense, these payments can be seen as the equivalent of "principal". On the same date that the parties enter into the *istina'a*, they also enter into a forward lease. The forward lease specifies that the leasing arrangements will commence at a future date. That future date is by reference to the date on which the customer, as the Al-Sani', is to sell and deliver the asset to the Islamic financier under the *istina'a*.

During the construction phase, the Islamic financier will normally charge advance rent under the forward lease. The advance rent will usually be calculated based on a conventional benchmark by reference to the total amounts that have been paid by the Islamic financier under the *istina'a*. If the leasing arrangements begin on the projected lease commencement date, the advance rent must be taken into account and set off against the rent that is payable as from the leasing commencement date. Usually, the commercial intention is that the Islamic financiers are to retain their financial return during that construction phase. Therefore an additional amount of rent is charged (usually in the second lease period) which equals the credit obligation in relation to the advance rental. The two amounts are set off. This means the Islamic financiers retain their financial return during the construction phase.

There are risks that an Islamic financier will face under the forward lease if the leased asset is not available on the lease commencement date. The leased asset will not be available for leasing under the forward lease if the customer fails to sell and deliver the asset to the Islamic financier under the *istina'a*.

4.3 Use of special purpose vehicles (SPVs) in more complex structures

As can be seen there are potential risks for the Islamic financier in relation to being a party to an *istina'a* or *ijara* transaction. With an *istina'a*, it is the purchaser of the asset that becomes the owner. If the asset in question is one such as a power station or aircraft, there could well be liabilities that attach by virtue of the Islamic financier being the legal owner. When it comes to leasing the asset it will also continue to remain liable as the owner both to the lessee and to third parties.

Contractual risk mitigation terms can be added, including:

(a) an indemnity from the customer under the *istina'a* in case the asset is defective; and

(b) indemnity provisions in the service agency agreement in which the lessee (as the service agent) agrees to indemnify the Islamic financier as lessor if liabilities arise due to its failure to perform its service agency obligations properly (i.e. major maintenance, property insurance and ownership taxes).

However, ultimately the Islamic financier is taking the credit risk on the customer and there is no certainty that third parties would not join them into legal proceedings.

One possible solution is for the Islamic financiers to provide for a special purpose company to be the party to the *istina'a* and the *ijara*. Whether this will ring-fence potential liabilities will depend on the jurisdiction.

If an SPV is to be used, the question arises how it is to pay the installments due to the customer under the *istina'a* and how will it perform its functions under the *ijara* as well as channeling the rentals and exercise price to the Islamic financier. The SPV could be said to be acting as the *Wakil* or agent of the Islamic financier through a *Wakala* agreement (agency agreement). However, as it will merely be acting as the agent anything that it properly does under the *Wakala* arrangements would be construed to be acts of the principal, the Islamic financier. So it is not certain whether the intended ring-fencing would work here.

Another method that has been used is for the SPV to be set up as being a mudaribmudarib under which it takes the funds from the Islamic financier and invests them in buying the asset under the *istina'a* and then leasing it under the *ijara* arrangements. However, the SPV would be set up so that it would not be intended for it to take any action, and such action that it would need to take would have to be taken by someone else. This would be in the form of a transaction administrator or delegate. The issue here, however, would be which person or persons would be taking the required action and on whose instructions. It may be difficult to escape the conclusion that those instructions would ultimately be coming from the Islamic financier.

Another issue with a Mudaraba arrangement is that in many Middle East countries a *mudarib's* status is very close to that of a common law trustee in that the assets it holds are recognised as belonging to the investors (the *Raab al Maal*) – in this case the Islamic financier. In this instance, therefore, the use of an SPV as a mudarib may also not achieve the aim of ring-fencing the Islamic financier from the underlying liabilities.

Another method may be to consider an "orphan" SPV as a method of ring-fencing liability. The use of such SPV will need detailed analysis taking into account the jurisdiction(s) involved.

4.4 Inter-creditor issues

In many large Middle East projects there will be an Islamic *ijara* tranche alongside a conventional tranche.

The fundamental difference between the two tranches is that the Islamic financier owns the leased asset. This may result in a mismatch between the rights and obligations of financiers as the conventional lenders will not have an ownership interest, but will take security over the financed assets. These challenges, however, have been resolved in many financings to date.

Usually, there will be a common terms agreement and / or an intercreditor agreement that regulates the relationship between the two sets of financings. Intercreditor agreements address issues such as different payment periods, the nature of rights held by the conventional banks as secured creditors as against the Islamic financial institutions as title holders to the assets, and how to deal with default interest.

An example of the type of issue that can arise is the conventional banks will often want the leased assets held in the name of the Islamic financier, as lessor, to be subject to security. There can often be concerns by the Islamic financier that its granting security over the leased asset in some way could be construed to be some form of guarantee of the underlying conventional debt. Usually the mortgage or pledge will need to be carefully worded so that, for example, it is seen as securing the performance of its obligations under the common terms agreement or intercreditor agreement to, for example, ensure that all proceeds from the leased assets are shared in a pro rata manner[13].

4.5 Re-characterization issues

The AAOIFI Standard on *Ijara*[14] provides that an *ijara* financing is not the same as a hire purchase transaction. The difference it maintains is that, with hire purchase, ownership and title to the asset pass as soon as the last installment is paid and no other documents are needed. However, AAOFI's position is that, with an *ijara* financing, ownership can only pass if the purchase or sale undertaking is exercised and an additional sale or transfer document is executed.

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[13] Article 164 1) of the UAE Commercial Code (Federal Law No. 18 of 1993 relating to Commercial Transactions) states: "A commercial pledge is concluded over a chattel as a guarantee for a commercial debt". (Unofficial English translation)

[14] Appendix B to Shari'a Standard No. (9) – *ijara* and *ijara Muntahia Bittamleek*.
The separate document between the agent and syndicate banks commonly takes one of two forms – a special Mudaraba agreement or an investment agency agreement. The syndicate banks in these arrangements are referred to as 'Participants' instead of lenders

There is the possibility in some jurisdictions that the courts may decide to look at the *ijara* transaction as a whole and conclude that the parties intended the transaction to be something other than a lease, and that it was in fact a sale by installments transaction. Much will depend on the facts and the jurisdiction but it is interesting to note that in an unreported case, a Dubai Court took the position that, when all of the documents were looked at together, rather than in isolation, the *ijara* transaction was a sale by installments.

There are Shari'a arguments that can be employed to maintain that the transaction is really one of lease, but it is interesting to note that the courts may look at the transaction in another way.

5. Conclusion

The various developments in the area of *istina'a* and *ijara* and the way in which they can be combined has greatly assisted the promotion of Islamic financing and, in particular, Islamic project financing. Specific Shari'a preferences in *istina'a* and *ijara* transactional documents have evolved over time and it is likely that this trend will continue. Nonetheless, *istina'a* and *ijara* are seen as robust techniques and will likely continue to be mainstays of the Islamic finance industry.

CHAPTER 4

Mudaraba and Musharaka Financing: Background and Practical Implementation

1. Introduction

From the various Islamic structures that have been used for Islamic financings, the commodity *Murabaha* (sometimes referred to as *Tawarruq*), as discussed in Chapter 2 of this book, has been extremely popular and an important tool in developing the Islamic finance market but this has meant that *"Islamic Banking has become a system of debt accumulation rather [than] one of contribution*[1]*".* Its popularity is due to a variety of reasons including its ease of administration and the relative standardisation of commodity *Murabaha* documentation in the market. Despite its popularity with Islamic investors and borrowers, there have been many critics of the *Murabaha* structure and these critics have included pre-eminent scholars and Islamic experts as evidenced in the following passages:

> *"Murabahah…should neither be taken as an ideal Islamic mode of financing, nor a universal instrument for all sorts of financing. It should be taken as a transitory step towards the ideal Islamic system of financing based on Musharakah or Mudarabah. Otherwise its use should be restricted to areas where Musharakah or Mudarabah cannot work*[2]*".*
>
> *"The precise economic substance for which Riba was forbidden is present in [Tawarruq]*[3]*".*

For Islamic financing to dismiss its critics and to continue growing, other financing arrangements are required to step out of the shadow of the commodity *Murabaha* structure and to become the "go-to" structures in Islamic financings. In the next sections we will examine two such structures, namely the Musharaka and the *Mudaraba* structure, which are "*far less popular than debt-based financing methods because, as we will see, they are more challenging to implement*[4]*".*

2. An overview of key principles of *Musharaka*

A *Musharaka* is a partnership between two or more parties and may take a variety of forms such as a permanent equity investment, a partnership in a specific project or a diminishing partnership where the Islamic investor's share in the partnership is reimbursed over time by the borrower. It is a versatile structuring tool that can be used for both debt financing and also capital market financing by way of *Sukuk* issuance. In a *Musharaka*, all the parties involved in the *Musharaka* contribute to the joint business and the contribution can be either as cash or a contribution in kind. For the contribution in kind, its market value is what determines the share of the partners in the capital.

There are a number of basic rules that must be complied with for a *Musharaka* to be *Shariah*-compliant and for its implementation. These conditions can be summarised as follows:

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1 Asharq al-Awsat (16 April 2009), *The effect of debt on Islamic banking* at http://www.aawsat.net/2009/04/article55255259
2 Usmani, Muhammad Taqi (2010), *An Introduction to Islamic Finance*, p.151
3 El-Gamal, Mahmoud (2006), *Islamic Finance: Law, Economics, and Practice*, p.71
4 Abdullah, Daud Vicary and Chee, Keon (2010), *Islamic Finance - Why it Makes Sense Understanding its Principles and Practices*, p.180

(1) the parties to a *Musharaka* can be Muslims or non-Muslims, but in either case they must not be imprisoned and must be of sound mind. A minor may enter into a *Musharaka* if permitted by their guardian[5]. There is a difference of opinion in relation to indebtedness and insolvency whereby some are of the view that this would prohibit a party from entering into a *Musharaka* whereas there are others of the view that an indebted person can take part in a *Musharaka* in order to give them an opportunity to rectify their economic state;

(2) when a *Musharaka* is entered into, the conditions of agency are automatically integrated into the *Musharaka* so that the parties to a *Musharaka* are agents of one another and have equal rights;

(3) it is permissible for a partner to be a sleeping partner in a *Musharaka*;

(4) the *Musharaka* joint business must be permissible under *Shariah* so, by way of example, if it were in an alcohol or gambling venture, this would not be permissible;

(5) a partner to a *Musharaka* may require the other partner to provide some form of security or pledge to cover losses that are a result of its misconduct and negligence;

(6) subject to the following conditions, it is permissible for a third party to provide a guarantee for the loss of capital of a partner:

    (i) the third party should not own more than half of the issued share capital of the guaranteed joint venture;

    (ii) the guaranteed joint venture should not own more than half of the issued share capital of that third party;

    (iii) the *Musharaka* agreement should not be conditional on such a guarantee; and

    (iv) the guarantee should not be provided for any consideration. In other words, the fulfilment of the obligations of the third party of the guarantee is not a condition for the validity of the *Musharaka* agreement;

(7) the rules of terminating the *Musharaka* are as follows:

    (i) it is terminated when the specific purpose of the *Musharaka* has been achieved;

    (ii) when a partner wishes to withdraw from the *Musharaka*, following sufficient notice to the non-withdrawing partner;

    (iii) if a partner dies. In such circumstances that partner may be replaced by its heirs; and

    (iv) if all the *Musharaka* capital is depleted and is lost;

[5] Al-Atasi, Muhammad Khalid (1403 AH), *Sharah Majallah al Ahkam al Adliah*, Article 1335

(8) a partner may give a binding promise to buy the assets of the *Musharaka* within the period of operation or at the time of liquidating the *Musharaka*, at the market value of the assets. A promise to buy the assets of the *Musharaka* at the face value of the assets or at a pre-agreed price is not permissible[6]; and

(9) in relation to a diminishing *Musharaka* which can be used for the purpose of financing fixed assets such as home financing, car financing and plant and machinery financing, the contractual arrangement for this structure can be set out in three main, but separate, contracts in the following sequence:

   (i) a contract between partners to create a joint ownership over the fixed asset. The borrower promises, before or after the lease agreement is finalised, to purchase the share of the Islamic investor in the fixed asset;

   (ii) the Islamic investor leases its share of the fixed asset to the borrower partner and the borrower partner agrees to pay rental for the leased asset to the Islamic investor; and

   (iii) the borrower undertakes to periodically purchase the Islamic investor's share of the fixed asset and accordingly the rental decreases over time as the borrower owns a greater percentage of the fixed asset.

An essential factor for the parties as to whether they will enter into a *Musharaka* arrangement are the profit and loss mechanics. The fundamental rules relating to the sharing of the profit and loss in a *Musharaka* are as follows:

(1) the ratio of profit for each partner must be agreed upon at the start of the partnership but the partners may at any point in time and by mutual agreement amend the ratio;

(2) the ratio of profit does not need to be in proportion to the capital invested into the business by each partner. It can differ because in addition to the capital being contributed, there are other factors to be considered to determine the profit such as the labour and work contributed to the *Musharaka* by each partner;

(3) the ratio of profit should be in proportion to the actual profit accrued to the joint business as a percentage of net earnings of the business rather than being in proportion to the capital invested by the partners. It is not permissible to fix a rate of profit for any of the partners or a percentage of the capital or investment of the partners;

(4) each partner suffers losses according to the ratio of its investment in the *Musharaka*[7]*;*

(5) a sleeping partner cannot receive more profit than the proportion of its capital invested into the business;

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6 See the Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI) statement on Sukuk dated February 2008

7 Ibn Qudama, Abu Muhammad Abdullah bin Ahmad (1367 AH) *Al Mughni*, pp. 33 and 62

(6) a partner may decide to cap its share of profit with any profit above this cap distributed to the other partner; and

(7) the partners may agree that an amount of the profit is kept aside for the purpose of creating a reserve account.

3. An overview of the key principles of *Mudaraba*

Whereas in a *Musharaka* all the parties contribute to the joint business, in a *Mudaraba* the Islamic investor is known as the "*Raab al Maal*" and contributes the funds to the *Mudaraba*. The borrower acting in its capacity as the "*Mudarib*", uses these funds based on its agreement with the *Raab al Maal* and the *Mudarib* agrees to provide its entrepreneurial skills and management to the joint business. *"By allowing Mudaraba, Islam has intended to fulfil an important economic function by way of encouraging the hiring of capital and that of trade skills on judicious terms of risk-sharing, leading to the benefit of society and the concerned parties*[8]*"* As with the *Musharaka*, the *Mudaraba* structure is also a versatile structuring tool that can be used for both debt financing and also capital market financing by way of *Sukuk.*

A summary of the significant features of the *Mudaraba* and for its implementation are as follows:

(1) a *Mudaraba* can be conditional or unconditional. It can be restricted to a particular business or left open by the *Raab* for *Maal* for the *Mudarib* to exercise its judgement in investing the *Mudaraba* funds in any business. Furthermore the *Raab al Maal* may impose other conditions on the *Mudarib* such as for example specifying a time limit on the *Mudaraba* contract, specifying the assets that may or may not be traded in and restricting the *Mudarib* from dealing with particular companies or in certain specified regions. These restrictions are permissible as long as they are mutually agreed to by the *Raab al Maal* and the *Mudarib* and they are not counter-productive to the interests of the *Mudaraba;*

(2) there is no restriction on the number of persons contributing to the *Mudaraba* or in relation to the number of working partners[9];

(3) the joint business must be permissible under *Shariah*. For example it would not be permissible for the *Mudarib* to invest the *Mudaraba* funds in alcohol or gambling ventures;

(4) it is preferable for *Mudaraba* capital to be in the form of cash because a contribution in kind is less certain. If there is to be a contribution in kind, the value must be clearly determined at the time of entering into the *Mudaraba*. It is not permitted to use a debt owed by the *Mudarib* as a contribution in kind to the *Mudaraba* as the capital provided to the *Mudaraba* joint business should be free from all liabilities;

(5) subject to the permission of the *Raab al Maal*, the *Mudarib* may invest its own capital to the *Mudaraba* so that *Musharaka* and *Mudaraba* are combined.

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[8] Ayub, Muhammad (2011), *Understanding Islamic Finance*, p.322

[9] Ibn Qudama, Abu Muhammad Abdullah bin Ahmad (1367 AH) *Al Mughni*, p. 32

In such circumstances, as long as the *Mudarib* has capital in the *Mudaraba* business, the *Mudarib's* rights and liabilities will be governed by *Musharaka* rules. This is in contrast to the *Raab al Maal* who is not allowed to work for the joint business, although it does have the right to oversee the *Mudarib's* work. This is the view of the majority of traditional jurists;

(6) the *Raab al Maal* may require the *Mudarib* to provide a guarantee to return the funds only in circumstances whereby the *Mudarib* is negligent in the use of the funds or if the *Mudarib* breaches the conditions set out in the *Mudaraba;*

(7) the *Mudarib* may give a binding promise to buy the assets of the *Mudaraba* within the period of operation or at the time of liquidating the *Mudaraba,* at the market value of the assets. A promise to buy the assets of the *Mudaraba* at the face value of the assets or at a pre-agreed price is not permissible; and

(8) the *Mudaraba* may be terminated unilaterally by either the *Raab al Maal* or the *Mudarib* unless:

    (i) the *Mudarib* has already commenced the business, in which case it is binding up to the date of actual or constructive liquidation; or

    (ii) the parties have agreed on a specific termination date. In such circumstances the mutual agreement of both the *Raab* al *Maal* and the *Mudarib* is required to terminate the *Mudaraba.*

If the *Mudaraba* assets are all in cash at the time of termination, the cash will be distributed between the *Raab al Maal* and the *Mudarib* according to the agreed profit distribution ratio. However, if the assets are illiquid, the *Mudarib* shall be given an opportunity to liquidate and sell the *Mudaraba* assets and then the proceeds shall be distributed between the *Raab al Maal* and the *Mudarib* according to their agreed profit distribution ratio.

As with any form of financing, the profit and loss mechanics are fundamental for the parties in determining whether they will enter into a *Mudaraba* arrangement.

The main rules relating to the sharing of the profit and loss in a *Mudaraba* are as follows:

(1) the *Mudaraba* profit is shared between the *Raab al Maal* and the *Mudarib* pursuant to a predetermined and mutually agreed ratio at the time that the *Mudaraba* contract is concluded. This profit distribution ratio may at any point in time, and by mutual agreement, be amended by the *Raab al Maal* and the *Mudarib*;

(2) it is agreed that the *Raab al Maal* bears the financial loss exclusively[10]. The loss means a shortfall in the capital or investment of the *Raab al Maal*. The loss to the *Mudarib* is in relation to the time and effort that it had committed to the business;

[10] Ibn Qudama, Abu Muhammad Abdullah bin Ahmad (1367 AH) *Al Mughni*, p. 33

(3) no profit can be paid unless the capital of *Mudaraba* is maintained;

(4) at the time of the *Mudaraba's* liquidation, should its losses be greater than its profits, the net loss must be deducted from the *Mudaraba* capital;

(5) it is permissible for the *Raab al Maal* and the *Mudarib* to agree that if the profit realised from the joint venture is over and above a specified ceiling, then one of the parties may take a greater share of the profit. In the event that the profit realised from the joint venture is less than that specified ceiling, then the profit shall be shared according to the agreed profit distribution ratio;

(6) it is not permissible to fix a rate of profit for any of the parties to a *Musharaka* or a percentage of the capital or investment of the parties[11];

(7) it is not permissible to specify that profit from a particular transaction should be paid to the *Raab al Maal* and that profit from another transaction should be paid to the *Mudarib*;

(8) any ambiguity regarding the profit distribution ratio makes the *Mudaraba* contract invalid[12]. In such circumstances, the *Mudarib* will be paid for the work it undertakes, but it shall not receive any share of the *Mudaraba* profit; and

(9) the *Raab al Maal* and the *Mudarib* may agree that an amount of the profit is kept aside for the purpose of creating a reserve account. In the event that the *Mudaraba* incurs a loss, that loss may be compensated for from the reserve account.

4. Key differences between *Musharaka* and *Mudaraba*

Having analysed both the *Musharaka* and the *Mudaraba* structures and the rules relating to their profit and loss distribution, an examination of their key differences is important in order to better understand each structure. They are as follows:

(1) The investment in a *Musharaka* comes from both the Islamic investor and the borrower whereas under the *Mudaraba*, the investment is typically from the *Raab al Maal* only and not from the *Mudarib*. The exception to this is that subject to the permission of the *Raab al Maal*, the *Mudarib* may invest its own capital to the *Mudaraba* so that *Musharaka* and *Mudaraba* are combined.

(2) Under a *Musharaka* arrangement, all partners share in the losses of the business according to the ratio of investment, whereas under the *Mudaraba,* unless the *Mudarib* has acted negligently, in bad faith or with dishonesty, it is the *Raab al Maal* who suffers the financial loss. The *Mudarib* only loses the time and effort that it had committed to the business.

[11] Al-Marghinani (1957), *Al-Hidaya*, translated into English by Charles Hamilton, p. 256
[12] Ibn Qudama, Abu Muhammad Abdullah bin Ahmad (1367 AH) *Al Mughni*, p. 30

(3) The management of the business under the *Musharaka* can be run by all partners. Furthermore any partner can work for the *Musharaka.* Contrast this with the Mudaraba where it is the *Mudarib* who runs the business with no involvement of the *Raab al Maal* who only has a right to oversee the *Mudarib's* work.

(4) Typically the partners liability under a *Musharaka* arrangement is unlimited. This means that in an insolvency type scenario, any liabilities incurred over and above the assets of the partnership shall be shared pro rata by all the partners, unless the partners had agreed between themselves that neither party shall incur debt during the course of business. In such circumstances the partner that breached this restriction is responsible for the liabilities that are over and above the assets of the partnership. This differs to the *Mudaraba* whereby the liability of the *Raab al Maal* is limited to its investment.

The exception to this rule is if the *Raab al Maal* permitted the *Mudarib* to incur debts on its behalf[13].

(5) All the assets of the *Musharaka* are jointly owned by the partners in accordance with the proportion of their contribution, once their capital is contributed to the *Musharaka.* The result is that each of the partners benefits from the appreciation in value of the assets. On the other hand in a *Mudaraba* structure, the assets purchased by *Mudarib* are for and on behalf of the *Raab al Maal* and they are therefore owned by the *Raab al Maal*. The effect of this is that the *Mudarib* earns a profit if it sells the assets at a profit but it does not benefit from the appreciation in value of the assets.

(6) Profit can be distributed on an annual, quarterly or monthly basis by valuation of the assets in a *Musharaka*[14]*,* whereas for a *Mudaraba*, the conservative view has been that final distribution should only occur after dissolution and liquidation of the *Mudaraba* business at maturity. However contemporary jurists agree that periodic distributions to the *Raab al Maal* under a *Mudaraba* can be achieved by way of constructive liquidation of the *Mudaraba* assets at periodic intervals. The amount of such periodic distribution is determined as the difference between the market value and the par value of the *Mudaraba* assets.

5. Practical implementation of *Musharaka* and *Mudaraba*

In practice *Musharaka* and *Mudaraba* financing structures have already been used for a variety of purposes in the financial market. For example *Musharaka* structures have been utilised in project finance, trade finance, home finance, microfinance and securitisation and *Mudaraba* structures have been used for financing working capital purposes, trade finance, project finance, microfinance and securitisation.

[13] Ibn Qudama, Abu Muhammad Abdullah bin Ahmad (1367 AH) *Al Mughni*, pp. 18 and 35
[14] Ibn Qudama, Abu Muhammad Abdullah bin Ahmad (1367 AH) *Al Mughni*, pp. 5 and 64

Both structures have also been used in capital market financing by way of *Sukuk* issuance although their popularity has decreased since the 2008 ruling by the Accounting and Auditing Organisation for Islamic Financial Institutions (AAOIFI) (see section 1.7 (Conclusion) below for further details). Additionally fund management has also been carried out on a *Mudaraba* basis whereby the "*fund manager would get a fee on agreed terms that may be any specified amount or percentage of the net asset value of the fund*[15]".

Islamic investors have not yet fully explored the potential of equity-based financing structures such as *Musharaka* and *Mudaraba* for a variety of reasons ranging from the added complexity of the documentation including challenges in fixing the rate of return from these structures in advance, a fear that the borrower may dishonestly show that their business did not earn profit in order to avoid paying a return to the Islamic investors and the potential that there may be unwillingness from the borrower to share the profits of their business with the Islamic investor[16]. Furthermore the development of equity-based financing structures has also been curtailed due to availability of easier to implement debt-based financing alternatives.

6. The approach of the Middle East and the South East Asian Market

The demand for Islamic finance has to date been greatest in the Middle East and South East Asia, which are both regions that are predominantly Muslim. Notwithstanding the differences that can exist between the two regions due to the different schools of Islamic jurisprudence adopted in each region, the permissibility of *Musharaka* and *Mudaraba* is accepted by *Shariah* scholars in both the Middle East and in South East Asia. "*As such these contracts do not seem to pose any issue from a Shariah perspective as scholars from a variety of backgrounds, working in a variety of regions, for institutions headquartered across the two regions of interest, are in agreement on its permissibility*[17]*".*

7. Conclusion

Musharaka and *Mudaraba* have historically been used as financing structures but their popularity has declined since the 2008 ruling by AAOIFI which criticised the use of a purchase undertaking in *Musharaka* and *Mudaraba* structures, where the exercise price was set as a fixed amount determined by the face value of the assets rather than by reference to their market value. As a result the Islamic finance industry has more recently relied upon debt-creating financing structures such as Murabaha*,* Ijara, Istisna' and Salam.

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15 Ayub, Muhammad (2011), *Understanding Islamic Finance*, p.201

16 For further details see Usmani, Muhammad Taqi (2010), *An Introduction to Islamic Finance* (2010), pp.77-80

17 Hassan, M. Kabir and Mahlknecht, Michael (2011), *Islamic Capital Markets Products and Strategies*: Gintzburger, Anne-Sophie, *An analysis of Global Trends and Regional Pockets in the Application of Islamic Financial Contracts in Malaysia and the Gulf Cooperation Council*, p.318

There are a number of jurists and financial experts who have been advocating that equity-based financings are the optimal Islamic finance structure. It is also accepted by these same jurists and financial experts that there are areas where Musharaka or Mudaraba financing is not feasible and other financial structures based on debt-creating models are more appropriate and acceptable. The issue is not the permissibility of debt-creating financial structures, but a preference for equity-based financial structures as they are more consistent with the spirit of Shariah. As Sheikh Taqi Usmani has summarised:

> "*Shariah scholars have allowed … [the use of debt-creating financing structures] … only in those spheres where Musharaka cannot work and that too with certain conditions. This allowance should not be taken as a permanent rule for all sorts of transactions and the entire operations of Islamic Banks should not revolve around this*."[18]

The aim should be to create a healthy balance between debt-based and equity-based financing structures in order to provide society with a healthy equilibrium for the development of the economy. The real challenge is to find a way of making equity-based financing structures more attractive to both Islamic investors and borrowers. Equity-based financial structures are more difficult for Islamic investors to implement as a result of the additional due diligence required as to who would be an appropriate business partner. It also requires that Islamic investors develop more stringent risk-management controls. The net effect is that it requires the Islamic investor to utilise greater resources in looking after and running the joint venture business and this makes equity-based financing structures less attractive to them.

The break-through may emerge once Islamic investors are sufficiently motivated to encourage equity-based financing structures. This will occur when the Islamic investors share the actual profits earned in the business venture with the borrower, as the profits in such cases should be greater than the rates of interest under conventional financing structures or the profit pursuant to the debt-creating financing structures.

This will make the increased complexity and requirements of the equity-based financing structure worth the extra effort by the Islamic investor.

Accordingly borrowers will need to start appreciating the added complexity of equity-based financing structures and be willing to financially compensate the Islamic investor for this complexity by sharing with them the profits of their business.

The question is whether borrowers are ready and willing to pay such a price and whether the Islamic investors are ready and willing to take equity based risk?

[18] Usmani, Muhammad Taqi (2010), *An Introduction to Islamic Finance* (2010), p.241

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CHAPTER 5

Islamic Financing in the Bank Market

1. Introduction

The previous chapters in this guide have introduced the key principles of Islamic finance and described some of the most common structures used in the industry. These structures can be used and adapted across all areas of financial services and the purposes of Chapters 5 to 11 of this guide are to discuss how these structures can be applied in the context of specific financial products and situations.

This chapter will focus on Islamic finance in the bank market and, in particular, in the syndicated bank finance space. In addition to explaining how Islamic syndications can be structured, this chapter will address a number of practical issues and challenges faced by banks and financial institutions wishing to document a Shari'a-compliant syndicated facility.

One of the key requirements for any syndicated finance transaction is that each financier's exposure can be sold in the secondary market so this chapter will discuss the mechanics and particular issues surrounding the trading of Shari'a-compliant debt.

As the Islamic finance industry has grown, it has ceased to be the exclusive preserve of Islamic banks and it has become increasingly common for conventional banks to participate and arrange Shari'a-compliant syndications. Similarly, a number of borrowers who may have no internal requirement to raise all their finance using Islamic structures have sought to tap into the Shari'a-compliant syndication market as an extra source of liquidity. To assist conventional lenders and borrowers who may be looking at Islamic finance for the first time, this chapter discusses the ways in which certain concepts found in conventional loan finance are adapted (or replaced) in Shari'a-compliant financings.

2. Syndication structures for Islamic finance

2.1 Advantages and development of syndicated finance

A syndicated financing has a number of key advantages over a bilateral facility:

(a) the entity looking for finance is able to raise a larger amount by sharing its financing needs among a group of financiers;

(b) negotiating with a small number of arranging banks before syndicating to a wider group of financiers is much more efficient than negotiating a series of individual bilateral facilities (and is much easier to manage when the facility needs amending or restructuring);

(c) security over the same assets can be offered to the group of financiers, something which would not be possible with bilateral facilities without negotiating complex inter creditor arrangements; and

(d) the documentation allows for financiers to trade their exposure in the secondary market.

Although capital market issuances can provide these advantages, syndicated facilities provide a hybrid instrument allowing the sharing of credit risk between various financial institutions (combined with the ability to trade) without the disclosure and marketing burden that bond issuers face. It is also far easier to obtain consents to amendments and waivers under syndicated financing than in relation to bond issues.

Conventional syndicated loans were developed during the 1970s, initially in relation to sovereign debt deals, to provide the advantages set out above. Once Islamic financial institutions developed products suitable for large scale commercial financing, they also sought to develop structures to enable those products to be used in syndications.

2.2 Conventional syndicated loans

In a conventional syndicated loan, from a contractual perspective, each lender makes a separate and independent loan to the borrower. Although payments to and from the lender and borrower are made through an agent bank, the agent is undertaking a purely mechanical role and a debt is owed directly from the borrower to each lender. Syndicated loan documents make it clear that each bank may independently enforce its rights against the borrower (subject to certain restrictions on matters such as acceleration of the loans) and that no bank is liable for the failure of another bank to advance funds.

2.3 Islamic syndicated facilities – the principal difference

As explained in the previous chapters, Islamic finance structures are more complex than simply lending money in return for interest. To varying degrees, all Islamic finance structures involve the buying, selling, constructing, leasing, investing or managing of commodities, investments, other assets or services. The contractual relationship between financier and customer is much more involved.

It is therefore not practical for a member of the syndicate to have a direct contractual relationship with the customer. For example, commodity murabaha facilities involve entering into a series of commodity trades with two brokers on each profit payment date – it would clearly be impractical for each financier in a syndicate to have to go through this process.

In relation to Ijara facilities where the financier needs to own the relevant asset, sharing legal ownership amongst a group of financiers is equally impractical.

As a result, the agent bank's role on a syndicated Islamic finance transaction is, at least from a contractual perspective, quite different to that of its conventional counterpart. Instead of simply acting as an administrative and paying agent, the agent bank under an Islamic syndication enters into the contractual arrangement with the customer directly and enters into a separate agreement with the syndicate banks pursuant to which the syndicate banks will give the agent the funds. The contractual relationship between ultimate financier and customer is therefore indirect.

The separate document between the agent and syndicate banks commonly takes one of two forms – a special Mudaraba agreement or an investment agency agreement. The syndicate banks in these arrangements are referred to as ‘Participants’ instead of lenders.

2.4 The first Islamic syndications – Special Mudaraba Arrangements

In the 1990’s, Islamic banks began to use special Mudaraba structures in order to syndicate their facilities. Chapter 4 of this guide discusses the principles of Mudaraba in detail and describes how an Islamic investor (the Raab- al-Maal) invests funds with the customer (acting as Mudarib). The Mudarib uses the funds in accordance with an agreement with the Raab-al-Maal and the profits are shared between them.

In the context of syndications, the agent bank acts as Mudarib and the Participants are the Raab al Maal. The special Mudaraba agreement entered into between the Mudarib and Raab- al-Maal requires the Participants to place funds with the Mudarib who uses those funds (known as ‘Contributions’) to finance the Shari’a-compliant facility being provided to the customer (for example a Murabaha or Ijara facility).

The Mudaraba is described as a ‘Special’ Mudaraba (or ‘conditional’ Mudaraba) because the Mudarib is only allowed to use the funds provided by the Participants to fund the facility with the customer, and for no other purpose. The Mudarib must pass on any remittances received from the customer (by way of principal repayment or profit) to the Raab-al-Maal, in accordance with the proportion invested by each Participant.

In accordance with the principles of Mudaraba, the Mudarib and the Raab-al-Maal must share the profit in pre-agreed proportions. Given that the Mudarib’s role is principally an administrative one (the Mudarib has little discretion in ‘managing’ the facility with the customer as the terms and conditions of the facility will, as in any conventional loan agreement, be set out in detail in the finance documentation), the Mudarib usually only receives a fraction of one per cent of the profit. It should be noted that, to comply with the Shari’a requirements of Mudaraba, if no profit is made, the Mudarib should not receive any remuneration.

2.5 Investment Agency Arrangements

It is more common today for syndication arrangements to be documented using an ‘Investment Agency Agreement’ in place of the Special Mudaraba Agreement. The form of any investment agency agreement is substantially the same as the Special Mudaraba Agreement (see paragraph 2.6 below for a description) but, instead of acting as Mudarib, the agent bank acts as the Investment Agent or Wakeel. As the relationship between Participants and Investment Agent is one of agency, not Mudaraba, the Investment Agent may charge a fee up-front (and an annual agency fee) and is not entitled to any share of the profit in respect of its role as Investment Agent.

2.6 Form of documentation used for Special Mudaraba and Investment Agency Agreements

As mentioned above, Special Mudaraba Agreements and Investment Agency Agreements follow substantially the same form. Due to the fact that the Investment Agency Agreement is by far the more common choice for syndicated Islamic facilities in today's market, the rest of this chapter refers to Investment Agency Agreements and Investment Agents. However, other than the treatment of fees and profit, the points discussed below apply equally to both types of document.

In the European, Middle Eastern and Asian markets (where the vast majority of Islamic facilities are syndicated), Investment Agency Agreements are hybrid documents loosely based on conventional funded sub-participation documentation, supplemented with the agency and syndication provisions from Loan Market Association (or Asia Pacific Loan Market Association) standard form conventional facility agreements.

The key provisions in an Investment Agency Agreement can be summarised as follows:

(a) *Investment Agent appointment*

Each Participant appoints the Investment Agent to act as its agent in respect of the facility. As explained above, the agency role involves more than simply acting as a paying and administrative agent under a conventional syndicated loan. In addition to these responsibilities, the Participants appoint the Investment Agent to enter into the facility documentation (for example Murabaha or Ijara documents) with the customer on their behalf.

(b) *Contributions by participants*

Whenever the customer requests a utilisation under the facility (for example entering into a purchase contract under a Murabaha Facility, or selling assets to the Investment Agent to be leased back under an Ijara facility), the Investment Agent will ask each Participant to put it in funds (by making a 'Contribution' to the Investment Agent) in proportion to their respective commitments under the facility. The process works in a similar way to an agent under a conventional facility informing each lender of the amount it needs to contribute to a loan.

(c) *Remittances*

Provided a Participant has made its Contribution available to the Investment Agent, it is entitled to its share of any payments received by the Investment Agent from the customer (called 'Remittances'). The rights of each Participant are 'limited recourse', meaning that the Investment Agent is only obliged to make payments to Participants to the extent it has received a corresponding payment from the customer.

(d) *Transfers by participants*

The provisions which enable a Participant to assign or transfer its rights and obligations under the Investment Agency Agreement are similar to those found in conventional loan agreements. However, there are certain implications in relation to trading syndicated Shari'a-compliant facilities which are discussed in more detail in section 3 below.

(e) *Boilerplate provisions*

An Investment Agency Agreement will include most of the boiler plate syndication provisions found in conventional loan agreements, such as clauses relating to the Investment Agent's rights and duties, loss sharing amendments and waivers defaulting Participants and, if the transaction is secured, the appointment and duties of a security agent.

2.7 The US approach – conventional / Islamic back-to-back structure

In the United States, due to the scarcity of Islamic banks, most Islamic finance has been driven by the desire of certain customers to raise finance in accordance with Shari'a principles. Most of the banks providing finance to these customers are conventional banks which are not familiar with the principles of Islamic finance.

As a result, back-to-back structures involving conventional and Islamic facilities have been developed. Under these structures, a syndicate of banks lends money to a special purpose vehicle (SPV) as borrower pursuant to a conventional syndicated loan agreement. The SPV (as financier) then enters into an Islamic facility with the customer, using the proceeds of the loans borrowed under the conventional loan agreement.

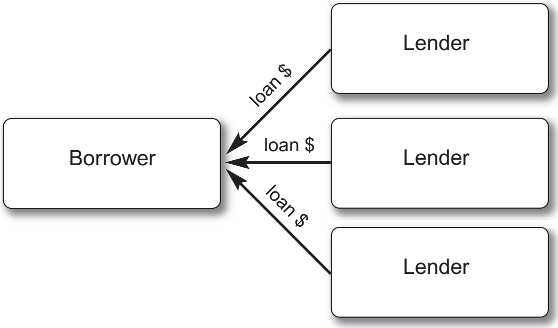
The commercial terms (including pricing) under the Islamic and conventional facilities match so that there is a complete pass through of payments. The matching terms ensure that any default by the customer under the Islamic facility will also be default under the conventional facility. The conventional lenders will take security from the SPV over its rights against the customer (and, if the transaction is secured, any security given by the customer will be assigned to the conventional lenders).

Although these structures appear to provide an ideal solution to the problem of conventional lenders funding Shari'a-compliant customers, they do have their disadvantages. Perhaps most importantly, Shari'a scholars may look at the entire arrangement and, as a result, not consider it to be Shari'a-compliant – although the customer is not incurring conventional debt, the overall structure still encourages (and relies on) conventional finance. In addition, the structures are more complex to document than direct Shari'a-compliant facilities and, due to the lack of precedent in US courts, it is not certain that the conventional lenders will have the same rights of enforcement against the customer that they would have in a direct borrowing arrangement, due to the intervening SPV.

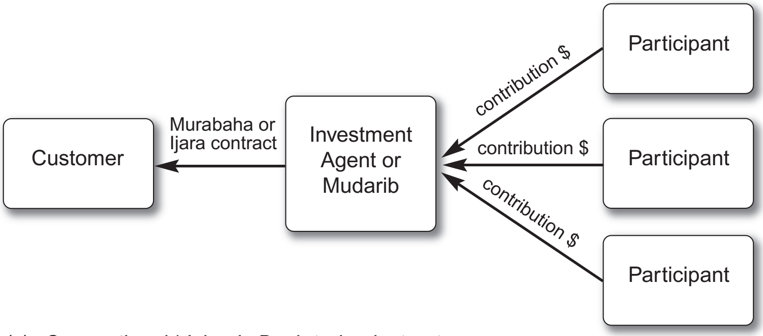
2.8 Structure diagrams

The following diagrams show the basic contractual relationships between customers, agent banks and financiers in relation to the structures described above.

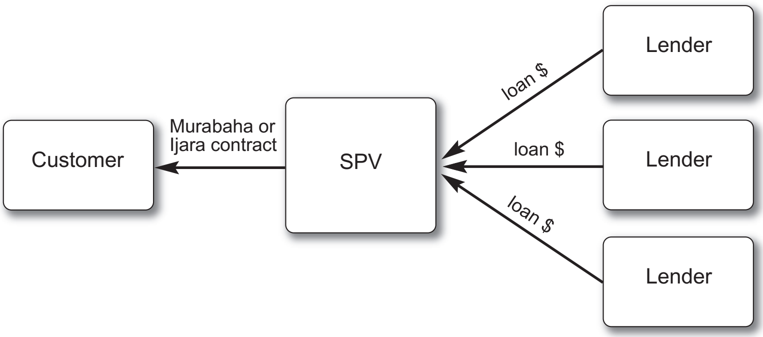
(a) *Conventional Syndicated Loan*



(b) *Investment Agency / Special Mudaraba Structure*



(c) *Conventional / Islamic Back-to-back structure*



3. Trading syndicated Islamic facilities

As discussed in section 2.1 above, one of the most important characteristics of syndicated financings is that the financiers are able to trade their commitment and participations in a secondary market. Due to the fact that Shari'a prevents the trading of debts (particularly trading at anything other than par), this creates certain issues that need to be considered in the context of Islamic syndications.

The majority of this section focuses on trading syndicated commodity Murabaha facilities – this is because not only are these the most common form of Islamic syndicated finance, but they also create the most difficulties.

3.1 Trading commodity Murabaha facilities

When considering trading Murabaha facilities, the following Shari'a principles are relevant:

(a) a deferred sale price must be fixed from the date of the relevant Murabaha contract – it is not possible to decrease the deferred sale price if it is paid early or increase it if it is paid late; and

(b) a debt cannot be bought or sold for anything other than par.

The impact of the above rules can be demonstrated by using the following example. Assume the existence of a $100 syndicated commodity Murabaha facility, with profit periods of 6 months and a profit rate of 12% per annum. If a Participant with a 50% interest in this facility wanted to sell its entire interest in the facility at par on a date falling 2 months into a 6 month profit period, it would expect to receive $50 plus $1 accrued profit to that date ($1 representing 2 months profit on $50 at 12% per annum). However, the profit in a Murabaha transaction does not "accrue"; it is fixed on the date of the relevant commodity sale. The Participant in our example is therefore owed $53 by the customer from the day the commodity transaction occurs. This payment of $53 does not have to be made for 6 months but it is a fixed debt of $53 throughout that period. Therefore, in order to sell its participation at par after two months, it would need to sell it for $53. This is obviously not a commercially viable transaction as the purchaser of the debt would get no return for the remaining 4 months of the profit period.

Selling participations under a Murabaha facility, in a commercially viable manner, during a profit period is therefore problematic without breaching the Shari'a principles set out above.

As a result, Investment Agency Agreements for syndicated commodity Murabaha facilities usually include a restriction preventing assignments or transfers during profit periods. However, it is possible for Participants to trade their commitments under a facility on a deferred payment date. In our example, the new Participant would contribute $50 to the new commodity transaction and the exiting participant would receive $53 representing its share in the maturing trade. In effect, the new and exiting participants are simply swapping places – there is no actual buying and selling of debt. Due to the fact that on deferred payment dates, where new commodity transactions are being entered into (commonly called "rollover dates"), the payments due between debtor and

Investment Agent (on behalf of the Participants) are netted off, the new Participant would as a matter of course pay the exiting participant $50 for its rights in the 'rolled-over' maturing deferred sale price.

In the context of restructurings, the requirement that any transfer or assignment of a participation in a Murabaha facility must fall on a deferred payment date has caused some problems. When a murabaha facility goes into default, the Investment Agent will stop entering into new Murabaha contracts so there will be no further deferred payment dates. As a result, it is not possible to effect an assignment or transfer in accordance with the terms of the Investment Agency Agreement. Although conventional financiers could sub-participate their participation in these circumstances (sub-participation is not usually restricted in Investment Agency Agreements because the arrangement is a separate contractual relationship outside of the terms of the Shari'a-compliant documents), this is not an ideal solution as it can cause problems when the sub-participant wants to be recognised as 'creditor of record' in any insolvency proceedings.

In these circumstances, conventional financiers may also seek to assign their rights in breach of the restrictions contained in the Investment Agency Agreement. It is worth noting that transfer provisions in syndicated Shari'a-compliant facilities typically relate only to the rights and obligations between the Investment Agent and the Participants (other than in relation to indemnities and similar provisions), because the Participants have no direct contractual claim against the customer. The debt is owed by the customer to the Investment Agent, and the Participants have a contractual claim against the Investment Agent to account for any proceeds it has received from the customer.

Having said that, the customer is usually a party to the Investment Agency Agreement such that, if any trades have been carried out in breach of the documentation, the exiting Participant would have breached its contract with the customer and could be liable for such breach. Ascertaining damages would be complex and it could be argued that the customer has suffered no loss as a result of the breach.

However, when it comes to challenging the validity of any purported trade, it is presumably the Investment Agent (in its capacity as the obligor in relation to the actual obligations assigned) who has the right to object. If the Investment Agent accepts a trade (notwithstanding the fact that it was in breach of the documentation), it could be argued that the customer has no grounds to challenge its validity.

Even if the trade was invalid as between the parties to the finance documentation, English case law supports the argument that the exiting Participant holds the relevant rights on trust for the new participant. In this vein, even if the exiting Participant remained the Participant of record, any proceeds recovered would have to be accounted to the new Participant. It would be unusual for the documentation to expressly prohibit any such trust. As with sub-participants, beneficiaries under a trust would need to be heard in court insolvency proceedings through the relevant trustee.

The issues surrounding the consequences of trades conducted in contravention of contractual provisions are complex, particularly in Shari'a-compliant financings where an Investment Agent is the direct holder of the claim. Although it is likely that any purported assignee would ultimately be entitled (by way of a constructive trust or otherwise) to receive the proceeds of any distribution, the question of who is entitled to vote and who may serve on any official committee of creditors appointed in insolvency proceedings, would require detailed analysis of all underlying documentation, including the documentation relating to the trades themselves.

In consensual restructurings (as opposed to judicial insolvency proceedings) the issues around trading can be mitigated if the parties agree to continue entering into rolling Murabaha contracts, notwithstanding the default. Such an arrangement can also mitigate issues surrounding default payments discussed in section 4.4 below.

3.2 Trading other syndicated Islamic finance structures

The other Islamic finance structures discussed in this guide (Ijara, Mudaraba and Musharaka) all involve assets which are either leased to the customer (in the case of Ijara), invested with the customer (in the case of Mudaraba) or co-owned with the customer (in the case of Musharaka). In each case, the financier has an ownership interest in the relevant assets.

When these facilities are syndicated using an Investment Agency Agreement, each Participant owns an interest in the underlying assets, through the agency of the Investment Agent. As a result, any trade relating to such a financing actually constitutes the sale of an interest in an asset (rather than a debt). As a result, it is possible to sell for any price, and the prohibition on selling debts at anything other than par is irrelevant.

4. Adapting concepts in conventional loan facilities for syndicated Islamic facilities

This section looks at how some of the concepts commonly found in conventional syndicated loan facilities agreements are adapted in the context of Islamic syndications.

4.1 Prepayments

Prepayments under Shari'a-compliant facilities are implemented in different ways, depending on the underlying Islamic structure.

(a) *Prepayment of Murabaha facilities*

In Murabaha facility documentation, prepayment is often referred to as 'Early Settlement' – the customer has the right (or, in the case of mandatory prepayments, the obligation) to settle the deferred sale price prior to its deferred payment date. As discussed in section 3.1 in relation to the trading of Murabaha facilities, as profit on a Murabaha contract is fixed from the date of the Murabaha contract (and does not 'accrue' like interest), if the customer pays the deferred sale price early, it is contractually obliged to pay the full amount of profit which would otherwise be payable on the deferred payment date. The deferred sale price cannot be reduced because it is paid early (in the same way that it cannot be increased if paid late).

From the customer's perspective, this is clearly disadvantageous compared to the position in a conventional loan. In order to mitigate the issue, Murabaha facilities usually contain a rebate provision pursuant to which the Investment Agent (acting on the instructions of the Participants) may agree to 'rebate' some of the profit element of a deferred sale price which is settled early. For Shari'a reasons, this rebate must be voluntary and in the discretion of the Participants but, as a matter of market practice, customers are usually content to rely on the fact that Participants will agree to rebate part of the profit to ensure consistency with a conventional loan.

Under a conventional loan, if a borrower makes a prepayment during an interest period, it will be liable to pay 'break costs' to compensate lenders for any costs they may incur in relation to breaking any funding they obtained in the interbank market to fund the loan to the customer. Murabaha facilities do not need to include an express provision relating to break costs as Participants can simply reduce the amount of rebate they are prepared to give to take into account any break costs incurred.

As with conventional facilities, customers will often choose to make any prepayment on a deferred payment date to avoid break costs / rebate issues. Under a Murabaha facility, as a deferred sale price is due in any event on a deferred payment date (and cannot therefore be 'prepaid' on that date), prepayment is effected by reducing the cost price element of the Murabaha contract entered into on that deferred payment date. This results in the customer having to pay in cash the shortfall between the amount of the new and old Murabaha contracts which has the same effect as making a prepayment of a conventional term facility.

(b) *Prepayment of Ijara facilities*

As discussed in section 3.2 in relation to the trading of these facilities, Ijara facilities involve the ownership by the financier of an interest in an asset.

Prepayments under Ijara facilities are therefore usually implemented by way of the customer buying back all or part of this ownership interest from the financier. Where the facility involves a large number of assets as its subject matter, a partial prepayment can involve the buying back of an appropriate number of these assets. However, when the facility relates to one (or a small number) of large assets (e.g. a building), a partial prepayment will be effected by the customer buying back a proportionate share of the financier's ownership interest in the asset.

Prepayments can be voluntary or mandatory. However, in either case, the right or obligation to buy back all or part of the assets cannot be a contractual agreement between financier and customer as this would amount to a forward sale contract which is not permitted by Shari'a. The right to buy back (to implement a voluntary prepayment) is therefore contained in a sale undertaking and the obligation to buy back (to implement a mandatory prepayment) is contained in a purchase undertaking. Purchase and sale undertakings are unilateral promises (as opposed to contractual agreements) and are therefore permissible under

Shari'a. They are discussed in more detail in chapter 3 of this guide (Ijara Financing: Background and Practical Implementation).

4.2 Market disruption clauses

Following the global financial crisis and the disconnect between published LIBOR rates and lenders' costs of funds, much attention was paid to market disruption clauses in syndicated facilities. In a conventional syndicated loan agreement, following a market disruption event, the market disruption clause allows a lender to claim its actual cost of funds instead of the published LIBOR rate – a lender has plenty of time to ascertain its cost of funds and only needs to inform the facility agent prior to the date on which the interest payment is due.

Market disruption clauses have been adapted for us in syndicated Murabaha and Ijara facilities but there is one important difference. Due to the requirement that profit on a Murabaha contract, or rental for a rental period under an Ijara, must be fixed prior to the consummation of the Murabaha Contract (or start of rental period, as applicable), each Participant must ensure that its cost of funds is notified to the Investment Agent much earlier - effectively prior to the start of the 'interest period', instead of prior to the end of the interest period (as would be the case under a conventional loan).

4.3 Increased costs

Under a conventional syndicated facility, each lender can claim any increased costs by way of an indemnity claim against the borrower – this claim can be made at any time. Such a claim is impermissible under Shari'a because, when the customer enters into a Murabaha contract or agrees to commence a new rental period, the price / rental must be fixed. In Islamic syndications, if a Participant wishes to claim for Increased Costs, the Increased Cost amount is added to the next deferred sale price or rental for the next rental period, as opposed to being an immediate indemnity payment.

4.4 Default payments

As mentioned above in relation to prepayments, under Shari'a, a liability cannot be reduced if it is paid early. Similarly, it cannot be increased because it has been paid late. As a result, it is not permissible for Islamic financiers to charge any form of default interest.

However, it is permissible to include an incentive for the customer to pay on time. As a result, most Shari'a-compliant finance documents include a provision requiring the customer to pay 'Late Payment Compensation'.

This is payable by the customer following a payment default and is calculated in exactly the same way as conventional default interest (i.e. it will be at a rate which is 1% or 2% above the pre-default profit rate). The significant difference is that the Late Payment Compensation must be donated to charity - it cannot be retained by the Participants. The Participants are entitled to deduct any costs and expenses relating to the default but this cannot include funding costs or compensation for loss of opportunity. This is usually expressly stated in the documents. Late Payment Compensation therefore acts to deter the customer from paying late but it does not benefit the Participants financially.

4.5 Fees

In the same way as interest is prohibited under Shari'a because it provides a return based on the time-value of money, certain fees which are common in conventional finance transactions can be problematical in the context of Islamic financings.

(a) *Arrangement fees*

Arrangement fees are usually calculated as a percentage of the principal amount of the relevant financing. As an arrangement fee can be construed as payment for services rendered (in arranging the financing) and is not calculated by reference to the time the financing is drawn or available to be drawn, arrangement fees are acceptable in Islamic finance transactions.

(b) *Commitment fees*

Commitment fees are charged by banks to compensate them for the cost of keeping a facility available for drawing and are often expressed as a percentage of the margin to be charged when the loan is actually drawn. They are calculated in a similar way to interest and cannot be charged in Islamic finance transactions.

However, it is possible to amend the way that profit is calculated on a Murabaha transaction, or rent in an Ijara, to include an element of commitment fee. Instead of being charged on a quarterly basis as is common in a conventional facility, an amount equivalent to commitment fee can be added to the deferred sale price of the next Murabaha contract in a commodity Murabaha facility, or to the rental payment in respect of the next rental period in an Ijara facility.

The risk for the banks on a Murabaha facility is that, if the facility is never utilised, it will not be possible to charge the fee (as there is no Murabaha contract entered into which can include the fee as an element of profit). As a result, and due to the fact that including commitment fees as part of profit is frowned upon by a number of scholars, commodity Murabaha facilities often have short availability periods to avoid the need for the banks to charge anything for keeping their commitment open.

(c) *Prepayment fees*

Prepayment fees represent an adjustment to the amount payable by the customer as a result of paying a sum due on an earlier date than the date anticipated. As mentioned above, once a deferred sale price or rent for a rental period is calculated, it is fixed – it cannot be increased or decreased depending on when it is paid. As a result, prepayment fees must be documented either as an additional element of profit on the next murabaha contract or the next rental period, or as an administration fee to compensate the banks for the extra administrative burden of dealing with unexpected prepayments.

CHAPTER 6

Islamic Capital Markets

1. Overview of the global Islamic capital markets[1]

Islamic capital markets continue to expand and develop, in particular in the Middle East and South East Asia, as issuers have increasingly identified these markets as a potential source of attractively priced liquidity. This has, particularly since 2010, resulted in a significant increase in the number of domestic and international *Sukuk* issues (*Sukuk* being commonly described as the "Islamic alternative to bonds"), the increased use of *Sukuk* in project financing and aircraft financing, and the emergence of comparatively new Islamic capital markets products, such as Islamic unit trusts and Islamic REITS. This growth is highlighted by reports that global *Sukuk* issuance reached a record level of around US$137 billion in 2012[2].

This chapter focuses primarily on *Sukuk,* as these are the cornerstone of the global Islamic capital markets, summarising the different types of *Sukuk* that may be encountered in the Islamic capital markets, looking at how each is structured and highlighting a number of key *Sukuk*-related issues that stakeholders should be aware of.

2. The role of *Sukuk* in Islamic capital markets

Sukuk, which are generally structured to create an economic effect equivalent to that of a "conventional" fixed or floating rate bond, are primarily used by corporates and sovereign states to raise *Shari'a* compliant medium to long term funding. There has, however, been an increasing recent trend towards issuing *Sukuk* with shorter tenors, often of a year or less, which fulfil an economic role similar to that of commercial paper. As with other capital markets instruments, *Sukuk* can be issued in single or multiple tranches, with the potential for different pricing and maturities for each tranche.

2.1 What exactly is a *Sukuk*?

Sukuk[3] are defined by the Accounting and Auditing Organisation for Islamic Financial Institutions (AAOIFI) as being:

"*Certificates of equal value representing undivided shares in the ownership of tangible assets, usufructs and services or (in the ownership of) the assets of particular projects or special investment activity*[4]"

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1 Investors purchase *Sukuk* issued by a special purpose vehicle ("SPV"). The *Sukuk* represent a right to payment of the Periodic Distribution Amount (i.e. profit) and the Dissolution Amount (i.e. principal) on redemption. The SPV then declares a trust over both the proceeds and over the assets acquired using the proceeds, so that it acts as trustee for the certificate holders. Each certificate is thereby intended to represent an undivided beneficial ownership interest in the relevant assets underpinning the trust

2 The Company enters into a Sale and Purchase Agreement with SPV, acting as the trustee, pursuant to which it sells assets which are capable of being leased (often land and tangible assets such as plant and machinery) to the SPV

3 The SPV then leases the land or other assets back to the Company pursuant a lease agreement between the parties (*Ijara*) in consideration for the periodic payment of rental by the Company (which will be equivalent to the "Periodic Distribution Amount" payable by the SPV to the Certificate holders)

4 The SPV pays Periodic Distribution Amounts to the Certificate holders using the rental payments received from the Company

Sukuk are therefore intended to be certificates of ownership (often issued in the form of global certificates) giving the holders the right to a share of the profit and other returns generated by a specific asset or pool of assets. The *Sukuk* holder's return should therefore ultimately depend on the performance of those assets, although in practice sukuk are structured in a manner which seeks to ensure that the *Sukuk* holder's receive a return equivalent to the return they would have received under a conventional bond.

Each *Sukuk* is generally transaction-specific, its structure being determined by reference to (i) the type of the asset(s) which are to be used to underpin the structure and to generate revenues, (ii) the relevant legal regime and (iii) the degree of risk which potential investors are willing to accept.

2.2 How does a Sukuk vary from a bond?

The key distinction between a *Sukuk* and a conventional bond is that the *Sukuk* holders' return is based not upon the promise of the issuer to pay a coupon of 'x'% per annum (as in the case of a conventional bond) but upon their entitlement to a share in the revenues that flows from the *Sukuk* holders' ownership interest in the underlying assets. This position contrasts sharply with that under conventional bonds, where the bondholders typically have a contractual right to receive specified principal and interest payments from the issuer, no matter how well or badly the issuer's business performs. However, in the case of "asset-based" *Sukuk*, the return a *Sukuk* holder receives is typically no different to the return a bond holder receives, irrespective of the performance of the underlying assets.

2.3 Who would typically issue Sukuk?

Sovereign and quasi-sovereign entities currently account for a large proportion of *Sukuk* issued in local currencies, being responsible for 81% by value of such *Sukuk* issues between 2011 and January 2013. The remaining 19% of *Sukuk* issued in local currencies were issued by corporates, a figure which represents a significant decrease from the equivalent position over the previous decade. The picture alters significantly when looking at US$ and other "hard" currency denominated *Sukuk* issues, as corporate issuers are more prevalent in such structures, accounting for 45% of such *Sukuk* issues between 2011 and January 2013[5].

Most *Sukuk* issuers are incorporated in GCC countries, Malaysia or Indonesia, but *Sukuk* issuance is not geographically limited. 2012 saw the first *Sukuk* issued by a financial institution in Kazakhstan while *Sukuk al-Ijarah* have been issued by the Governments of both Turkey and Pakistan.

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[5] Upon (i) the occurrence of an event of default or maturity, or (ii) the exercise of any applicable put or call options, the SPV will sell, and the company will repurchase, the land or other assets pursuant to the exercise of a Sale or Purchase Undertaking. The consideration for such sale / repurchase will be payment of the "Exercise Price", being a sum equal to the Principal Amount plus any accrued and unpaid Periodic Distribution Amounts owing to Certificate holders

2.4 The regulatory environment

Sukuk are asset backed or asset based investments which should involve a degree of risk, the extent of which depends on the structure in question. As such, they are unsurprisingly subject to many of the same regulatory issues as are applicable to other more "conventional" capital markets instruments.

The issue and marketing of a *Sukuk* therefore often involves the production of a detailed prospectus describing the business and containing appropriate risk warnings, the distribution of such prospectus being limited, as with other capital market instruments, by legal and regulatory restrictions on offer, sale or transfer of *Sukuk* certificates. To take one example, *Sukuk* are treated as debt or asset backed securities under the United States Securities Act of 1933, with the result that Saudi Electricity Company's US$2 billion *Sukuk* had to be structured, when offered to US investors, so as to comply with the requirements of Rule 144A.

2.5 Listing and rating

Sukuk can be listed, often on the London Stock Exchange or on the Malaysian Stock Exchange, Bursa Malaysia (which recently introduced new rules facilitating the listing of Exchange Traded Bonds and Sukuk on Bursa Securities, in order to make them more readily available to retail as well as institutional investors).

Sukuk can also be rated by credit agencies – to take one recent example, a *Sukuk* issued by the Islamic Development Bank in 2012 received an AAA rating.

2.6 The evolution of the *Sukuk* and the development of other Islamic capital markets products

Historically, the most prevalent *Sukuk* structures for international issuances were the *Ijara Sukuk* (based on a lease transaction), the *Mudaraba Sukuk* and the *Musharaka Sukuk* (based on a sale transaction). The Islamic capital markets are, however, becoming increasingly varied and complex, as issuers explore the use of other *Sukuk* structures, including hybrid structures involving a number of different underlying transactions.

While the *Sukuk* is by some considerable margin the main Islamic capital markets product, in its many variations, other capital markets products are evolving. These include Islamic unit trusts, a collective investment scheme in which investors acquire interests in a portfolio of *Shari'a* compliant shares and assets, and variant of such unit trusts, the Islamic real estate investment trust (or REIT) in which the investors acquire an interest in a portfolio of real estate assets to be used by businesses carrying on *Shari'a* compliant activities.

2.7 Regional variations in capital markets products and structures

While *Sukuk* and other Islamic capital markets products have generally been evolving, there are still clear regional variations when looking at Islamic capital markets instruments. *Shari'a*-compliant financing structures adopted in the Middle East can differ considerably from those adopted in other regions and, in particular, South East Asia. There are a number of reasons for these distinctions, including some differences in the interpretation of *Shari'a* between Middle Eastern Scholars and Asian Scholars, different local laws and the fact that prevailing tax rates in South East Asia tend to be higher than those in the GCC region, increasing the need for those financing structures to be tax efficient as well as *Shari'a*-compliant.

3. Structural and legal issues surrounding Sukuk

3.1 What assets can underpin the *Sukuk*?

The relevant assets intended to underpin the *Sukuk* structure must:

(a) be unencumbered as at the issue date of the relevant *Sukuk;*

(b) have a market value on the issue date equal to or exceeding the principal amount of the *Sukuk* being issued; and

(c) be used for *Shari'a*-compliant purposes.

The *Sukuk* are required to represent an interest in physical assets where they are to be considered tradable at a price other than par by investors. In such circumstances, the proportion which the value of those physical assets should bear to the face value of the *Sukuk* has been the subject of scholarly debate. Some scholars have been comfortable with physical assets underlying *Sukuk* structures representing at least 33% of the face value of the *Sukuk* while others have required between 51% and 70% of the assets underlying *Sukuk* structures to be physical assets. Having said that, some scholars are considering other asset classes nothwithstanding they may lack tangibility in the sense of being something that one can touch or see.

3.2 The role of the issuer

In order to identify and keep the assets underlying the *Sukuk* separate from a company's other assets, the relevant assets may be transferred to a project based joint venture or into an off-balance sheet special purpose vehicle ("SPV"), which then issues the *Sukuk*. The SPV will normally act as trustee, holding the relevant assets, and the income deriving from them, on trust for the *Sukuk* holders.

It is, however, not essential that the assets underpinning the *Sukuk* should be transferred into a SPV or project based joint venture. In some structures this does not occur, particularly if there are legal or taxation issues with transferring assets into another legal entity. In such cases, the company itself acts as the issuer. Having said that, the main purpose of an SPV is to enable the Islamic strucuturing to occur in a way that would enable an economic profile equivalent to that of a bond.

If used, the SPV is typically incorporated in a low tax jurisdiction, such as the Cayman Islands, with its shares being held on charitable trust by a person who is unconnected with the transferor company. The SPV is also usually structured so as to be "insolvency remote", with restrictions being imposed to prevent it from engaging in any other business or incurring any liabilities outside the relevant transaction.

3.3 Parties to the *Sukuk*

Those involved in setting up and running a *Sukuk* structure may include (i) the originating company, (ii) the issuer, which as noted above is often an orphan SPV, (iii) the investors, (iv) mandated lead arrangers, (v) paying agents, (vi) *Shari'a* boards and / or consultants, (vii) regulators and (viii) listing and settlement agents. A further legal role that differentiates *Sukuk* from bonds is that played by the delegate (usually the trustee services company of a major international investment bank) to whom the issuer (as trustee) delegates its functions, duties, powers and discretions etc. The delegate represents the interests of the investors as a class of creditors of the originator.

3.4 Periodic distributions

The *Sukuk* will normally be structured so that the underlying assets generate periodic payments which should, if the assets perform as expected, be equivalent to the "Periodic Distribution Amounts" payable by the SPV to the *Sukuk* Certificate holders. Such Periodic Distribution Amounts have a similar economic effect to coupons payable under a "conventional" bond.

3.5 Transferability of the *Sukuk*

Bay' Al-Dayn generally prohibits the buying and selling of *Sukuk* certificates where there is a transfer of debt obligations, although some scholars do accept the validity of a transfer of debt at par value. This is a major consideration in a restructuring context, as if the value of the underlying assets has fallen, it is unlikely that there will be a significant number of purchasers willing to acquire the *Sukuk* at par value.

Sukuk are therefore likely to be illiquid in a restructuring context, particularly when compared to instruments used in "conventional" capital markets, for which there is often an active secondary market, provided that the discount to par which is being offered by the seller is deep enough.

This is, however, the general position. In principle, provided that there is sufficient tangibility (based on the ratios which can vary between 33% and 50%) in the *Sukuk* assets in order to satisfy the *Shari'a* requirements, the certificates can be tradeable at any price irrespective of the value of the assets.

3.6 Redemption and unwinding of the *Sukuk* structure

The *Sukuk* documentation will normally contain specific provisions dealing with the unwinding of the *Sukuk* at maturity or, if earlier, on the occurrence of an event of default. It should, however, be noted that not every *Sukuk* has a maturity date – some recent issues by Islamic financial institutions, such as the 2012 Abu Dhabi Islamic Bank Tier 1 Capital *Sukuk*, are expressed to be perpetual in that the *Sukuk* certificates are perpetual securities in respect of which there is no fixed redemption date and accordingly, the *Sukuk (*which in this case was based on a *Mudaraba* structure) is a perpetual arrangement with no fixed end date. In order to qualify as Tier 1 Capital, the *Sukuk* was required to (1) have no maturity date, (2) be subordinated to depositors, general creditors and subordinated debt and (3) only be callable at the option of the issuer after a minimum of five years. Tier 1 Capital has advantages for both investors and issuers. It is an important benchmark for investors when comparing financial institutions globally and allows them to diversify their risk portfolio and invest in companies with solid fundamentals at higher yields than they would receive from conventional debt instruments. As for the issuer, it has the discretioin to cancel distributions together with the requirement of principal write-down or mandatory conversion to common equity and it also presents a cost-effective means of accessing a wider investor base without diluting shareholders.

3.7 Purchase undertakings

The extent of the underlying commercial risk inherent in a *Sukuk* structure is, however, largely determined by the mechanism contained in the Purchase Undertaking to calculate the Exercise Price payable to the SPV, when the underlying assets are repurchased at maturity.

The value of such an undertaking may, however, depend on the type of *Sukuk* under consideration, as while a purchase undertaking for a *Sukuk al-Ijara* may specify a pre-agreed exercise price linked to the amount invested, purchase undertakings in *Mudaraba, Musharaka* and *Wakala Sukuk* should include a fair value calculation mechanism. The differing approach arises from the *Shari'a* view that *Mudaraba*, *Musharaka* and *Wakala* structures are akin to equity and thus losses should be shared in those structures.

3.8 Credit enhancement and protection

While it is essential, from a *Shari'a* perspective, that a degree of risk remains with the *Sukuk* holder, several techniques have been used in *Sukuk* structures to mitigate that risk, to the extent permissible. These are described below.

3.8.1 Reserve accounts

In some recent *Sukuk* structures, the issuer or company has established a reserve account to protect the capital investment of the *Sukuk* holders if a default occurs.

3.8.2 Liquidity facilities

In *Sukuk al-Mudaraba and Sukuk al-Wakala, Shari'a* compliant liquidity facilities have been used to ensure that the investors receive scheduled Periodic Distribution Amounts. Such facilities were criticised by AAOIFI, as the liquidity facility has a similar economic effect to a guarantee in favour of the investor, negating the risk to which the latter is exposed.

3.8.3 Intercreditor arrangements

The terms of the *Sukuk* structure may contain priority arrangements, protecting the position of certain *Sukuk* holders in the event that the company or issuer encounters significant financial problems. While some scholars have questioned the validity of tranching risk relating to an asset, some *Sukuk* structures include intercreditor priority arrangements, with the right to repayment of one class of *Sukuk* holder being subordinated to the rights of another class of *Sukuk* holder.

3.9 Documenting the *Sukuk*

The key capital markets document, apart from the prospectus, is the trust deed or indenture, which typically contains both the terms and conditions of the *Sukuk* and the basis on which the underlying assets are held for the benefit of the *Sukuk* holders. The other *Sukuk* documents will depend on the relevant structure. To take one example, key *Sukuk-al-Ijara* documents (where the Sukuk is based on income generated from the lease of an asset) may include (i) a sale and purchase agreement transferring the relevant asset to the SPV, (ii) a lease agreement between the SPV, as the new owner of that asset, and the company, (iii) a service agency agreement and (iv) sale and purchase undertakings which are triggered at maturity or on an earlier default.

3.10 Which governing law applies?

Market practice is that documents be governed by the laws of a particular jurisdiction rather than by *Shari'a* law, largely because of the need for legal certainty, should any contractual dispute arise. In practice, the trust deeds for many *Sukuk* are governed by English law, while the underlying Sukuk documents, such as any lease agreement or sale and purchase undertaking, are often governed by reference to the location of the company or the asset in question. This approach avoids the challenges involved in applying *Shari'a* law to commercial contracts, given the potentially differing views of *Shari'a* Scholars in different parts of the world.

4. Types of *Sukuk*

While each Sukuk is generally transaction specific, it is possible to identify a number of generic structures, with *Sukuk* being potentially based on a sale transaction (*Murabaha, Salam and Istisna*), a lease transaction (*Ijara*), ownership of a business or joint venture (*Musharaka* and *Mudaraba*) ownership of an investment undertaken by an agent (*Wakala*), or a combination of these. Depending on the structure adopted, the investor's return will come from profit from the sale of an identified asset, rental from an identified asset or income generated from a business or investment. The most commonly used *Sukuk* structures are described below.

4.1 The *Ijara Sukuk*

The *Ijara Sukuk* probably remains the most widely used *Sukuk* structure, particularly in US$ denominated *Sukuk* issues which are aimed at the international market. Diagram 1 at the end of this Chapter, contains a simplified structure diagram for an *Ijara Sukuk* and a brief description of the cash flows involved. The *Ijara Sukuk,* under which the *Sukuk* holders obtain their return from rental and sale payments generated by the underlying asset, was historically the most prevalent Islamic capital markets instrument. They remain very popular today, being generally characterised as a relatively low risk investment (although the *Sukuk* holders do bear the risk of total loss of the leased asset).

The essence of the *Ijara Sukuk* is that the company enters into a sale and purchase agreement with the SPV issuer, pursuant to which the company sells assets which are capable of being leased (often land and tangible assets such as plant and machinery) to the SPV. The SPV then leases the land or other assets back to the company pursuant a lease agreement between the parties (*Ijara*) in consideration for the periodic payment of rental by the company to the SPV (which will be equivalent to the "Periodic Distribution Amount" payable by the SPV to the *Sukuk* certificate holders). At maturity, or on earlier termination, the lease is terminated and the underpinning assets are resold to the company, providing the funds with which the SPV can pay the "Dissolution Amount" to the *Sukuk* certificate holders (the "Dissolution Amount" being equal to the investors' original investment in the *Sukuk*).

4.2 The *Mudaraba Sukuk*

Diagram 2 of this Chapter contains a simplified structure diagram for a *Sukuk al-Mudaraba* and a brief description of the cash flows involved. In a *Sukuk al-Mudaraba* the originating company enters into a *Mudaraba* Agreement with the SPV, pursuant to which the SPV invests the *Mudaraba* capital (the proceeds from the *Sukuk* issuance) in a portfolio of assets which are to be managed by the company in accordance with an agreed investment plan. Unlike the *Ijara Sukuk,* this structure does not necessarily provide a fixed stream of payments to the SPV, as (while this may be the objective) the generation of profits from the underlying portfolio of assets may be uneven.

In accordance with the terms of the *Mudaraba* Agreement, (i) the company as *Mudarib* applies its skill and knowledge in managing the assets, and (ii) the *Mudarib* makes periodic payments of the resulting profits to the SPV, which then uses such amounts to pay Periodic Distribution Amounts to the *Sukuk* certificate holders. To the extent that the payment of profits is less than the Periodic Distribution Amount payable by the SPV to the *Sukuk* holders, the company may provide a *Shari'a*-compliant liquidity facility (repayable by the SPV) to satisfy any such shortfall. At maturity, or on earlier termination, the *Mudaraba* Agreement is terminated and the portfolio of *Mudaraba* assets is liquidated, with the proceeds providing funds with which the SPV can pay the Dissolution Amount due to the *Sukuk* certificate holders.

4.3 The *Wakala Sukuk*

The *Wakala Sukuk* structure is being increasingly commonly used in US$ denominated *Sukuk* issues which are aimed at the international market, either on a stand-alone basis or as part of a "hybrid" structure (discussed in Section 5 below)[6].

The *Wakala Sukuk* structure is very similar to that of the *Sukuk al-Mudaraba,* the key difference being that, instead of the SPV entering into a *Mudaraba* Agreement with the company, the SPV, as *Muwakil* (principal) appoints the company as its agent (*Wakeel*) to invest the *Muwakil's* funds in a portfolio of *Shari'a*-compliant assets, such as non-real estate *Ijara* assets. The *Wakeel* is entitled to a fee for its services. In addition, some scholars have taken the view that any profit made above an agreed profit rate may also be paid to the *Wakeel* as an incentive fee pursuant to the term of a *Wakala* agreement but other scholars, including the author, do not accept this view. This is also the case in a *Mudaraba* context.

The *Wakeel* makes periodic payments of the resulting profits from its investments to the SPV, which then uses such amounts to pay Periodic Distribution Amounts to the *Sukuk* certificate holders. At maturity, or on earlier termination, the *Wakala* Agreement is terminated and the investment portfolio is either liquidated or sold to the company, with the proceeds providing funds with which the SPV can pay the Dissolution Amount to the *Sukuk* certificate holders.

4.4 The *Musharaka Sukuk*

Musharaka is a joint venture between two or more parties with each party contributing to the capital of the joint venture (either in cash or in kind).

In a *Sukuk al Musharaka* structure, the SPV and the company enter into a *Musharaka* Agreement under which the SPV agrees to contribute funding and the company agrees to contribute consideration in kind to a joint venture between the SPV and the company, with any resulting profits and losses from the joint venture being shared between the parties in the agreed proportions specified in that *Musharaka* Agreement. This structure is seen as being of a higher risk than some of those described above, as the SPV's return is calculated by its share of the actual profits generated by the joint venture; it is not permissible to specify that any lump sum or fixed periodic amount should be payable to the SPV under the agreement, no matter how well, or badly, the joint venture performs.

Any profits paid to the SPV are used to pay Periodic Distribution Amounts to the *Sukuk* certificate holders. At maturity, or on earlier termination, the *Musharaka* Agreement and the underlying joint venture are both terminated, with the SPV's share of the resulting proceeds providing the funds with which it pays the Dissolution Amount to the *Sukuk* certificate holders.

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[6] The SPV pays the "Dissolution Amount" to the certificate holders, being an amount equal to the Exercise Price

4.5 The *Murabaha Sukuk*

In a *Sukuk al-Murabaha,* the SPV uses the proceeds from the *Sukuk* issuance to purchase an asset which has been identified by the company from a third party. The SPV then on-sells that asset to the company for an amount equal to the original purchase price plus an element of profit. The company pays this purchase price to the SPV in instalments, which are then used by the SPV to make Periodic Distribution Amounts and then to pay the Dissolution Amount to the *Sukuk* certificate holders.

The key difference between this Sukuk structure and those described above is that the Sukuk holders do not have recourse to any physical or tangible asset (unless of course the Sukuk is structured as an asset backed transaction).

The key point here is that there are no assets underlying a Murabaha Sukuk once the commodities have been sold by the SPV and thus the Sukuk do not represent an underlying ownership interest in a pool of assets (like the other structures) but rather a right to a receivable. The underpinning asset is always a receivable from the company, namely its obligation to pay the purchase price to the SPV.

5. Hybrid structures

The market has recently seen a growth in “hybrid” structures which involve two or more different underlying contracts (often a *Wakala* and *Mudaraba* or a *Wakala* and *Murabaha*). While such hybrids constituted only 2% of new issues in that market between 2001 and 2010, that figure rose to 15% between 2011 and January 2013[7].

6. Convertible *Sukuk*

Recent innovative Islamic capital markets transactions have included the issuance of convertible and exchangeable *Sukuk,* where the *Sukuk are* convertible into equity (or, in the case of the Sabana Reit S$80 million 4.5% convertible *Sukuk* due 2017, convertible into units in a real estate investment trust). There are, broadly speaking, two types of convertible *Sukuk* in the market at the moment. The first is the “vanilla” convertible *Sukuk*, which is convertible at the option of the *Sukuk* holder into a pre-determined amount of existing shares. The second is the “Pre-IPO” convertible *Sukuk*, which gives the investor the right to participate, potentially at a discount, in any public offering of the company’s shares, if any such offering takes place during the lifetime of the *Sukuk.*

7. Recent tightening up of *Sukuk* guidelines

AAOIFI, the Accounting and Auditing Organisation for Islamic Financial Institutions, is established in Bahrain and is supported by a membership that includes central banks, Islamic financial institutions and other participants from the international Islamic banking and finance industry.

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7 Ibid at page 25

During the course of 2007, the chairman of the *Shari'a* board of AAOIFI criticised a number of *Sukuk* structures used in the market, in particular *Mudaraba*, *Wakala* and *Musharaka,* arguing that, in his view, they were not *Shari'a*-compliant. In February 2008 the AAOIFI *Shari'a* board, having met on various occasions, among themselves and with a number of market participants, issued the following guidance on *Sukuk* issuance, which has persuasive influence:

Sukuk must represent ownership in real or physical assets, which may also include services or *usufruct* (the right to use and derive profit or benefit from another person's property);

- the originator / obligor must be able to prove the transfer of title in its records and may not retain title to the assets sold or transferred under the *Sukuk* structure;

- *Sukuk* may not represent receivables or debts unless they form part of a sale of assets by a financial or commercial institution;

- the obligor (whether *Mudarib*, partner in a *Musharaka* or agent / *Wakeel*) may not provide a liquidity facility; and

- a *Mudarib*, partner in a *Musharaka* or agent may not undertake to purchase the *Mudaraba* or *Musharaka* assets at the face value of the *Sukuk. S*uch purchase must instead be at market value or a value to be agreed upon at the time of purchase. A lessee in an *Ijara Sukuk* may, however, redeem the *Sukuk* by purchase of assets at a pre-agreed price, provided that the lessee is not a *Mudarib*, partner in a *Musharaka* or agent.

The focus of the 2008 statement was on the last bullet point. The other comments mentioned were not expressly mentioned.

This guidance does not mean that *Sukuk* issued in breach of these guidelines are invalid. It does, however, mean that there may be structural differences between *Sukuk* issued prior to this guidance and those issued afterwards.

8. Conclusion

The Islamic capital markets are growing, and the range and complexity of Islamic capital market instruments is increasing. There is no reason to believe that this trend will not continue, as jurisdictions are increasingly taking steps to facilitate the issuance of domestic and international *Sukuk* and other Islamic capital markets products, and to make them more accessible to retail investors, thereby allowing companies to tap new sources of liquidity. The level of *Sukuk* issues over the next few years is also likely to be fuelled by the need to replace significant levels of existing *Sukuk* which mature during 2013 or 2014. It is, however, an unfortunate economic reality that there will also inevitably be defaults or potential defaults relating to such products and that restructuring professionals will, in developing a refinancing or restructuring strategy, need to be aware of the key issues typically arising from Islamic capital markets structures[8].

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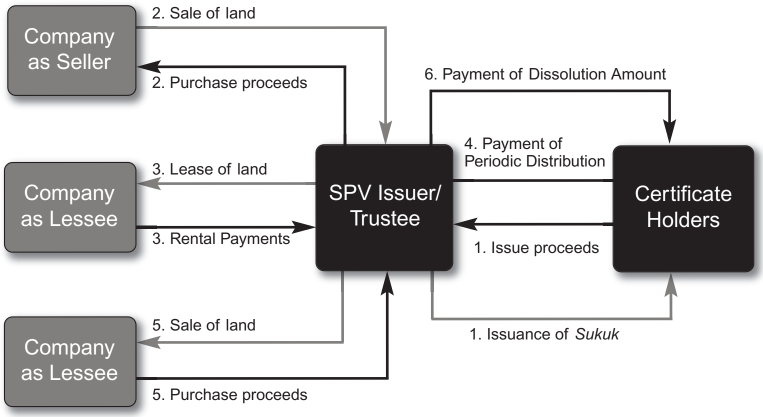
[8] At the time of writing Dana Gas PJSC, had just confirmed that it had completed the refinancing of US$ 1 billion *Sukuk-al-Mudarabah* issued by Dana Gas Sukuk Limited, following approval of a refinancing plan by both *Sukuk* Certificate holders and Shareholders. The plan involved a US$70m cash pay-down, the cancellation of another US$80 million of existing *Sukuk* already owned by PJSC and the issue of new *Sukuk* of US$ 850 million (US$425 million of Convertible *Sukuk* and US$425 million of Ordinary *Sukuk*) which were listed on the Global Exchange Market of the Irish Stock Exchange

Diagram 1 - The structure and payment flows involved with an *Ijara Sukuk*

This Appendix contains a simplified structure diagram and brief description of the cash flows involved in an *Ijara Sukuk*, which is one of the most common structures used in structuring.



1. Investors purchase *Sukuk* issued by a special purpose vehicle ("SPV"). The *Sukuk* represent a right to payment of the Periodic Distribution Amount (i.e. profit) and the Dissolution Amount (i.e. principal) on redemption. The SPV then declares a trust over both the proceeds and over the assets acquired using the proceeds, so that it acts as trustee for the certificate holders. Each certificate is thereby intended to represent an undivided beneficial ownership interest in the relevant assets underpinning the trust.

2. The Company enters into a Sale and Purchase Agreement with SPV, acting as the trustee, pursuant to which it sells assets which are capable of being leased (often land and tangible assets such as plant and machinery) to the SPV.

3. The SPV then leases the land or other assets back to the Company pursuant a lease agreement between the parties (Ijara) in consideration for the periodic payment of rental by the Company (which will be equivalent to the "Periodic Distribution Amount" payable by the SPV to the Certificate holders).

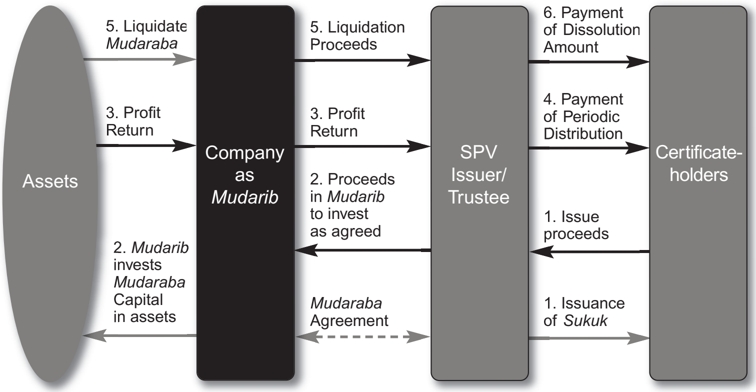
4. The SPV pays Periodic Distribution Amounts to the Certificate holders using the rental payments received from the Company.

5. Upon (i) the occurrence of an event of default or maturity, or (ii) the exercise of any applicable put or call options, the SPV will sell, and the company will repurchase, the land or other assets pursuant to the exercise of a Sale or Purchase Undertaking. The consideration for such sale / repurchase will be payment of the “Exercise Price”, being a sum equal to the Principal Amount plus any accrued and unpaid Periodic Distribution Amounts owing to Certificate holders.

6. The SPV pays the “Dissolution Amount” to the certificate holders, being an amount equal to the Exercise Price.

Diagram 2 - The structure and payment flows involved with a *Sukuk al-Mudaraba*

This Appendix contains a simplified structure diagram and brief description of the cashflows involved in a typical *Sukuk al-Mudaraba*.



1. Investors purchase *Sukuk* issued by the SPV, which declares a trust over the proceeds (and the assets acquired using the proceeds, in this case the assets and contractual rights under the *Mudaraba* Agreement). Each certificate is thereby intended to represent an undivided beneficial ownership interest in the assets underpinning the trust.

2. The Company enters into a *Mudaraba* Agreement with the SPV, acting as trustee for the *Sukuk* holders, pursuant to which the SPV invests the *Mudaraba* Capital (i.e. proceeds) in certain assets in accordance with an agreed investment plan.

3. In accordance with the terms of the *Mudaraba* Agreement, (i) the Company as *Mudarib* applies its skill and knowledge in managing the assets, and (ii) the *Mudarib* makes periodic payments to the SPV equal to the expected periodic income amount (“Profit Return”) which will be equivalent to the “Periodic Distribution Amount” payable by the Trustee to the Certificate holders, and will be payable on (or prior to) the same dates as the Periodic Distribution Amount is payable to Certificate holders.

4. The SPV pays Periodic Distribution Amounts to the Certificate holders using the Profit Return.

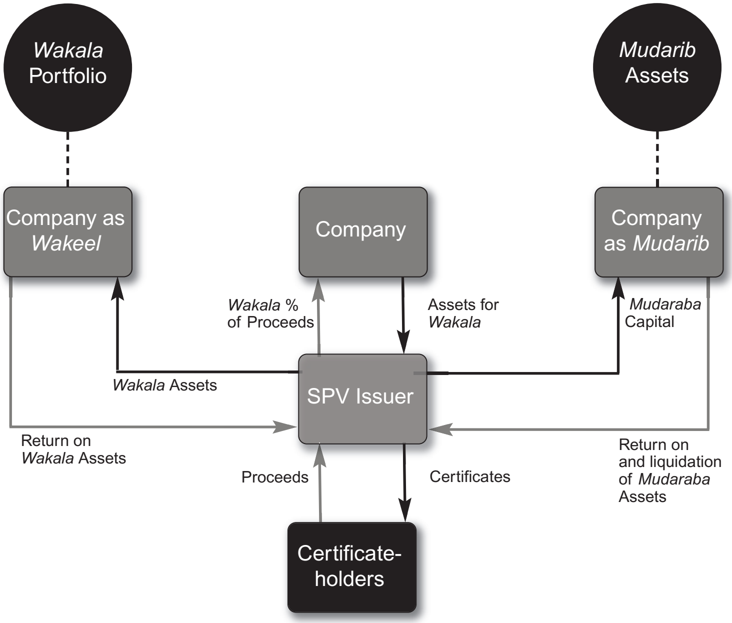
5. Upon an event of default or on maturity, the *Mudarib* will liquidate the portfolio of *Mudaraba* assets and will pay “Liquidation Proceeds”, being an amount equal to the *Mudaraba* Capital plus the accrued but unpaid Profit Return to the SPV, which will in turn be equivalent to the Dissolution Amount due to Certificate holders.

6. The SPV pays the amount received from the Company, the “Dissolution Amount”, to the *Sukuk* holders.

7. To the extent the Profit Return is less than the Periodic Distribution Amount, the Company may provide a *Shari’a*-compliant liquidity facility (repayable by the SPV) to satisfy any such shortfall.

Diagram 3 - Hybrid *Sukuk* structures

Sukuk structures continue to develop. Recently, many financial institutions issuing *Sukuk* have used more complex hybrid structures (using multiple components within the structure). Depending on the particular circumstances, a hybrid structure may include both "tangible" and "non-tangible" assets, a feature which has the advantage of allowing issuers to issue *Sukuk* on a more "asset efficient" basis than previously. A typical hybrid structure (using *Wakala* and *Mudaraba*) is illustrated below.



The proceeds of the *Sukuk* issue are used (i) to purchase assets for the purpose of the *Wakala* portfolio and (ii) as capital for a *Mudaraba*. The split of proceeds and percentage of tangible assets in the *Wakala* Portfolio and *Mudaraba* will depend on the views of the particular scholar as to the application of the underlying principle relating to tradability.

The periodic returns on the *Wakala* Portfolio and *Mudaraba* assets fund the periodic distribution amounts payable by the SPV on the Certificates. The redemption amounts payable in respect of the Certificates are generated from (i) the liquidation proceeds of the *Mudaraba* and (ii) the exercise price payable under either the purchase undertaking or sale undertaking upon the sale of the *Wakala* assets.

CHAPTER 7

Restructuring Islamic Facilities

1. Introduction

The role that Islamic finance plays in the global financial markets has changed considerably over the past decade. Islamic finance is now estimated to account for around US$1 trillion of all global debt and continues to evolve in both developed and emerging economies. Whilst some commentators argue that Islamic "debt" is more resilient than conventional debt in a receding market, the inability of an obligor to service its debt hits both.

Islamic finance is based on principles that suggest it is a "fairer" system of finance, where profit and loss is shared between financier and obligor and where there is limited scope for unjust enrichment. In such a system, however, what happens when an obligor defaults?

The relatively recent growth of Islamic finance and the subsequent global recession has forced practitioners in the Islamic finance space to consider and develop workable and *Shari'a* compliant solutions for restructuring debt, ensuring (to the extent possible) they allow for both financiers and obligors to be treated fairly. Restructuring efforts and intercreditor arrangements have been further complicated where existing financings are multi-sourced, often with export credit agency involvement and/or a portfolio of conventional and Islamic facilities and structures.

This chapter analyses some of the key issues faced by practitioners working on restructurings of Islamic finance transactions, together with some of the potential solutions. We also look at how the INSOL International principles[1] themselves do not pose any issues from a *Shari'a* perspective, rather serve just as well as a framework for refinancing or restructuring Islamic facilities as they do conventional facilities.

2. Assessing creditor claims

A critical starting point for any restructuring is to ascertain the rights and rankings of the various creditors – this ultimately drives the restructuring plan. Where there are multiple facilities and a single obligor, it is important that, in accordance with the sixth INSOL principle, any restructuring plan retains the rights of the financiers under each of the facilities (for example, secured financiers should be treated equally under any new structure).

To understand the rights of each financier or group of financiers, a comprehensive review is required of all facility documentation. This is often more challenging for Islamic facilities, where documentation is heavier and the rights of the financiers may be spread across several finance documents. The documentation itself may be more sophisticated in some cases than others, which can make it harder to ascertain what the rights of a particular creditor are. Given the relatively recent focus on Islamic finance, many financial institutions have developed their own in-house documentation which can sometimes lack details on how to deal with defaults or assets in an enforcement scenario.

[1] Statement of Principles for "A Global Approach to Multi-Creditor Workouts", 2000

In addition, the interpretation of *Shari'a* (and what is acceptable) may differ depending on both geography and *Shari'a* board composition, leaving a wide discrepancy between market documentation – some provide for more genuine risk sharing, whereas others, whilst purporting to follow a risk sharing principle, contain contractual safeguards to ensure the financier earns a return equivalent to that in a conventional financing. On *wakala* structures, for example, whilst a wakeel cannot be *obliged* to generate a specified return in any given period (as it is essentially acting as an agent of the bank (or muwakkil)), there may be other mechanisms provided for in the documentation to ensure that the bank's risk is mitigated. Such mechanisms may include liquidity facilities being provided by the wakeel and, ultimately, the purchase undertaking being exercisable against the obligor if the required return is not achieved.

An added complexity with *Shari'a* compliant facilities is their "asset-based" nature. This is particularly an issue with *ijara* facilities, where financiers may assume they have a right to the underlying property or other asset being leased under the facility. The reality is that on an unsecured *ijara* financing it is unlikely that, following a default, the financiers will have any right to foreclose on an asset and realise the proceeds thereof. Under an *ijara* facility, the rights of a financier are typically exercised through the purchase undertaking, where the relevant assets are "put back" to the obligor for an exercise price equal to the outstanding "debt". Whilst this crystallizes an unsecured debt claim for the financier there is, in the majority of cases at least, no recourse to the assets themselves.

In certain cases, however, where there has been a "true sale" of an asset pursuant to an *ijara* transaction (i.e. the legal ownership has moved across to the investment agent / sole financier), the financiers will have an ownership right to the asset which can be disposed of. We would note that such a "true sale" is the exception rather than the rule.

The misconception referred to above (i.e. asset based vs. asset backed) has also been seen on the restructuring of other Islamic finance structures. *Mudaraba, musharaka* and *wakala* structures, for example, all imply either a pooling of resources or investment by a *mudarib* or *wakeel* of resources or assets owned by the financiers (often into the construction or purchase of tangible assets). Ultimately, the usual analysis on a default is the same as that on an *ijara* structure - the financiers are not legal owners of assets and are unsecured unless legal title has been transferred or specific asset security has been granted. (There is a contrast between what the structure achieves from a *Shari'a* perspective and what it achieves from a strict legal perspective, but there is little jurisprudence to guide market participants on how a court would treat such a distinction, particularly in countries where *Shari'a* is a body of principles that a court can apply in making its determinations.)

As such, when looking at the position of multiple groups of financiers, it may be that the Islamic banks rank together with other unsecured creditors, even where from a strict *Shari'a* perspective they should have had a stronger position.

3. Implementing the restructuring plan

Following discussion of creditors' rights and, specifically, classification of rankings and claims, the next step is to develop and implement the restructuring plan. Whilst doing so, it is fairly common on both conventional and *Shari'a* compliant restructurings to have a standstill period in place in line with the first, second and third INSOL principles.

A restructuring plan is likely to include a combination of write-offs, changes to commission / profit rates, deferrals in maturity and potentially some further credit enhancements (such as additional security). The position under *Shari'a* compliant financings is no different, and indeed all of the above are an important part of any restructuring plan. Restructuring fees are also permitted on Islamic finance restructurings, but how such fee is recovered may need consideration and there may of course be certain institutions which either waive their right to such a fee or require this to be donated to charity (particularly given the spirit of Islamic financing and the underpinning doctrines of fairness and just enrichment).

Debt to equity swaps, whilst widely accepted within conventional finance, are a relatively recent development on restructurings of Islamic finance and a number of additional considerations apply. Almost all of the Islamic "debt" for equity swaps to date have been seen in the context of either exchangeable and convertible *sukuk* transactions, where the conversion concept is factored in and documented at the outset. On a restructuring, where Islamic financiers may ultimately take an equity stake in the underlying obligor, a key consideration is the activities undertaken by the obligor, which need to themselves be *Shari'a* compliant (i.e. unrelated to alcohol, gambling, pork, arms, pornography or tobacco, etc.) and any cashflows from non-*Shari'a* compliant activities should be limited to five per cent. of aggregate revenue[2].

Where there are multiple Islamic facilities, one option may be to consolidate these into a single facility. This was the approach adopted on the original Global Investment House restructuring, where a number of *wakala* arrangements were replaced with a single *murabaha* facility. To be able to implement such a plan, however, there needs to be agreement between the various financiers and related *Shari'a* boards as to the structure to be adopted.

In addition, the extent to which certain costs can be recovered may differ across Islamic facilities. By way of example, certain *Shari'a* boards may permit costs incurred as a result of complying with a change in law or regulation (known in conventional financing as increased costs) to be recovered from an obligor and levied in a subsequent profit period (for example, as an additional profit element on a *murabaha* structure or additional rental element on an *ijara* structure). Some *Shari'a* scholars, however, take the view that such costs are unacceptable and further eliminate the distinction between conventional and Islamic finance – in such cases, *Shari'a* compliant institutions move ahead with the knowledge that they may need to absorb such costs in the future.

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[2] Based on the Shari'a standards set by the Accounting and Auditing Organisation for Islamic Financial Institutions (AAOIFI)

Where *Shari'a* boards are unable to agree on a structure or approach to consolidate facilities, the only solution may be to amend and restate the original documentation. Whilst this may work from a *Shari'a* perspective, it necessarily makes the documentation process more lengthy and cumbersome and therefore can impact the restructuring timeline.

When developing any restructuring plan (and in accordance with the fifth INSOL principle), it is critical to have a comprehensive overview of the obligor's affairs and current business model. This is particularly helpful on *Shari'a* compliant restructurings where new assets may be useful tools in structuring new Islamic facilities. The use of such assets, however, may itself raise new intercreditor issues, with conventional creditors unlikely to agree to any transfer of legal title to an asset to Islamic financiers unless they receive suitable additional compensation or security.

Given the prevalence of commodity *murabaha* transactions over the past ten years, a significant number of Islamic finance restructurings have involved or comprised *murabaha* structures. More detail on how commodity *murabaha* transactions are structured can be found in Chapter 2 of this book.

4. Shari'a approvals

As referenced above, *Shari'a* approval is one of the main considerations when looking at any restructuring of an Islamic facility. Discussions as to which structure will be used and how debt will be repackaged or refinanced should be front-ended to the extent possible, failing which approvals can often be significantly delayed or withheld until further amendments are made to address *Shari'a* concerns. *Shari'a* pronouncements (or *fatwas*) are equally important on restructurings of existing facilities as they are for new financings (the difference being that where existing documents and structures are used the *fatwa* should already be in existence and be forthcoming).

Whilst Islamic financial institutions will usually have their own *Shari'a* boards issuing a *fatwa*, where the entity being restructured is *Shari'a* compliant it may also have a *Shari'a* board. In addition, where an obligor has a mix of conventional and *Shari'a* compliant finance outstanding it is often preferable for one of the *Shari'a* compliant financiers to maintain a position on any steering or co-ordinating group set up in accordance with the fourth INSOL principle stated in the "Statement of Principles for a Global Approach to Multi-creditor Workouts" (in an effort to address any *Shari'a* concerns as early as possible).

5. Asset value

Where Islamic facilities are asset backed (e.g. *ijara*), the value of those assets immediately prior to a restructuring may be markedly different to that at inception. Where the same assets are to be used as part of a restructured facility going forward, there may need to be further assets contributed by the obligor to meet the required transaction value. This needs to be considered together with any asset disposal programme (i.e. where the proceeds are to be used to repay existing financiers), otherwise the obligor may be in a position where it is short of assets required to restructure its *Shari'a* compliant facilities. There may be further considerations where additional assets include land, where any "true sale" may significantly reduce the value of assets available to the remaining creditors by way of security.

The asset disposal programme should also be careful not to involve any assets forming part of an Islamic facility structure, where such assets are required to be owned (whether legally or beneficially) by the financier group. Where such assets are inadvertently included, the "debt" intended to be repaid by the disposal of such assets would need to be refinanced using a different structure. Alternatively, where certain assets are already part of an Islamic financing structure but are required to be disposed of, the obligor may be able to substitute other assets into the structure at its discretion by exercising rights under a substitution undertaking – provided these have a corresponding value, this allows the original assets to be freed up for sale.

6. Summary

As highlighted above, whilst it is feasible to restructure Islamic facilities and the steps and tools for doing so are substantially similar to those for conventional facilities and there are a number of additional considerations which need to be taken into account when putting together a restructuring plan involving Islamic finance. There is further complexity in implementation, particularly where there may be a mix of conventional and Islamic facilities. Well documented facilities will assist any restructuring efforts, failing which the process of determining the rights and positions of the creditors can be a lengthy and cumbersome process. Whilst we have touched upon some of the issues involved, restructurings of Islamic finance transactions are still relatively new. As Islamic finance continues to grow and the market expands further, knowledge and know how on Islamic finance restructurings will also evolve, with *Shari'a* boards and scholars playing a critical role in shaping this going forward.

CHAPTER 8

Restructuring Sukuk Transactions

1. Overview

In the wake of the recent global financial turbulence, the Eurozone debt crisis and the resulting volatility in international capital markets, issuers are actively looking at reviewing their capital structures. Indeed, some Gulf-based issuers are examining the application of liability management strategies and / or restructuring strategies in the context of their existing sukuk transactions. In that context, they are asking whether it is possible to achieve a waiver or amendment through a consent solicitation if their financial covenants are being stressed. Questions such as "can we buy-in and cancel debt at relatively depressed prices?" or "can we extend the maturity of an outstanding series of debt securities, by exchanging it for a new series of longer-dated instruments?" are increasingly raised with legal and financial advisers.

In Part I of this chapter, we examine the challenges involved in a liability management exercise for a sukuk as compared to a conventional debt issuance and explore some common restructuring techniques. These techniques form the building blocks for a possible approach to restructuring a sukuk transaction, which is set out in Part II. Acknowledging that the challenges in each liability management exercise for a sukuk will be different and will depend on the specific underlying Islamic structure, in Part III, we refer to recent market examples to demonstrate that it is possible to implement restructurings which have the same commercial effect for an obligor seeking to manage its outstanding liability under a sukuk transaction.

1. Part I

1.1 Common debt restructuring techniques

An issuer seeking to restructure its outstanding debt securities has several tools for liability management at its disposal. Without exploring alternatives available to it under applicable bankruptcy rules, which lie outside the scope of this article, the company may decide between a number of strategies, the most common of which involve a tender offer, exchange offer, consent solicitation or any combination of these. Although such options are available to both issuers of conventional debt securities and sukuk (the Shari'a-compliant alternative to conventional interest-bearing fixed income securities), implementing one or more of the above strategies becomes significantly more complicated in the case of restructuring sukuk transactions. The reason for this added complexity lies in the nature of sukuk as an asset-based security.

In contrast to conventional bonds, which represent the issuer's contractual debt obligations to bondholders, sukuk represent an undivided ownership interest in an underlying tangible asset and therefore a right to receive a share of profits generated by such asset base, which can be structured to produce a fixed income return. Furthermore, for a sukuk structure to be Shari'a-compliant, there must be a direct link between the assets that underpin the cash flows on the sukuk and the ownership interest of the investors in such assets. Typically, this link can be achieved through the 'sale' of an asset to a newly formed special purpose vehicle ("SPV") that will hold such assets on trust or as an agent for the investors.

As a result of the inherent proprietary nature of sukuk, the implementation of some of the liability management strategies outlined above is more complex and has greater limitations than the application of similar strategies to conventional debt securities. The limitations of these strategies as applicable to sukuk restructurings are explored further below.

1.1.1 Tender offers

An issuer with outstanding capital markets securities may decide to launch a public offer to purchase some or all of its securities should they be trading at a level below the par value which the issuer would need to pay to the relevant security holders upon maturity. Such an offer may be open to all holders of the securities or to all holders other than those in specified jurisdictions (for example, certain U.S. holders may be excluded for specific U.S. regulatory reasons). Once the targeted holders are identified, the issuer will inform them of the offer by way of an offer document. This document will describe the terms of the offer and will be posted through the clearing systems and / or through any announcement system utilised by the relevant stock exchange on which the securities are listed.

In conventional transactions, it is usually the issuer of the securities who would be seeking to repurchase and cancel its own outstanding securities. In contrast, in a sukuk structure the roles of the obligor (the entity seeking to manage its liability) and the issuer (the SPV) are not fulfilled by the same legal entity. Consequently, it is necessary to establish a relationship between the obligor and the SPV so that the sukuk issued by the SPV may be repurchased by the obligor and subsequently cancelled. This is a common structural feature of the liability management of sukuk transactions.

1.1.2 Exchange offers

An exchange offer typically involves an offer to the holders of existing securities to exchange some or all of those securities for an amount of new securities. Exchange offers are a convenient liability management tool should an issuer desire to extend the maturity of an outstanding debt obligation whilst retaining substantially the same investor base that is already familiar with the credit risk associated with that issuer.

As an exchange offer involves the issuance of new securities, it is often subject to greater regulation than a straight tender offer. The issuer will need to produce an exchange offer memorandum to describe the terms of the exchange to investors and will typically appoint a dealer manager to manage the exchange offer process. The issuance of new securities will typically necessitate an update to the original disclosure which was used for marketing the original securities. Although these factors can push out the timeline of an exchange offer when compared to a tender offer, it is nonetheless a relatively straight forward process for an issuer of conventional securities to undertake an exchange offer. This is particularly true where the issuer has established a programme and an existing series of securities can be exchanged for a new series to be issued under the same programme.

The approach with respect to a sukuk structure may be more complicated due to the fact that, before 2009, sukuk were generally documented as standalone transactions and not as repeat issuance programmes. In addition, the SPV in most standalone sukuk transactions is typically established for one issue of sukuk only and is not permitted to issue further sukuk for the purpose of any liability management exercise. Accordingly, in order to undertake an exchange offer of a standalone sukuk transaction, a new SPV would need to be established as the issuer of the new series of sukuk and it would need to acquire a satisfactory set of underlying assets to collateralise the new sukuk to be issued. As with a tender offer, it is ultimately the liability of the obligor under the original sukuk which will need to be managed. Accordingly, the exchange offer will seek to extinguish the obligor's obligations under the original sukuk and replace them with obligations under the new sukuk.

1.1.3 Consent solicitations

An issuer may also consider launching a process to amend the terms of its existing securities by approaching holders of such securities for their consent of the identified amendments. The decision to amend the existing terms and conditions may be motivated by a desire to avoid a potential breach of a troublesome covenant or to introduce new terms. For example, it is common for an issuer to propose a "call" option which would allow it to redeem its securities at a specified price prior to their stated maturity.

The amendment process is generally done by way of an extraordinary resolution at a meeting of the holders of the relevant securities. One of the advantages of obtaining the consent of securityholders in this manner is that an extraordinary resolution will bind the entire class of holders. Provided that the necessary quorum and voting thresholds are achieved at the meeting, it will therefore be possible to retire an entire series of securities.

It is not unusual that a consent solicitation is accompanied by a tender or exchange offer. In such instances, an issuer may also wish to use the opportunity to remove certain troublesome covenants or other provisions in order to make the existing securities less attractive to hold, thereby inducing investors to participate in the exchange or tender offer. With conventional securities, issuers wishing to solicit the consent of investors to a waiver or change to the terms and conditions of the securities may offer some form of voting incentive, such as an increase to the interest rate. Unfortunately, offering such incentives is not always possible under a sukuk structure without simultaneously increasing the amount of income generated by the sukuk's asset base. For example, in the case of a sukuk-al-ijara, where the periodic profit amount (coupon equivalent) is derived from the rental payable by the lessee to the SPV in its capacity as lessor, there would need to be a corresponding increase to the rental payments under the ijara that would match the increase in the periodic profit amount. In such circumstances, some Shari'a scholars may need to be consulted as to whether there are any issues with any increase in the rental amount, and subsequently the periodic profit amount, which is to be paid to investors.

2. Part II

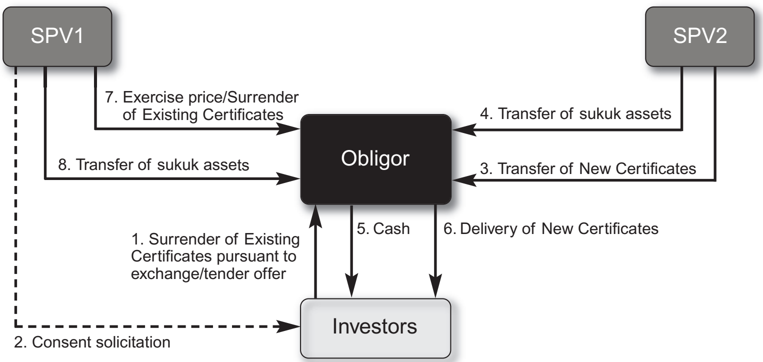
2.1 Restructuring a paradigm *sukuk-al-ijara* transaction

From the perspective of commencing a sukuk restructuring, the limitations on using liability management techniques may appear onerous but they are not insurmountable. In Part II of this chapter, we examine a possible approach to restructuring a paradigm sukuk – al-ijara transaction in order to allow an obligor to manage its outstanding liabilities.

To facilitate our illustration of how a sukuk restructuring may play out in practice, we need to make several assumptions. The obligor in our paradigm structure will undertake both a tender offer and an exchange offer with respect to the existing certificates (the "Existing Certificates"). In addition, a consent solicitation would be undertaken in parallel in order to incorporate buy-back and cancellation mechanics into the Existing Certificates and to allow the maturity of the Existing Certificates to be 'accelerated'. For the sake of simplicity, we have also assumed that the tender and exchange offer is open to all investors and that a majority of the investors (holding at least 75 per cent. of the Existing Certificates) would choose to participate in one of the two offers and that the appropriate quorum and voting thresholds would be met. We have further assumed that the relevant resolutions would be passed prior to the settlement date to allow the redemption of the Existing Certificates on the settlement date and that the obligor has sufficient sukuk assets available to collateralise the new certificates to be issued by the SPV (the "New Certificates").

The liability management exercise will culminate on a single settlement date on which those investors wishing to participate in the tender offer would submit their Existing Certificates for a cash payment and those choosing to participate in the exchange offer would exchange their Existing Certificates for New Certificates. Any Existing Certificates acquired by the obligor pursuant to the tender offer and / or exchange offer would be cancelled with any remaining certificates (the "Remaining Certificates") being redeemed on the settlement date through the 'acceleration' of the Existing Certificates.

A representation by way of a diagram of the restructuring is set out below together with a step-by-step discussion of the events which would take place leading to settlement.



Structural steps (utilising the numbering in the structure diagram above)

1. Pursuant to the tender offer and exchange offer launched by the obligor to holders of the Existing Certificates issued by the existing issuer SPV ("SPV 1"), the obligor will be obliged to deliver either New Certificates or cash to the relevant holders as consideration on the settlement date.

2. SPV 1 will undertake the consent solicitation in order to amend the terms and conditions of the Existing Certificates to incorporate buy-back and cancellation mechanics and to 'accelerate' the maturity of the Existing Certificates such that they would be redeemed on the settlement date rather than their original maturity date. A meeting of holders of the Existing Certificates in relation to the amendments would be held prior to the settlement date in accordance with the meeting provisions in the terms and conditions of the Existing Certificates. As a condition to the acceptance of either the exchange offer or the tender offer, each investor must provide an irrevocable undertaking to vote in favour of the resolutions proposed as part of the consent solicitation.

3. The obligor will subscribe New Certificates issued by a new issuer SPV ("SPV 2") in an amount equal to the amount of Existing Certificates to be exchanged pursuant to the exchange offer.

4. In consideration for the subscription of the New Certificates, the obligor will transfer sukuk assets to SPV 2.

5. On the settlement date, the obligor will make a cash payment to the investors who accepted the tender offer in settlement of the tender offer.

6. On the settlement date, the obligor will deliver New Certificates to those investors who accepted the exchange offer in exchange for their Existing Certificates.

7. On the settlement date, the obligor will surrender to SPV 1 for cancellation the Existing Certificates acquired by it pursuant to either the tender offer and / or the exchange offer.

   It is possible that certain holders of the Existing Certificates did not participate in either the tender or exchange offer. In such circumstances, the obligor, on the settlement date (which will now also be the maturity date of the Existing Certificates), will exercise its rights under a unilateral sale undertaking and make a payment of the exercise price (being an amount equal to all amounts due and payable under the Remaining Certificates) to SPV 1. SPV 1 will then pass on the proceeds of the exercise price to the holders of Remaining Certificates in order to redeem the Remaining Certificates and thereby enable the collapse of the structure in its entirety.

8. SPV 1 will transfer the sukuk assets to the obligor in consideration for the surrender of the Existing Certificates and payment of the exercise price by the obligor in step 7 above.

3. Part III

3.1 Effects of the sukuk restructuring and additional observations

Following settlement as described in steps 5 to 8 above, the obligor will have discharged in full its obligations with respect to the Existing Certificates and the Existing Certificates will therefore cease to exist. Instead, the obligor will have obligations under the New Certificates to those investors who chose to accept the exchange offer. The terms of the New Certificates may include a longer maturity and may also carry a higher profit rate in order to have induced investors to accept the exchange offer. The obligor may also have used cash reserves for the purpose of the tender offer to retire a portion of Existing Certificates in order to extinguish some of its liabilities going forward. From a commercial standpoint, the implementation of the sukuk restructuring allows the obligor to manage its obligations by putting it in the same position as a conventional bond issuer that implements a liability management strategy involving a tender and exchange offer and a consent solicitation, albeit with some additional steps and considerations.

Despite the added complexity of restructuring sukuk transactions, the problems are not without solution as evidenced by successful public transactions, such as the Government of Ras al Khaimah liability management transaction and the JAFZA sukuk consent solicitation.

We also note that another (untested) example of a capital markets solution to liability management could take the form of a debt-for-equity swap. Here, a company's creditors may agree to cancel some or all of the company's debt owed to them in exchange for an equity stake in the business. This option could be favoured in circumstances where the business is not generating sufficient revenue to continue to fund payments on any restructured debt capital markets instrument. Given that a sukuk certificate effectively represents an undivided ownership interest in an underlying income-generating asset, sukuk investors might find such an exchange offer particularly appealing as it would effectively represent an exchange of one type of equity interest (in the asset underpinning the sukuk) for another (equity in the obligor) at a negotiable price. However, in a market which to date has been dominated by government related issuers, it remains to be seen how practical debt-for-equity swaps will be for obligors who have majority shareholders government ownership interests.

4. Conclusion

Although the challenges in each liability management exercise for a sukuk will be different, depending on the commercial rationale and, most notably, the underlying Islamic structure, these challenges are not insurmountable and it is possible to implement restructurings which have the same commercial effect as for an obligor seeking to manage its outstanding liability under a conventional transaction.

As the current global economic volatility continues, it is likely that obligors under sukuk transactions will become increasingly interested in managing their liabilities by restructuring their existing sukuk obligations. Recent sukuk transactions have demonstrated that obligors are keen to establish sukuk programmes in place of standalone sukuk issuances in order to provide maximum future flexibility vis-à-vis liability management and we see this trend continuing. Indeed, many of the new sukuk transactions which have been structured post the economic crisis of 2009-2010 contemplate future liability management strategies from the outset by incorporating structural features, such as buy-back and cancellation mechanics, which would facilitate the restructuring of such transactions in the future, thereby reducing the reliance on complex and potentially time-consuming restructurings. These developments continue to demonstrate the growing maturity and versatility of the sukuk market and the adaptability of conventional capital markets technology in a Shari'a-compliant manner.

CHAPTER 9

Islamic Funds

1. Overview

This chapter focuses on Islamic funds and addresses at a high level the key issues relevant for establishing and operating a *Shari'a*-compliant fund. The chapter begins by reviewing alternative approaches for *Shari'a*-compliant funds. The chapter then examines *Shari'a*-compliance and the role of the *Shari'a* supervisory board. The different types of Islamic funds are also described, with specific focus on *Shari'a*-compliant real estate funds and private equity funds. The chapter concludes with a brief description of the outlook for Islamic funds.

2. Key considerations

A *Shari'a*-compliant fund is an investment fund which is structured and governed in accordance with *Shari'a* principles. In many respects, a *Shari'a*-compliant fund and a conventional fund are the same, especially in relation to elements such as applicable regulation and tax. The main differences between a *Shari'a*-compliant fund and a conventional fund are the mechanisms used to achieve *Shari'a* compliance.

A *Shari'a*-compliant fund may adopt several slightly different approaches with respect to *Shari'a*-compliance – a fully *Shari'a*-compliant fund, parallel *Shari'a*-compliant and conventional funds, a *Shari'a*-compliant feeder fund or a conventional fund with excuse/opt-out rights for *Shari'a*-compliant investors. The approach adopted by a *Shari'a*-compliant fund ultimately depends on the proposed investment strategy, the target investors, the *Shari'a* screening criteria and the availability of *Shari'a*-compliant debt (if leverage is necessary).

The majority of *Shari'a*-compliant funds are established as limited partnerships. From a *Shari'a* perspective, these constitute *shirka* partnerships. Accordingly, a fund will have to be structured in a manner such that any loss suffered by the fund will be attributed to each of the investors proportionately to their invested capital. This means that a corporate vehicle is typically not feasible due to the existence of separate management and participating classes of shares. One alternative is a unit trust structure, whereby a fund company issues units to investors. Such a contractual arrangement is quite common with Middle East-sponsored funds domiciled in Bahrain. *Shari'a*-compliant funds with international sponsors, however, are typically structured as limited partnerships domiciled in the Cayman Islands or other traditional offshore jurisdictions familiar to international investors.

The compliance by a fund and its manager with *Shari'a* principles restricts the standard operation of a fund, including the types of permissible investments and leverage (e.g., limits on financial ratios, use of swaps and derivatives, prohibition on interest and a requirement to purify any *haram* income), the equalisation mechanism for subsequent closing investors, the default mechanism (e.g., late payment amounts and forfeiture) and the payment of any carried interest or performance fee and preferred return.

Shari'a prohibits all forms of interest or *riba*, which means that carried interest and performance fees need to be memorialised in a *Shari'a*-compliant manner. This is usually achieved through the use of a restricted *mudaraba* arrangement, whereby one party provides management services instead of capital (i.e., the fund manager) and each party receives a pre-agreed percentage of the profits generated by the activities of the *mudaraba* calculated on the basis of certain hurdles (such as IRR levels).

Any penalties sought to be imposed on investors need to be carefully assessed. It is not permissible to impose any default interest. Also, any charge which may be considered unjust from a *Shari'a* perspective may prove problematic.

Any income received by an Islamic fund from an investment which is not *Shari'a*-compliant must be removed from the profits of the *Shari'a*-compliant fund prior to distribution to investors. Any such *haram* income must be donated to a charity either identified by the *Shari'a* supervisory board or nominated by the investors. The manner in which the *haram* income is calculated will depend on the fund and its investment strategy and how easily such income may be identified.

3. Alternative approaches

3.1 Fully *Shari'a*-compliant fund

In principle, a *Shari'a*-compliant fund must only invest in *Shari'a*-compliant assets and be financed solely through *Shari'a*-compliant debt. However, where this becomes overly restrictive, the *Shari'a* supervisory board may permit the inclusion of limited exceptions in the fund documents (although these will not be widely drafted). For example, where non-*Shari'a*-compliant financing is necessary for an investment, such financing may be permissible provided that it does not exceed a pre-agreed threshold (usually around 33%) of the acquisition cost of the investment. This provides greater flexibility for the fund and manager in operating the *Shari'a*-compliant fund.

3.2 *Shari'a*-compliant parallel fund

As a result of their unique operating and investment restrictions, fund managers also frequently establish a Shari'a-compliant fund as a parallel fund, which invests proportionately in investments on substantially the same terms and at the same time as the main conventional fund, provided these investments are Shari'a-compliant. There is no obligation on the Shari'a-compliant parallel fund to invest in all investments made by the main fund and therefore it does not participate in any investments that are not Shari'a-compliant. While the parallel fund has the same fund manager and investment focus as the conventional fund, such a structure allows the fund manager to provide a Shari'a-compliant fund for investors without restricting the operations of the conventional fund and burdening its investors with any additional costs.

3.3 *Shari'a*-compliant feeder fund

One alternative is to establish a *Shari'a*-compliant feeder fund for *Shari'a*-compliant investors. The feeder fund enters into a *murabaha* agreement with the main conventional fund pursuant to which the feeder fund generates a return comparable to that received by the conventional investors in the main fund. The use of the *murabaha* distances the *Shari'a*-compliant feeder fund from any *haram* activity by the conventional fund. The *Shari'a*-compliant feeder fund typically provides investors with a "wrapper" to the offering document of the main conventional fund.

3.4 Conventional fund with investor excuse / opt-out

It is also possible to establish a conventional fund and grant any *Shari'a*-compliant investors the right to be excused / opt-out from any investments that are not *Shari'a*-compliant. A standard excuse / opt-out mechanism is built into the fund documents, which grants an investor the right to be excused / opt-out from participating in certain investments. An investor that exercises this excuse right would not be considered a defaulting investor with respect to such investment and would not participate in any returns related to such investment. Note that this approach does not address the other issues raised by a conventional fund, such as the equalisation mechanism for subsequent closing investors and the payment of any interest upon default.

4. *Shari'a* compliance

4.1 Generally

A *Shari'a*-compliant fund must operate and base its investment decisions on *Shari'a* principles. Investors in *Shari'a*-compliant funds have three main concerns:

- investments made by the fund must be *Shari'a*-compliant;
- any leverage used by the fund must be *Shari'a*-compliant; and
- compliance by the fund with *Shari'a* principles must be assessed and continuously monitored by recognised *Shari'a* scholars.

4.2 Investment restrictions

The investment policy of a *Shari'a*-compliant fund must ensure that any investments made by the fund do not contravene *Shari'a* principles. Certain potential investments are prohibited as *haram*. These investments include companies or assets involved in:

- the production, sale, distillation or distribution of alcoholic beverages or related products;
- gambling, casinos, lotteries and related games;
- the production, sale, distribution or slaughter of pork and pork-related products;

- non-Islamic banks, financial institutions and insurance companies; and
- pornography and obscenity of any form.

A number of investments fall into a “grey area”, and whilst not explicitly declared to be haram, are generally discouraged for Shari’a-compliance purposes. These investments include:

- assets relating to tobacco and tobacco-related products;
- companies or assets involved in the entertainment business (film, video, theatre, cinema);
- companies using leverage provided on a non-*Shari’a*-compliant basis (although exceptions to this principle have been developed); and
- companies or assets involved in the production of weapons.

The prohibition on incurring any interest also has ramifications for the fund’s custodian (if any). Although a custodian of a *Shari’a*-compliant fund does not need to be *Shari’a*-compliant itself, any services it provides to the fund must be provided in a *Shari’a*-compliant manner. A *Shari’a*-compliant fund may not receive interest from time deposits or to enter into repo contracts. Any assets of the fund must therefore be placed in either a non-interest bearing account or an account subject to a commodity *murabaha* contract.

4.3 Screening

In accordance with *Shari’a* principles, the ownership of shares in a company is considered to be ownership in a proportionate share of that company’s business and assets. As a result, Muslim investors cannot own interests in a fund, which owns shares in a company that is involved in any *haram* activity.

As the conventional interest-based banking system predominates, it is virtually impossible for any company to conduct its financial affairs without breaching *Shari’a* principles regarding the prohibition of interest or *riba*. In order to increase access to the financial markets for Muslim investors, a group of leading *Shari’a* scholars has developed a series of screening criteria to identify non-*Shari’a*-compliant elements of a company and provide a means of avoiding or addressing issues in manner consistent with *Shari’a* principles. As a result, *Shari’a*-compliant investors may invest in companies that fulfil these screening criteria.

The standard screening criteria focuses on the following areas:

- business activity: at least 95% of gross revenues must be generated from *Shari’a*-compliant business activities;

- interest-based debt: a company's interest-based debt must be less than 33% of its equity or total assets. Market capitalisation is increasingly being used as a denominator to calculate the level of debt in order to capture the value of a company as perceived by the market, which also considers intangible assets such as intellectual property and goodwill when pricing a company's shares; and

- interest income: interest income must not be more than 5% of total income and should be deducted from dividend income and donated to charity to "purify" the company's earnings.

There are three general conditions to use with respect to the screening criteria. These are:

- where a company fulfils the criteria, this does not constitute an endorsement of its non-*Shari'a*-compliant practices. Investors should still encourage the company to adhere fully to *Shari'a* principles;

- the criteria only apply to companies that are majority owned by non-*Shari'a*-compliant shareholders. Companies that are majority owned by Muslim investors must be fully *Shari'a*-compliant; and

- the criteria are not necessarily applicable to private equity investments due to the extent of shareholders' influence and involvement in such companies. The criteria are only used for investments in listed companies where shareholders do not have direct influence on the management of the company's affairs.

The screening criteria are applied at the time of the investment decision and during the subsequent monitoring process by the *Shari'a* supervisory board to ensure that the company remains *Shari'a*-compliant.

There is significant ongoing debate as to the interpretation and application of the screening criteria, which often vary on a case-by-case basis. Recently, additional independent screening methodologies have also been developed by the Securities Commission of Malaysia and the Bahrain-based Accounting Auditing Organisation of Islamic Financial Institutions ("AAOIFI").

4.4 Islamic indices

In conjunction with the growth of the Islamic funds industry, several index providers have launched *Shari'a*-compliant versions of their main indices and several sub-indices. An Islamic equities index filters companies included in a conventional index using the *Shari'a* screening criteria.
The Islamic equities indices currently available include:

- Bursa Malaysia *Shari'a* Index;

- FTSE Global Islamic Indexes;

- Dow Jones Islamic Market Indexes;

- Standard & Poor's *Shari'a* Indexes;
- Global GCC Islamic Index; and
- MSCI Islamic Index Series.

5. *Shari'a* supervisory board

Shari'a law does not have a uniform set of standards and interpretations. While some institutions, such as AAOIFI, work to unify the various interpretations and opinions of scholars, they have no enforcement power. Accordingly, whether an investor views a particular fund and its investments as *Shari'a*-compliant will depend upon the review and approval by a *Shari'a* supervisory board engaged by the fund manager or, indeed, the investor's own consultant or supervisory board.

Most Middle East funds simply engage an already existing *Shari'a* board (typically the *Shari'a* supervisory board of the fund's sponsor or anchor investor). Alternatively, a fund may hire a *Shari'a* consultant or establish its own *Shari'a* supervisory board comprised of various Islamic scholars. There are also certain service providers with their own *Shari'a* boards, which may be engaged on a contractual basis to advise a fund. A *Shari'a* supervisory board is typically composed of between three and five Islamic scholars who specialise in *fiqh al muamalat* (Islamic commercial jurisprudence).

The *Shari'a* supervisory board would typically be appointed to:

- review the structure paper and investment criteria of the fund at the outset and provide an "in principle" approval, subject to review of the final fund documentation;
- review the fund documentation to ensure that it complies with the principles of *Shari'a* (e.g., ensuring that there are no default interest provisions and the arrangements are sufficiently certain as to their fundamental terms) and issue a *fatwa* confirming that the structure of the fund, the investment criteria and the fund documentation are *Shari'a*-compliant; and
- on an on-going consultancy basis, conduct periodic audits to ensure compliance with the investment criteria and that all investments during the term of the fund are *Shari'a*-compliant.

The *Shari'a* supervisory board will agree with the fund manager the approach for exercising its oversight over the fund. There are two alternative approaches to this oversight:

- agree a *Shari'a*-compliant investment policy and investment restrictions in advance and including these in the fund documentation (this removes the need to obtain prior approval for each individual investment made by the fund, but may lack flexibility as the principles of Islamic finance evolve); or
- require *Shari'a* supervisory board approval for each individual investment as and when made (and any related financing).

When establishing a *Shari'a*-compliant investment policy for a fund, the fund manager and the *Shari'a* supervisory board will agree on a framework to deal with any violations of *Shari'a* principles. Typically, the fund manager will be responsible for any capital losses resulting from a non-*Shari'a*-compliant investment and must dispose of the offending investment immediately upon becoming aware of the error. Where the fund manager becomes aware of a passive breach of *Shari'a* principles following a compliance review and the reason for the investment being non-*Shari'a*-compliant is of a permanent nature (e.g., the portfolio company has started a non-*Shari'a*-compliant business), the fund manager is obliged to dispose of the investment within a limited time period as determined by the *Shari'a* supervisory board. Where the reasons for the investment failing to comply with *Shari'a* principles are of a temporary nature (e.g., a financial ratio has been breached), the fund manager may keep the investment under observation for a time period agreed with the *Shari'a* supervisory board and will only be required to dispose of the investment should the breach not be remedied within such specified time period.

6. Types of Islamic funds

6.1 Equities funds

An Islamic equities fund is prohibited from holding, buying or dealing in shares of companies involved in *haram* activities. Islamic equities funds tend to employ *Shari'a* screening when choosing equity investments and these screening techniques concentrate on both the business activity of the target company as well as the company's financial ratios. Typically, at least 95% of gross revenues must be generated from *Shari'a*-compliant business activities, interest-based debt must be less than 33% of the company's equity or total assets and interest income must not be more than 5% of total income. Islamic equities funds generate profits through both the capital gains of buying and selling equities and any income received through holding equities in portfolio companies. Any distribution representing profit earned from non-*Shari'a* sources must be donated to charity.

6.2 Index funds

Islamic index funds tend to passively track *Shari'a*-compliant versions of indices and sub-indices. Investing in accordance with an index spreads risk across a range of securities and reduces the impact that fluctuations in a single security may have on the overall return of a fund.

6.3 Exchange-traded funds

An exchange-traded fund ("ETF") is a fund with units or shares traded on a stock exchange that tracks an underlying index. ETFs provide a relatively low cost, simple and tax efficient way of accessing liquidity pools for a wide range of stock markets. The majority of ETFs are designed to track an underlying index, which allows an investor to gain exposure to a particular sector or hedge their position in a basket of securities without having to purchase the underlying assets. Investors trade units or securities in an ETF on stock exchanges in the same way as they trade securities in companies. With the development of *Shari'a*-compliant versions of indices and sub-indices, ETF providers are targeting Islamic markets and ETFs are being launched to track both *Shari'a*-compliant equity and *sukuk* indices.

6.4 Mezzanine financing funds

Mezzanine financing funds enter into *murabaha* transactions to provide financing to companies. The *murabaha* financing provides an equity-like return for the fund and may be supplemented by a *wa'ad* to provide the fund with the option to convert the financing into equity in the company under certain circumstances. As the financier in a *murabaha* transaction may only hold title to the asset for a brief period of time, *murabaha* funds do not hold assets. As a result mezzanine financing funds are typically close-ended funds and are not traded on a secondary market.

6.5 Commodity funds

Islamic commodity funds purchase commodities (other than those considered *haram*, such as pork or wine, or those considered currencies, such as gold and silver) with the purpose of resale at a later date to generate a profit. The commodity in question must be actually or constructively owned by the fund (i.e., the risk of the commodity must have passed to the fund) prior to resale and short-selling of commodities is not permitted. Future contracts relating to commodities are usually entered into on the basis of *salam* and *istisna'a* contracts.

6.6 REITs

An Islamic real estate investment trust Real Estate Investment Trust ("REIT") is a listed fund that invests in income producing properties with tenants that engage in permissible activities under *Shari'a*. It is important to consider what tenant activities are permissible and the position where tenants conduct mixed *Shari'a* and non-*Shari'a*-compliant activities. In Malaysia, guidance provides that where tenants conduct mixed activities, the fund manager must ascertain and then aggregate the total amount of non-*Shari'a*-compliant activities of the tenants. Where non-*Shari'a*-compliant rental income exceeds 20% of total turnover, the investment will not be considered sufficiently *Shari'a*-compliant for an Islamic REIT. Furthermore, an Islamic REIT cannot hold an investment where all of the tenants conduct a small percentage of non-*Shari'a* activities, notwithstanding that the aggregate amount of non-*Shari'a*-compliant activity is less than 20% of total turnover.

6.7 Real estate funds

Shari'a-compliant real estate funds (other than REITs) may take several forms. The form ultimately utilised by a fund manager will be determined by a number of factors, including whether conventional leverage is necessary to acquire the property, the nature of the activities carried out by tenants of the property, whether the property is in existence or under construction and whether the fund is acquiring the property for capital gain on sale or for rental income.

The main challenge for a *Shari'a*-compliant real estate fund is the need to use conventional leverage when there is no Islamic financing available within certain markets. Where conventional leverage is necessary, it is usual for a fund to employ a bifurcated structure (subject to local tax issues), whereby an orphan company will be incorporated to enter into the conventional financing with an *ijara-wa-iqtina* entered into with the fund to allow the fund to enjoy the economic benefits of the property.

A *Shari'a*-compliant real estate fund also must consider the business of the tenants of any property acquired by the fund for long-term rental income. If the property is owned by an orphan vehicle as part of a bifurcated structure as part of a strategy of generating capital gains, it is possible for the orphan vehicle to sell the property such that the fund never receives any *haram* income. The level of scrutiny applied will be determined by the *Shari'a* supervisory board, but it is likely that any tenant involved in solely *haram* activity that represents over 5% to 10% of the aggregate rental income will not be acceptable. The analysis is more subjective where a tenant is involved in a business that may lead to a certain level of *haram* income, such as a conventional hotel, and it may be possible in such circumstances to apply *Shari'a* screening criteria to the tenants in consultation with the *Shari'a* supervisory board. The tenancy agreements and any lease arrangements will also need to be drafted in a *Shari'a*-compliant manner.

Additional structuring challenges arise where the target property is under construction or renovation. If the fund acquires the land for construction or property for renovation and finances the construction or renovation solely with equity, then there are no additional issues to be considered (other than ensuring that any contracts for the construction or renovation) are *Shari'a*-compliant. If financing is required in respect of a renovation, certain existing areas of the property may be able to be used for financing (e.g., pursuant to a sale and leaseback *ijara*), such that the structuring may be relatively simple. If financing is required by the fund for construction on bare land or the value of the existing property on a renovation is insufficient, the structure will likely be a more complex *istisna'a* arrangement with a forward lease element, whereby the fund would be appointed by the Islamic bank to construct the property on its behalf, deliver the property on completion and then lease the property back until the financing has been repaid. Other considerations, such as *Shari'a*-compliant insurance solutions (i.e. *takaful*), are also important issues to resolve.

6.8 Private equity funds

Shari'a-compliant private equity funds operate in much the same way as conventional private equity funds. Due to their investments in equity and risk sharing between investors and the manager, traditional private equity funds fit nicely within the *Shari'a* paradigm.

The standard management structure of a private equity fund is permissible under *Shari'a* principles. The management fee is considered an agency arrangement (where the fee is a fixed amount or a percentage of capital commitments or net asset value) and the carried interest or performance fee is viewed as a *mudaraba* agreement (a silent partnership where one party provides capital and the other party provides expertise and management in return for a share of the profit). While the basic documentation for a *Shari'a*-compliant private equity fund is similar to that of a conventional fund, certain terms, such as the equalisation mechanism for investors admitted after the first closing and the charging of interest on amounts due by defaulting investors, must be revisited in the context of *Shari'a*.

A *Shari'a*-compliant private equity fund may only finance the acquisition of a target company with *Shari'a*-compliant financing instruments. In addition, the leverage of the target company itself is important. If a *Shari'a*-compliant private equity fund purchases a controlling stake in a company with conventional leverage, certain *Shari'a* scholars permit the fund within the initial three years of ownership to either refinance the target company's debt with *Shari'a*-compliant financing or repay it. Alternatively, the *Shari'a*-compliant private equity fund may be able to retain limited conventional leverage at a portfolio company, provided that it does not exceed 33% of the total capital of the portfolio company. In such circumstances, the conventional debt of the target company may need to be reduced to meet the 33% threshold. This may be challenging and making companies involved in certain highly leveraged industries impossible to acquire.

The activities of the target company also need to be *Shari'a*-compliant. The amount of the target company being acquired is relevant for this analysis. If the target company will be completely owned by the *Shari'a*-compliant private equity fund or such fund will acquire a controlling stake in the target company, the expectation is that the company's activities would need to be completely *Shari'a*-compliant. If a minority stake is acquired in the target company, it may be possible to apply the *Shari'a* screening criteria to the activities of the target company.

7. Outlook

Although the Islamic funds industry has grown rapidly, it has not yet achieved its full potential. *Shari'a*-compliant funds still comprise only a small portion of the global funds industry. As population demographics in Muslim countries shift and encourage further savings, the demand for Islamic funds will continue to grow exponentially.

Historically, Islamic funds have tended to focus on real estate and equities, but these asset classes were badly hit by the economic downturn post-2008. While *Shari'a*-compliant real estate and equities funds continue to be a significant part of the Islamic funds market, investors now seek to invest in more diverse asset classes. As the Islamic funds offering continues to diversify, it is imperative that practitioners, including *Shari'a* scholars, support this trend by creating new and innovative structures to enable investors to access a wider range of Islamic funds.

CHAPTER 10

Islamic Derivatives

1. Introduction and context

A nascent but rapidly developing market for Islamic derivatives has emerged in the past decade, though not unsurprisingly, not without its challenges. Conservative Shari'ah scholars and some commentators in majority Muslim states unfamiliar with the increasing sophistication of international capital markets have suggested that such instruments may fall foul of the basic tenets of Shari'ah[1].

Furthermore, the trading in derivatives instruments has attracted much controversy in the debate[2] to explain the reasons behind the 2008 financial crisis[3], with many casual observers tainting an entire product suite as nebulous without appreciating the crucial role that derivatives play in maintaining efficient financial markets.

In this context of heightened scrutiny, it is more essential than ever to understand how Islamic derivatives contracts offer genuine Shari'ah compliant solutions to the increasingly complex needs of Islamic institutions to effectively manage their risk and maintain liquidity.

In this chapter, we will explore what Islamic derivatives are, how they are shaped by the differences in scholastic opinion that have led to an adoption of variant structures within the broad product groups, the key forms of traditional Islamic financial transactions that are embedded within Islamic derivatives for Shari'ah compliance purposes before turning our attention to the mechanics of the two most commonly traded Islamic derivatives products, Profit Rate Swaps and FX Forward transactions. Finally we will look at how these transactions are documented and discuss developments towards a documentation standard that will shape this product area for years to come.

2. Islamic derivatives – a basic overview

A financial derivative is an instrument whose value is derived from the performance of an underlying asset-examples of reference assets include commodities, currency exchange rates, interest rates, bonds, loans, indices and shares. In principle, there is no reason to limit derivatives contracts merely to these asset classes, which leaves open the possibility of further innovation in the future.

The regularity with which financial derivatives instruments are traded is revealed by a recent estimate that the total outstanding notional of over-the-counter derivatives contracts now exceeds USD 600 trillion[4].

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1 Kamali, M.H., Prospects for an Islamic Derivatives Market in Malaysia, Thunderbird International Business Review, Vol. 41 (4/5) 523-540 (July-October 1999). Conservative scholars have been reticent to conclude that derivatives do not constitute either: i) Riba (as the payment of interest rate is essential to the operation of an IRS), ii) Gharar (as to the uncertainty of a future floating interest rate in an IRS) or iii) Maisir (if derivatives contracts are not entered into solely for hedging purposes)

2 Jobst, Andreas A and Sole, Juan, IMF Working Paper, Monetary and Capital Markets Department, Operative Principles of Islamic Derivatives - Towards a Coherent Theory

3 Note also the G20 Summit in Pittsburgh in 2009, where the participants committed to key principles and timelines for derivatives reform

4 http://www.bis.org/publ/otc_hy1305.pdf

Islamic derivatives form a subset of each of the above-listed asset classes, in as much as they produce an economic effect similar to that of their conventional equivalents, whilst still adhering, both in form and substance, to the precepts of Shari'ah.

3. Scholastic interpretation – regional variations

To properly understand the landscape of Islamic derivatives, it is crucial to contextualise the diversity of scholastic interpretation in its geographical and historical setting.

Shari'ah is not a homogenous system of law, but instead represents law derived from Islam's two principle sources: *Quran* and *Ahadith*. These sources contain, amongst other things, ethical injunctions enjoining Muslims to desist from entering into transactions that produce unjust enrichment without adequate risk sharing, but are not otherwise prescriptive.

Conceptually, Islam permits the juristic interpretation of divine revelation (*Ijtihad*) where it is not otherwise evident and broadly, what is not proscribed may be permitted so long as in the opinion of a jurist, none of Islam's fundamental tenets are violated.

Over the centuries, the four main Sunni schools of thought (*Madhabs*) have developed their body of Islamic jurisprudence. In isolation, each *Madhab* represents an expression of the diversity in thought across a particular region, noting the social, political and economic views of its population. Together, the *Madhabs* demonstrate the vast spectrum of views that exist across an Islamic world that spans from Morocco to Indonesia.

In their true context, *fatwas* illustrate the plurality and diversity of Islamic jurisprudence and may be likened to common law judicial interpretation of precedent. It is as possible to have *fatwas* that express diametrically opposed opinions on certain Islamic derivatives structures, as it is to have compelling dissenting opinions in common law judgments.

Given this plethora of possibilities, Islamic derivatives are themselves not yet a standardised set of products, nor are they all governed by uniform documentation. The greatest challenge facing this fast developing area of Islamic finance is to secure a consensus fatwa on each of the main types of Shari'ah compliant transaction in a documentation format that is broadly acceptable to scholars representing each of i) the main *Madhabs* and ii) the main Islamic finance jurisdictions.

4. Foundations – traditional Islamic commercial transactions explored

Islamic derivatives structures commonly embed well-established forms of Islamic transaction as an underlying mechanism to achieve Shari'ah compliance whilst producing an economically equivalent effect to conventional derivatives transactions. We explore the most commonly used traditional Islamic transactions that form the basis of Islamic derivatives, below.

4.1 Murabaha (“cost-plus” sale transaction)

This is the most frequently featured underlying transaction used in Islamic derivatives products. A Murabaha involves a purchase and on-sale of a commodity “for a price at which the vendor has purchased it, with the addition of a stated profit known to both the vendor and the purchaser”[5]. The knowledge of the profit amount, at the point of sale, distinguishes a Murabaha from a Musawama, where in the latter, the profit amount is not known to the purchaser.

The payment for a Murabaha typically occurs on a deferred basis, enabling those structuring an Islamic derivatives transaction to match the cash flows to meet their needs.

4.2 Wa’ad

A wa’ad is a unilateral undertaking made by a promisor for the benefit of a promisee and has been the subject of much debate. Opponents suggest that it is merely morally and not legally binding as it lacks consideration and amounts simply to a “gratuitous gift”[6]. Proponents, including several respected contemporary jurists, suggest that this form of contract has been accepted since classical times and they deal with the lack of consideration by ensuring that a wa’ad is executed as a deed under English law.

Wa’ads are most often used as a form to document Murabaha transactions – in many cases, parties will execute two unilateral wa’ads that are equal and opposite, so that each party sets out its obligations under an undertaking in favour of its counterparty. The dual wa’ad structure for Murabaha transactions is often referred to as a Murabaha and Reverse Murabaha arrangement.

4.3 Bai Salaam

Bai Salaam or Bay’ al-Salaam is an advance sale contract with a deferred payment obligation, where the “seller undertakes to supply some specific goods to the buyer at a future date in exchange of an advanced price fully paid at spot”[7]. It represents a close Shari’ah equivalent to a forward contract, but the notable difference is that the “full price is payable at the time of the contract”[8]. Bai Salaam is also a notable exception to the general prohibition of forward purchase contracts under Shari’ah, which makes this a useful tool in modern Islamic finance as it can be used to mitigate the risk of movements in foreign exchange rates.

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5 Saleh, N., Unlawful Gain and Legitimate Profit in Islamic Law, pg. 117.

6 Barzilai, D., The Use of Waad in Islamic Finance Structures, www.islamisfinancenews.com, 17 July 2009

7 Usmani, M.T. and Obaidullah, M., www.LearnIslamicFinance.com

8 Iqbal, Z and Mirakhor, A., An Introduction to Islamic Finance – Theory and Practice, (2011), Second Edition

4.4 Arbun

Arbun, literally meaning an “earnest money contract”[9], is a form of conditional sale where the buyer pays a percentage of the purchase price in advance (effectively a deposit). If the purchaser concludes the purchase, the deposit amount is deducted, so the purchaser merely pays the balance. If the purchaser does not conclude the purchase, the deposit amount is forfeited.

An Arbun, then, is broadly similar to a call option, although it is noteworthy that in a conventional call option, the premium for the option and the purchase price are distinct. The Arbun structure is not without critics, who argue that the structure i) violates the principle of not conjoining “gratuitous contracts with onerous ones”, ii) unjustly enriches the seller and iii) requires no time limit on the option[10].

However, from classical times, the Hanbali *Madhab* has recognised Arbun contracts and more recently, so too has the OIC Academy, on the condition that the Arbun is time limited[11].

4.5 Rahn

Rahn is best described as a pledge typically made by a borrower granting security to its lender as collateral for non-fulfilment of its financial obligations[12]. To the extent that the pledgor is unable to make its payment, Iqbal and Mirakhor suggest that the pledgee is able to recover the value of the pledged property to discharge the payment obligation. Even if scholars opining on Islamic derivatives structures come to a consensus on Rahn as a mechanism to secure the payment obligations of derivatives counterparties, it is still a matter for courts in the relevant jurisdiction.

5. Islamic derivatives contracts

5.1 Profit Rate Swaps

A Profit Rate Swap (“PRS”) is structured as a sequence of murabaha transactions that can be potentially exercised on any exercise date by the in-the-money party. This mechanism features two principal cash flows:

(1) the market price paid by the purchaser to purchase the commodity from broker (the “Purchase Price”); and

(2) the market price paid by the client to the purchaser plus or minus an agreed profit amount (the “Sale Price”).

This second element is derived from two reference rates and enables the payment of a cash flow that produces the same net economic effect as a conventional derivatives transaction.

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[9] Vogel, F.E. and Hayes, S.L., Islamic Law and Finance: Religion, Risk and Return, (1998), pgs 156.
[10] Ibid, pg. 157
[11] Eighth Session, (1994), Fiqh Academy Journal, 1:794
[12] Iqbal, Z and Mirakhor, A., An Introduction to Islamic Finance – Theory and Practice, (2011), Second Edition

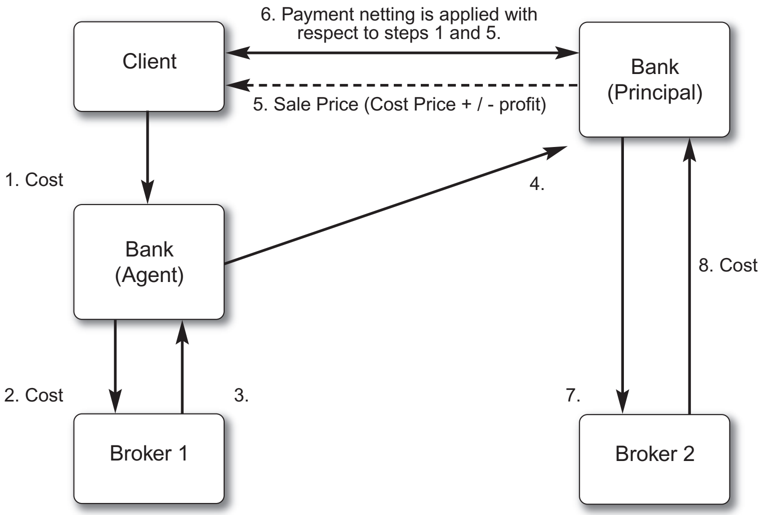
Most commonly, the PRS mechanism is used as an Islamic finance alternative to an Interest Rate Swap ("IRS") although it is also increasingly being used to offer Shari'ah compliant cross-currency swaps. PRSs are often documented by two unilateral Wa'ads, which are equal and opposite, so that on any exercise date, only one Wa'ad is capable of being exercised.

Where a PRS is offered as a Shari'ah compliant equivalent to an IRS, the reference rates are typically a Floating Rate and a Fixed Rate, which reflects the genuine need of Islamic institutions to manage any mismatches in their payment obligations under financing arrangements.

Under a conventional IRS, when a counterparty wishes to swap out a Fixed Rate into a Floating Rate, it is done by a periodic exchange of cash flows. However, in a PRS, this occurs instead on a net-basis with only the out-of-the-money party making a payment. Parties determine which is in the money and which is out-of-the-money based on the reference rates and other terms agreed at the time of entering into the contract.

Properly understood, this is a derivative transaction documented as a series of options that uses a Murabaha to generate a net cash flow economically equivalent to that of a conventional financial derivative.

Diagram 1. Murabaha mechanism for Profit Rate Swaps



Under Murabaha transactions, the Bank often acts in two capacities – as agent for the client to purchase the commodity ("Bank Agent) and as principal counterparty to the client in the PRS ("Bank Principal").

The mechanism works as follows (*numbers in the section below correspond to the numbers set out in the diagram on the previous page*):

1. Contractually, the Client purchases commodities (via Bank Agent) from the market and sells such commodities to a Bank Principal. In practice, it is the Bank Agent that actually purchases the commodities on behalf of the Client for a specified price (the "Cost Price"). As a result, an obligation arises on the Client to pay the Bank the Cost Price. Contractual payment netting may be applied to this payment (please see point 6 below).

2. The Bank Agent will purchase commodities from Broker 1 for the Cost Price. Please see points 7 & 8 below for further details as to these arrangements.

3. Described in point 2 above.

4. To fulfil its agreement to sell commodities to the Bank Principal, the Client has authorised the Bank Agent to deliver commodities to the Bank Principal.

5. The Bank Principal has undertaken to pay for the commodities. The price payable by the Bank Principal will be determined in accordance with the provisions of the transaction documents, being an aggregate of the Cost Price plus or minus a pre-determined profit (the "Sale Price"). Contractual payment netting may be applied to this payment (please see point 6 below).

6. The parties have agreed to provide for contractual payment netting (enforceable under English law when the parties are all solvent) between (i) the Cost Price owing by the Client to the Bank Agent (as outlined in point 1 above) and (ii) the Sale Price owing by the Bank Principal to the Client (as outlined in point 5 above). If:

   (a) the Sale Price is greater than the Cost Price, the Bank shall pay the net difference to the Client; or

   (b) the Cost Price is greater than the Sale Price, the Client shall pay the net difference to the Bank.

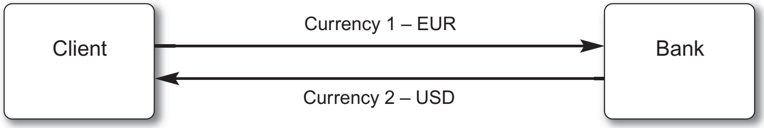
7. Upon receipt of the commodities, the Bank Principal will on-sell the commodities to another broker (Broker 2) and will receive the Cost Price for the commodities. The Bank may take steps to minimise its exposure to such brokers.

8. Described in point 7 above.

5.2 FX forward contracts

Typically documented using a wa'ad, FX forward contracts often do not use a Murabaha as it is considered sufficient that there is a sale of one currency in exchange for the purchase of another currency, provided that the transaction is entered into for genuine hedging purposes. The structure works as follows:

Diagram 2. FX Forwards / Options



1. Client undertakes to purchase Currency 2 from the Bank at an agreed rate, on an agreed date in the future;

2. The Bank does not provide an undertaking to the Client, but merely acknowledges receipt of the undertaking provided by the Client;

3. As the Bank is the beneficiary of an undertaking, it is able to decide at the future date whether to proceed with the currency exchange (it would only do so if it were in the money). The Bank will typically pay a premium for its ability to exercise.

6. A move towards document standardisation: the ISDA / IIFM Tahawwut Master Agreement

Currently, the majority of Islamic derivatives transactions are documented under bespoke arrangements, much like conventional derivatives were in the 1980s. Most Banks (Islamic or otherwise) have developed their own forms and prefer to use these whenever possible.

Encouragingly however, the Tahawwut Master Agreement (TMA) published by the International Swaps and Derivatives Association, Inc. (ISDA) and the International Islamic Financial Market (IIFM) in 2010 represents the first credible attempt at producing a document that may ultimately become a market wide, broadly adopted standard master agreement. The clear motivation for market participants to use a uniform standard that meets their needs is that it minimises legal and commercial risk, whilst simultaneously it reduces the burden of time-consuming analysis and negotiation. The publication by ISDA of its 1992 Master Agreement for documenting conventional derivatives transactions provided exactly this bedrock of certainty, which resulted in an exponential increase in liquidity. Market participants were at last satisfied that transactions they entered into with one counterparty were broadly fungible with transactions they entered into with other counterparties using this form of master agreement.

Until recently, the adoption of the TMA has been hard to gauge, with little anecdotal evidence to suggest a universal acceptance. However, the decision by the Saudi Arabian Monetary Authority (SAMA) in 2012 that all Saudi Arabian entities entering into Islamic derivatives transactions should use the TMA, may lead to a paradigm shift. Whilst the edict applies only to Saudi Arabian banks and clients trading amongst themselves, it is not hard to imagine Saudi Arabian counterparties preferring to use the TMA with all of their counterparties. This, in turn, may lead to the wider adoption required to take users of the TMA beyond the point of critical mass, where the TMA may truly be said to be the market standard for documenting Islamic derivatives.

The decision by SAMA, coupled with the publication of an ISDA opinion on the enforceability of netting arrangements in the TMA under English law[13] should provide key momentum to more widespread usage of the TMA, the ultimate corollary of which can only be greater liquidity and cheaper funding.

7. The ISDA / IIFM Tahawwut Master Agreement – demystified

The Tahawwut (Hedging) Master Agreement is intended for transactions entered into solely for hedging risks and cannot be used to govern speculative transactions. The TMA introduces the concept of Transactions and Designated Future Transactions, namely transactions that are capable of being documented immediately[14] and those that may be entered into in the future[15].

As an example, the two distinct elements of a PRS documented under the TMA are treated separately: the first Murabaha and any subsequent Murabaha entered into, as part of the PRS constitute Transactions, whilst any future Murabahas not yet entered into constitute Designated Future Transactions.

Designated Future Transactions that have been entered into become Transactions and the agreement relating to a Designated Future Transaction constitutes a DFT Terms Agreement[16].

Whilst the Shari'ah Advisory Panel of the IIFM has approved the form of the TMA, the approval does not extend to Transactions or DFT Terms Agreements, which puts the duty of ensuring Shari'ah compliance on parties to whom it is relevant.[17]

The TMA retains key concepts from the 2002 ISDA Master Agreement, notably:

(i) the single agreement concept, where the TMA, Confirmations and DFT Terms confirmations form a single agreement,

(ii) transaction netting and

(iii) close-out.

7.1 Early Termination following an Event of Default-Netting and Close-out mechanics

Following the designation of an Event of Default, the non-defaulting party has the right to designate an Early Termination Date. In the 2002 ISDA Master Agreement, an Early Termination Amount, in respect of the net sum owed by the defaulting party to the non-defaulting party (expressed as either a positive or negative number) is owed in respect of all transactions governed by such Master Agreement.

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13 Published by ISDA on 5 December 2013
14 For instance, a Murabaha transaction
15 For instance, a Musawama transaction documented by way of a wa'ad, for the purposes of close-out
16 A wa'ad is an example of a DFT Terms Agreement
17 The TMA can be seen as the template by which derivatives transactions can be documented, but the responsibility of structuring transactions in a Shari'ah compliant manner remains on parties entering into such transactions

The situation is considerably different under the TMA and reflects the need to ensure that the mechanism to generate any accelerated payments is Shari'ah compliant. Section 2 (c) provides for the netting of multiple Transactions but crucially, because of the distinction in the TMA between Transactions and Designated Future Transactions, it does not allow for the netting of payments across all Transactions and all Designated Future Transactions. Instead, the TMA creates two net amounts owing: i) a net amount in respect of all Fully Delivered Terminated Transactions[18] and ii) a net amount in respect of all Designated Future Transactions and all Non-Fully Delivered Terminated Transactions[19].

In order to facilitate the payout of each of these net amounts, under Section 2 (e) each party provides a wa'ad to enter into a Musawama transaction. As noted in Section 11.4 above, a Musawama is akin to a Murabaha transaction save that the purchaser is not aware of the profit amount – this is especially pertinent here because the profit amount in this Musawama reflects the loss of the non-defaulting party and is therefore an amount the purchaser is not capable of knowing in advance.

Under Section 6 (f) (v) of the TMA, the Relevant Index Determining Party[20] has one calendar year to exercise the wa'ad issued in its favour. If once the wa'ad is exercised, the other party fails to enter into the above noted Musawama, this constitutes an Event of Default which results instead in a liquidated damages claim.

Although the one-year wa'ad exercise period is a significant departure from the provisions of the 2002 ISDA MA, Section 6 (h) (ii) (4) of the TMA provides that the in-the-money party may defer its obligation to potentially purchase commodities to match the date on which it receives the Early Termination Amount.

8. Conclusion – looking to the future

The development of market standard documentation based on *fatwas* that are widely accepted, which the Tahawwut Master Agreement potentially represents, is a significant positive step. However, the widespread adoption of this document and the much greater liquidity it could provide depends on how the Islamic derivatives market overcomes some of the challenges that we have discussed in this chapter.

Key amongst these is the need for local laws in jurisdictions where the demand for Islamic derivatives is most prevalent to recognise the legitimacy of derivatives transactions entered into for hedging purposes. In particular, the certainty provided by a consistent acceptance that derivatives transactions are not of themselves repugnant to the principles of Shari'ah must be made a priority by lawmakers and regulators. This, together with legislation that underpins the building blocks of derivatives transactions such as transaction netting, set-off and the recognition of financial collateral arrangements in and outside of insolvency are a pre-requisite for the long term sustained growth of an Islamic derivatives market.

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[18] A Fully Delivered Terminated Transaction is, with respect to any Early Termination Date, any Terminated Transaction under which all goods or assets falling to be delivered have been delivered, irrespective of whether any payments fall to be made

[19] A Non-Fully Delivered Terminated Transaction is, with respect to any Early Termination Date, any Terminated Transaction which is not a Fully Delivered Terminated Transaction

[20] This is a reference to the Non-Defaulting Party

Several Muslim states have taken welcome steps towards recognising derivatives in financial regulation, with Saudi Arabia being a prime example when SAMA delivered on some of Saudi Arabia's G20 commitments to implementing derivatives reform. The legal certainty that is required for the Islamic derivatives market to thrive can be achieved by ensuring that such financial regulations are part of a coherent and co-ordinated legal regime that prevents individual judges from setting aside derivatives arrangements on Shari'ah grounds. It is in this sphere that the OIC, GCC or another similarly empowered organisation could play a crucial role.

The potential for the growth of Islamic derivatives is demonstrated not only by the increasing sophistication of the Islamic finance market but by the broader range of participants needing hedges. The market may well have begun with businesses using simple FX forwards to hedge against currency depreciation and borrowers looking to hedge rates mismatches but with the advent of a fast growing corporate and sovereign Sukuk market, Shari'ah compliant funds and an increasing amount of infrastructure funded in a Shari'ah compliant manner, dynamic new participants can be expected to galvanise the growth of Islamic derivatives products.

Furthermore, given the level of liquidity provided by investors interested only in Shari'ah compliant products, brought into particular focus by the 2008 financial crisis, and given also how far Islamic derivatives have come in the past decade, there seems little reason to not be optimistic about the future for this range of products.

CHAPTER 11

Nakheel Sukuk Case Study

1. Nakheel PJSC ("Nakheel") established the Anka'a Sukuk Limited AED 8,500,000,000 sukuk programme on 24 August 2011 (the "Trade Creditor Sukuk"). Since this time, Nakheel has used the Trade Creditor Sukuk to discharge its debt obligations to six different groups of trade creditors through six separate, but fungible issuances of sukuk certificates. This case study examines how Nakheel used Islamic finance techniques to facilitate this ongoing restructuring of its debt.

1.1 The background

On 25 November 2009, the Government of Dubai announced that a newly created entity, the Dubai Financial Support Fund would support the restructuring of Dubai World and its direct and indirect subsidiaries (together, the "Dubai World Group"). One of the most famous members of the Dubai World Group, the real estate developer and creator of Palm Jumeirah, Nakheel had outstanding debt and trade creditor claims of in excess of US$20 billion at the time of this announcement.

With insufficient funds to repay its numerous trade creditors, Nakheel decided to return to the capital markets to help solve its debt problems. However, despite successfully repaying three outstanding *sukuk-al-ijara* deals on their respective maturity dates, the announcement of 25 November 2009 had the effect of knocking the confidence of many of Dubai's capital markets investors. As such, a typical capital markets sukuk issuance whereby Nakheel would sell sukuk certificates to investors in return for cash was unlikely to succeed. Instead, Nakheel designed a capital markets sukuk structure whereby the SPV issuer (the "Trustee") issued *Shari'a* compliant sukuk certificates to its trade creditors in exchange for the cancellation of their respective debt claims against Nakheel. The Trade Creditor Sukuk remains the only sukuk structure in the GCC whereby the consideration for the acquisition of sukuk certificates is the cancellation of debt claims.

2. Credit enhancement features of the trade creditor sukuk

For the Trade Creditor Sukuk to be successful, Nakheel's trade creditors had to be convinced that the Trade Creditor sukuk certificates were more attractive than a debt claim against the Nakheel. With underlying concerns existing regarding Nakheel's ability to successfully meet all of its payment obligations, the decision was made to integrate significant credit enhancement into the Trade Creditor Sukuk structure.

Whilst Nakheel had in the past issued sukuk certificates with the benefit of mortgage security, following the announcement on 25 November 2009, market commentators began to scrutinise these structures, whose sukuk certificates were still outstanding. In particular, there was a particular focus on the ability of sukuk investors to seek to enforce mortgages in the UAE, with doubts cast over the timing, process and efficacy of such an action.

As such, Nakheel was committed to ensuring that the Trade Creditor Sukuk structure removed any such uncertainty in respect of the use of mortgages in a UAE sukuk transaction. Since mortgages would not be used in the Trade Creditor Sukuk structure, Nakheel decided to make the Trade Creditor Sukuk a true "asset backed" instrument, as opposed to the more typical "asset based" instruments that had previously dominated the UAE sukuk market.

At the time the programme was established, typical *sukuk al ijara* transactions did not provide sukuk investors with recourse to the underlying assets of the structure. Whilst land would typically be sold to a trustee on the issue date, these sales were not “true sales”. Despite contractually owning the land sold to it, in a default scenario, the trustee would typically be prevented from selling the land to anyone other than the transaction obligor.

In contrast to these “asset based” sukuk transactions, under the terms of the Trade Creditor Sukuk, in a default scenario, the Trustee is free to sell the assets backing the structure to a third party, with any proceeds received being applied towards the repayment of the sukuk holders. Practically, this situation would only occur if Nakheel fails to pay the exercise price due under the purchase undertaking in full. In these circumstances, the sale of the sukuk assets to the third party would be effected by the Trustee’s Delegate on the instructions of the sukuk holders. The incorporation of this feature provides Nakheel’s trade creditors with a level of comfort greater than that provided by the mortgages in previous sukuk transactions. This level of comfort, combined with a profit rate of 10 per cent per annum on each sukuk certificate has resulted in trade creditor claims in excess of AED 4.3 billion being settled through the issuance of Trade Creditor Sukuk.

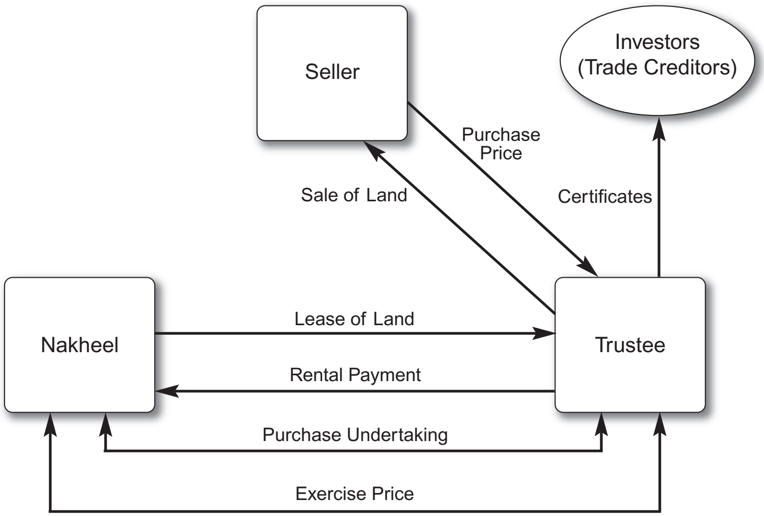
3. Flexibility in asset selection and issuance

Nakheel’s Trade Creditor Sukuk was designed to facilitate the restructuring of the company’s trade creditor debt. Due to the nature of the claims being made against Nakheel, in some cases, the claims require lengthy negotiation periods prior to their agreement. Due to the particular circumstances that surrounded these trade creditor claims, Nakheel required the flexibility to settle agreed claims with its trade creditors on an ongoing basis. The integration of “tap issuance” mechanics has provided Nakheel with this flexibility, with six tranches of Trade Creditor Sukuk having been issued to trade creditors as at 1 September 2013.

Whereas typical sukuk programmes allow multiple issuances of sukuk certificates through series issuances, the Trade Creditor Sukuk also provides Nakheel with the ability to make multiple “tap issuances” that form part of a single series, thereby providing fungiblity. The advantage of allowing fungible “tap issuances” is primarily seen from an investor perspective; as the aggregate size of the series increases with each “tap issuance”, the liquidity of the instrument also improves. As such, those trade creditors who received their sukuk certificates as part of the inaugural issuance on 25 August 2011 are fungible with trade creditors that received their sukuk certificates following the fifth “tap issuance” on 5 August 2013. This structural feature of the Trade Creditor Sukuk has resulted in a deeper secondary market for the trading of the sukuk certificates, thereby tightening the spreads for the benefit of the trade creditors.

Whilst fungibility amongst conventional bonds can also be achieved through the use of “tap issuances”, such a mechanism is rare in the Islamic market due to the structuring complexity created by *Shari’a* principals. A key principal of *Shari’a* compliant sukuk certificates is that each certificate must represent an undivided ownership interest in the assets of the sukuk. In a *sukuk al-ijara*, the sukuk assets are typically made up of land that is purchased a trustee, and then leased to the obligor. Whilst many sukuk programmes close the pool of sukuk assets on the issuance date of the sukuk certificates, the Trade Creditor Sukuk takes a different approach.

The diagram below is a simplified version of the Trade Creditor Sukuk structure.



On the issuance date of the first series of sukuk, the Trustee bought land from a seller, however the consideration for this purchase was not derived from subscription proceeds. Instead, the Trustee purchased the land backing the sukuk in consideration for the procurement of the cancellation of a corresponding amount of trade creditor debt claims. As such, the face value of each sukuk certificate issued to a trade creditor represents the size of the agreed debt claim of that trade creditor against Nakheel. Upon acquiring the land from the seller, the Trustee immediately leased the land back to Nakheel for rent, which funds the periodic profit payments due to the holders of the sukuk certificates.

Unlike other *sukuk-al-ijara* structures, the Trade Creditor Sukuk has allowed Nakheel to over-collateralise the pool of sukuk assets. This feature has enabled Nakheel to transfer parcels of land to the Trustee with a value greater than the sukuk certificates outstanding, thereby facilitating further “tap issuances” without the Trustee having to acquire new land. This has reduced the number of land sales and corresponding registrations that are often required for a land based *sukuk-al-ijara*.

4. The mechanics of a tap issuance

The first issuance under the Trade Creditor Sukuk took place on 25 August 2011. The issuance size was AED 3.8 billion, however the Trustee acquired land worth in excess of AED 5.5 billion.

Following the first issuance of sukuk, the Trustee owed Nakheel consideration of approximately AED 1.7 billion (representing the amount of over-collateralisation). This consideration (the "Deferred Purchase Price") can be reduced by the Trustee procuring the cancellation of further trade creditor debt claims in the future. The first "tap issuance" under the Trade Creditor Sukuk took place on 25 April 2012, when the Trustee issued sukuk certificates with an aggregate face value of AED 227.44 million. This issuance resulted in the Trustee's deferred payment obligation to Nakheel being reduced by an amount equal to the aggregate face amount of the sukuk certificates. The fungibility between the two different tranches of sukuk certificates was achieved through a mechanism whereby the existing sukuk holders agreed to share the sukuk assets with the holders of the new sukuk certificates issued pursuant to the "tap issuance". Should the sukuk certificates mature with Deferred Purchase Price still owing to Nakheel, that Deferred Purchase Price will be set-off against Nakheel's obligation to pay the exercise price to the Trustee under the purchase undertaking.

Should Nakheel wish to issue fungible sukuk certificates with a value greater than the Deferred Purchase Price, the Trustee will be obliged to purchase additional sukuk assets, such that the aggregate value of all sukuk certificates in the series is not more than the value of the land forming the basis of the sukuk assets. Following the sale of additional land to the Trustee, the sukuk trust will be extended, so that each sukuk certificate continues to represent a *pro rata* share in the sukuk assets of the series.

5. Further flexibility for Nakheel

As the Trade Creditor Sukuk was designed to assist Nakheel in the restructuring of its debt, it was very important that Nakheel retained the ability to move assets in and out of the sukuk structure during the life of the transaction. The Trade Creditor Sukuk grants Nakheel this flexibility through the incorporation of substitution mechanics.

As the Trade Creditor Sukuk is an asset backed instrument, it was necessary to ensure that any substitution of sukuk assets did not prejudice the sukuk holders in any way. As such, any substitution of land requires Nakheel to certify (based on independent valuations undertaken by professional experts) that the replacement land is at least equal in value to the existing land being replaced. The importance attached to the valuations enables the Trade Creditor Sukuk to maintain the integrity of an asset backed instrument.

Upon the establishment of the Trade Creditor Sukuk in August 2011, many of its structural features were unique in the market. In particular, it remains uncommon for sukuk programmes to facilitate tap issuances, over collateralisation, substitution (within an *ijara* structure) and have true "asset backed" status. The development of these features has enabled Nakheel to successfully restructure in excess of AED 4.3 billion of trade creditor debt claims over a period of almost two years. The fungibility of these sukuk certificates has enabled a deeper secondary market to develop, whereby trade creditors have been able to liquidate their holdings through the sale of their sukuk certificates to third parties. The presence of this secondary market is demonstrative of the confidence that investors have in the structure that was developed.

GLOSSARY

AAOIFI	Accounting and Auditing Organisation for Islamic Financial Institutions.
Amanah	a trust relationship in relation to an asset or item for which there is no liability or obligatory compensation in case of loss or damage.
Arboon	refers to a deposit advanced by a purchaser to a seller upon entering into a contract of sale in which the purchaser retains the option to either accept or reject the deal at the end of a specified period of time. If the sale is concluded on or before the specified date, the deposit will be counted as part of the purchase price; otherwise, if the buyer fails to execute the contract by the prescribed date, the deposit will be kept by the seller.
Bai	sale and purchase.
Bai al dayn	sale of debt.
Bai al inah	a loan disguised as a sale transaction. This is accomplished by buying back what one has sold for a lower price than that at which one originally sold it. This arrangement is prohibited by the majority of Shari'a scholars.
Bai al wafa	a sale with the right of redemption so that when the seller pays back the price of goods sold, the buyer returns the goods to the seller.
Bai sarf	a sale or exchange of currency.
Daman / kafala	guarantee or surety.
Fatwa	a certification of compliance with *Shari'a* precepts that is issued by a *Shari'a* scholar or supervisory board.
Fiqh	Islamic jurisprudence.
Gharar	uncertainty or a lack of specificity in a contract. Such ambiguity will render most contracts void under *Shari'a*.
Hadith	the written recordings of the sayings, doings and implicit approval or disapproval of the Prophet (pbuh).
Halal	permissible under *Shari'a*.
Haram	unlawful under *Shari'a*.

Hawala	literally meaning "transfer" and referring to an agreement by which a debtor is freed from a debt by another becoming responsible for that debt, the mechanism of Hawalah is used for settling accounts by book transfers without the need for physical transfer of cash and is currently used as a tool to execute foreign exchange transactions.
Ijara	lease of an asset for a specified period for consideration.
Ijara mawsufah	a concept whereby the lease of an asset may be agreed to commence on a future date
Ijara muntahia bittamleek (or ijarah-wa-iqtina'a)	a lease ending in the transfer of the ownership to the lessee but with the lease and the sale being separate and independent transactions.
Ijara thuma al-bai'	literally, lease followed by sale. The relevant asset is leased and at the end of the lease period the lessee will purchase the asset at an agreed price from the lessor.
Ijm'a	the consensus of jurists in Islamic jurisprudence.
Ijtihad	literally meaning effort or toil and used to refer to the process of legal reasoning or interpretation by jurists to formulate a ruling on a given issue on the basis of evidence found in Islamic sources.
Ikhtikar	monopoly or hoarding.
Ikhtilaf	disagreement or divergence of opinion.
Istislah	public welfare.
Istisna'a	a contract of sale of specified goods or assets to be manufactured, with an obligation on the manufacturer to deliver them upon completion.
Jahala	lack of knowledge or ambiguity in the terms of a contract, such that one or both of the contracting parties do not have full knowledge of the transaction. *Jahala* is one of the elements of *gharar* (see above) and will render a transaction void.
Kafala	see daman above.
Khiyar al-shart	an option to cancel a previously agreed sale within a specified time period.
Mal	assets, real goods or services.
Manfaa	usufruct or benefit derived from an asset.

Maslahah	public good or benefit.
Maysir	gambling or games of chance with the intention of making an unearned profit.
Mu'amalat	transactions; generally understood to be financial and contractual in nature.
Mudaraba	an investment relationship where one partner, the *rabb al-mal* (investor) contributes money and the other, the *mudarib* (manager), invests time and effort. The sharing of profits is agreed between the two parties, with any losses being borne by the investor, except in cases of managerial misconduct, negligence or violation of the agreed investment conditions.
Mudarib	the managing partner in a *mudaraba* (see above); generally, a contributor of labour rather than capital.
Mujtahid	legal expert or a jurist.
Murabaha	sale of goods with an agreed-upon profit mark-up on the cost. A *murabaha* transaction typically involves deferred payment terms, but such deferred payment is not one of the essential conditions of such transactions.
Musawama	a negotiated sale, ie, one in which each of its terms is negotiated by the parties to the sale. Thus, nearly all sales fall under this general category.
Musharaka	a form of partnership whereby each party contributes to the partnership capital in equal or varying degrees. Each of the parties becomes an owner of the capital and profits are shared on a pre-agreed basis. Losses, however, are shared in proportion to the contributed capital.
Musharaka mutaniqisah	a diminishing *musharaka* whereby one partner buys out, over a period of time, the ownership interest of another partner. This forms the basis for much of modern Islamic home finance.
Qabul	acceptance of contractual terms.
Qard hassan	a loan on which there is no interest.
Qiyas	analogical reasoning.
Quran	the recordings of the divine revelations delivered to humankind by the Prophet Mohammed (pbuh). The *Qur'an* is the primary source of Islamic jurisprudence.

Rab-al-maal	an investor or owner of capital in a *mudaraba* contract (see *mudaraba* above).
Rahn	mortgage or pledge.
Riba	an unlawful advantage leading to increase by way of excess or deferment, this term is most commonly used to refer to interest charged on a loan.
Salam	a contract for the purchase of a commodity for deferred delivery in exchange for immediate payment according to specified conditions.
Shari'a	often referred to as Islamic law and refers to the rulings contained in and derived from The *Quran* and the *Sunnah*. These cover every action performed by an individual or a society.
Shart	stipulation (in a contract).
Shirkah	a contract between two or more persons who launch a business or financial enterprise to make profits and may include both *musharaka* and *mudaraba*.
Shirkatul akd	a sub-category of *shirkah* in which partnership is brought about by means of a contract. Such a partnership may further be categorised as limited or unlimited.
Shirkatul milk	a sub-category of *shirkah* in which partnership is brought about by means of mutual ownership, as a result of purchase, inheritance, gift, bequest, or commingling of fungible assets.
Shura	consultation.
SPV	special purpose vehicle.
Sukuk	often referred to as Islamic bonds, *sukuk* (singular *"saqq*") are certificates evidencing an undivided ownership interest in an asset or group of assets.
Sunnah	the way of the Prophet Mohammed (pbuh), including his saying, deeds, approvals or disapprovals as preserved in the *hadith*.
Tabarru	a voluntary donation or contribution. The presence of *tabarru* makes an insurance transaction (see *takaful*) permissible and compliant with *Shari'a*.

Takaful	a *Shari'a*-compliant system of insurance in which the participants donate part or all of their contributions, which are used to pay claims for damages suffered by some of the participants. The company's role is restricted to managing the insurance operations and investing the insurance contributions.
Tasarruf	disposal, or the power of disposal in financial matters.
Tawarruq	the purchase of goods for deferred payment and their subsequent sale for immediate payment to a buyer other than original seller. This has become the most common technique for the provision of *Shari'a* compliant bank financings.
Ulema (plural of alim)	*Shari'a* scholars or jurists.
Ummah	Used to refer to the worldwide community of Muslims.
Wakala	agency; an agency contract, which may include in its terms a fee for the agent.
Wakil	an agent under a *wakala* arrangement.
Zakat	literally blessing or purification, *zakat* usually refers to an obligatory contribution or tax which is prescribed by Islam on all Muslims having wealth above a prescribed limit at a rate fixed by the *Shari'a*, with such tax earmarked to help the poor and needy.

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