

DEMYSTIFYING ISLAMIC FINANCE: WHAT IT MEANS AND HOW IT CAN CONTRIBUTE TO STIMULATING THE GLOBAL ECONOMY¹

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INTRODUCTION

TURMOIL IN GLOBAL FINANCIAL MARKETS has accentuated the role that Islamic investment may play in rejuvenating stagnant capital and credit markets. While further integration of Islamic financial institutions into the international economy is required, significant progress has been made in structuring and marketing Shari'a-compliant investment products within the existing frameworks of various legal systems. This proliferation of Islamic banking may usher in a better understanding of Islamic finance and the role it can play in the coming years.

The purpose of this article is to shed light on the basic principles of Islamic law, or Shari'a, through an elementary discussion of certain Shari'a-compliant legal structures commonly used in investment products and funding arrangements. It also discusses the need for a cooperative structuring effort required of bankers, Shari'a consultants, and lawyers to achieve the substantive objectives necessary for Shari'a-compliant investment structures.

This article also highlights how the recent growth in the Islamic banking industry has resulted in greater exposure to a variety of legal systems and compliance requirements. The integration of Shari'a-compliant investment products and Islamic financial institutions faces major challenges in many of these jurisdictions, particularly in the United States and the European Union.

STRUCTURING SHARI'A-COMPLIANT INVESTMENTS

In recent years, Shari'a-compliant investment vehicles have invested in assets and businesses in countries other than those customarily viewed as Muslim. Islamic investment vehicles have ranged from the relatively straight forward long-only equity funds to more challenging private equity and venture capital vehicles and, in some cases, short-only funds and limited structured products.

In doing so, Islamic structures have generally attempted to mirror structures familiar to western bankers and investors with respect to both the form



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the product takes and the underlying substantive investment objectives sought to be achieved for the investor. Despite such efforts, the fundamental principle of Islamic banking that profit and loss should be shared among the parties cannot be achieved in all conventional finance structures. Moreover Shari'a ethical restrictions limit the activities in which Islamic funds may be invested.

Deciding on an appropriate Shari'a-compliant investment structure requires an analysis of issues of both form and substance. The bankers and their legal advisors must consider aspects such as the structure of the relevant investment product, the investment objectives of the underlying products, regulatory compliance issues and marketability. The significance of form under Shari'a requires that certain timing and mechanical requirements must be observed for an investment structure to be declared Shari'a-compliant. It is imperative, for example, for an Islamic Ijara (Lease) fund to enter into, and in many respects, fully perform its obligations under the purchase agreement with respect to an asset before it can enter into the lease agreement with respect to that asset.

Role of Financial Institutions

From a Shari'a point of view, it is well established that almost any financial institution is permitted to offer Islamic investment products, unless that financial institution is prohibited for regulatory reasons from doing so,⁴ and a non-Islamic bank or a non-Muslim can engage in trading or investing in a Shari'a-compliant manner. A conventional financial institution in London or New York can, therefore, develop financial products which cater to the needs of its Muslim customers.

In some cases, the integration of Islamic finance and western regulation can be complex. While, typically, a separate department within an institution can develop and offer Shari'a-compliant products, some jurisdictions may require that Islamic banking licenses be independent from conventional licenses, thus creating two parallel systems: one Islamic and one conventional. Consequently, a discrepancy in regulation applicable to Islamic banks from those that apply to

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conventional or traditional banking institutions may arise, stemming primarily from the fundamental differences between the two industries.

Regardless of any perceived obstacles, western jurisdictions appear eager to allow Islamic finance to expand in their markets. For example, in a seminar on Islamic banking held in London in September 2002, Howard Davies, Chairman of the Financial Services Authority (FSA), emphasized the importance with which the FSA views Islamic banking and offered to work closely with the industry to ensure that the United Kingdom attracts financial institutions which specialize in Islamic banking, and cater to the needs of the Muslim community in the United Kingdom. However, he concluded with the following policy statement: “[The FSA] see[s] no objection of principle to the establishment of an Islamic bank in the UK. Indeed, [the FSA] would welcome a soundly financed and prudently managed Islamic financial institution in [the United Kingdom], which would be good for Muslim consumers, good for innovation and diversity in our markets, and good for London as an international financial center. But [the FAS has] to treat applications from Islamic institutions in the way it does those from other, conventional firms, to ensure that they can compete effectively, and in the long term, on a level playing field with conventional finance providers.”

This type of statement leads to various practical results. One result is that Islamic banks are subject to an additional layer of supervision by virtue of review by their Shari’a boards. While regulators do not assume the role of the arbiters of what constitutes a correct interpretation of Islamic law, they must enable detailed standards to be put in place and implemented to allow financial institutions to appoint experienced Shari’a advisors, while ensuring that any financial institution doing so remains sufficiently transparent both to satisfy the applicable laws of the particular jurisdiction and to provide its Shari’a advisors necessary access to conduct their review. This is clearly the case, for example, under the regulations applicable in Bahrain, the DIFC and Malaysia.

In structuring Islamic investment products, promoters and issuers must satisfy the demands of individual and institutional investors in the jurisdiction where they intend to offer such products. It follows

that promoters of Islamic funds and issuers of Islamic instruments should develop both a generalized understanding of Islamic law and a working knowledge of the regulatory system in force in the jurisdiction where the investment vehicle will be structured and should work with both legal and Shari’a advisors.

Role of Legal and Shari’a Advisors

In light of the dual regimes that may apply to Islamic finance products, structuring an Islamic product requires the early engagement of legal counsel and Shari’a advisors. Typically, non-Islamic financial institutions rely on recommendations made by their legal counsel in selecting Shari’a advisors on a product-by-product basis, while Islamic financial institutions have their own Shari’a supervisory boards to advise on transaction and provide Shari’a auditing or supervision.

Shari’a advisors represent differing schools of Islamic jurisprudence although many of them are knowledgeable in the teachings of the key schools. Care should be exercised in selecting a Shari’a adviser, as only a small number of Shari’a advisors combine an in-depth knowledge of Islamic law with a good understanding of and familiarity with conventional financial and economic concepts. Another factor to be taken into account in selecting a Shari’a adviser is the ability the institution’s representatives and legal advisors to communicate effectively with any potential Shari’a advisor. The mandate given by promoters of Islamic investment and finance instruments to Shari’a advisors includes assisting in the development of a suitable structure for the proposed investment product, reviewing documentation, issuing a Shari’a compliance certificate and providing on-going supervision, also known as a Shari’a audit, to ensure that the implementation of such structure is Shari’a-compliant.

Choosing a Jurisdiction

Whether a financial institution is structuring a conventional or Islamic investment fund, the local legal environment must be capable of accommodating the proposed structure as well as offering acceptable tax treatment. Some jurisdictions have proven to be extremely flexible in adapting to both conventional and Islamic structures, particularly Bahrain and Malaysia. In addition, the British Channel Islands and

the Cayman Islands continue to attract a growing number of Islamic funds and instruments.

A primary reason for the trend towards setting up Islamic funds in tax-friendly common law jurisdictions stems from their advanced trust systems which offer protection for the investors' beneficiary ownership over the assets of the fund. Legal concepts of beneficiary ownership becomes particularly important in the context of an issue of Islamic bonds (Sukuk), for example, where a special purpose vehicle is created to purchase certain assets and issues Sukuk that are backed-up by such assets. While some Shari'a recognized alternatives such as agency and custody declarations exist and have been utilised in some jurisdictions, arrangers and placement agents strongly prefer common law-based trust regulations while adapting the declaration of trust to comply with Shari'a.

Additionally, jurisdictions vary on their know-your-customer and other compliance requirements. A number of offshore jurisdictions have enacted and implemented the strictest compliance policies, such as Luxembourg and Dublin. Some Middle Eastern jurisdictions such as Bahrain and the DIFC have followed suit. If Islamic fund promoters and investors wish to continue to expand the availability of Shari'a-compliant investment products in these markets, the relevant compliance issues must be addressed.

In summary, structuring of Shari'a-compliant investments involves much more than the mere cloaking of a conventional fund with a Shari'a compliance stamp. Additionally, Shari'a-compliant investments are subject to the same, and occasionally higher, degree of compliance, risk and suitability analysis and scrutiny than conventional investment funds given Shari'a's emphasis on full and accurate disclosure.

EXAMPLES OF SHARI'A-COMPLIANT INVESTMENT STRUCTURES

Many financial industry professionals are today involved in the development of Shari'a-compliant alternatives to several the conventional investment vehicles available in western markets. Working together with experienced legal counsel and established Shari'a advisors, they have created Shari'a equivalents to a number of investment vehicles.

Long-only equity funds

In an Islamic long-only equity fund, amounts raised from investors are invested in shares of listed companies, provided that such companies have been declared to be Shari'a-compliant. In western jurisdictions, the companies in whose shares investment is

permitted are listed "Islamic" indices such as the Dow Jones Islamic Index, in the United States, or the FTSE Islamic Index, in the United Kingdom. Any companies listed on these, or similar, indices must first be declared Shari'a-compliant by the Shari'a advisers appointed by the relevant index. Otherwise, whether a company is suitable for investment under Shari'a will be verified by the Shari'a supervisory board appointed by a financial institution structuring the Islamic transaction. In either case, regular Shari'a auditing is usually conducted by specialised Shari'a advisers to ensure the fund's continued compliance with the requirements of Shari'a.

The investment manager of an Islamic long-only equity fund can act as a general partner (Modarab) under a Modaraba arrangement, an agent (Wakeel) under a Wakala arrangement or an investment manager pursuant to a contractual arrangement. The investment managers, Wakeels or Modarebs, as the case may be, usually adhere to pre-defined investment guidelines which set-out the industries in which the fund may invest and the financial ratios it must maintain. Regardless, the on-going Shari'a compliance of the fund should be audited regularly by a Shari'a supervisory board although external accounting firms also can be appointed to audit the fund's compliance with its investment guidelines.

Private Equity Funds

Shari'a compliance in the context of private equity funds can prove more complex, particularly in funds utilising leverage to purchase a controlling stake in a target company or which invest in leveraged target companies. An Islamic private equity fund must finance the acquisition of a target company through the utilization of Shari'a approved mechanisms. In addition, the leverage of the target itself is often relevant.

Different schools of Islamic jurisprudence have different views on the subject. Some Shari'a advisers are of the view that if an Islamic private equity fund were to purchase a controlling stake in a leveraged company, then such a fund would be given a fixed period of time, perhaps three years, to pay-off the target company's debt or convert it into Islamically acceptable debt. Another view prohibits any acquisition of a target company whose debt exceeds one third of its total capital.

In either case, the activities of the target company must be Shari'a-compliant. In addition, issues such as the nature of the debt (Islamic or non-Islamic) and the manner in which the total capital of the target company is calculated can be troublesome.

Sukuk

Often referred to as Islamic bonds, sukuk are essentially Islamic asset-backed securities. Linguistically a suk, is a note, with the term sukuk being the plural. The basic concept behind issuing Islamic sukuk, however, is for the holders of the Sukuk to share in the profits of large enterprises⁵. As such, a sukuk offering is backed by assets, where the underlying assets and the agreements entered into to acquire title or rights over such assets is compliant with Shari'a. Sukuk transactions can take a number of forms including an Ijara (sale-lease back) arrangement between the sukuk issuer and the counterparty, musharaka (partnership) arrangement between the issuer of the sukuk and the party seeking the financing or an arrangement where the issuer funds the counterparty's investment activities, such as a mudaraba (sweat equity) or wakala (agency). Payments made by the party seeking the funding should comply with Shari'a, and may take the form of rental payments or undertaking to purchase that the sukuk issuer had funded their acquisition at the outset.

While most of the sukuk issued to date have been backed by assets in Islamic jurisdictions such as Malaysia, Saudi Arabia, Bahrain, Kuwait and UAE, we are seeing a trend to utilizing such instruments in Islamic jurisdictions where Islamic banking is still at its infancy (e.g. Arab countries in the Levant (e.g. Jordan and Lebanon) and North Africa (e.g. Egypt and Tunisia), and in Western jurisdictions like the United States and the United Kingdom. For example, in the East Cameron Gas sukuk transaction, which constitutes the first-ever sukuk backed by oil and gas assets in America (as described in more detail below, the offering of the sukuk was structured to comply with United States regulations applicable to the offer, with the result being that the majority of the investors were not Islamic financial institutions⁶.

Ijara Funds

While often described as lease finance vehicles, Ijara funds differ from a lease in the conventional sense in substantive ways. In an Islamic Ijara Fund, the fund purchases the assets and on-leases them to the lessee. The agreed rent paid by the lessee to the fund, as lessor, is calculated such that an agreed profit element is built into the rent payment. An Ijara differs from a conventional lease in that Islamic law does not permit that a binding future sale or option be incorporated into the lease contract for the disposal of the residual value of the leased assets at the end of the lease term. Additionally, developing a floating rate

lease under Islamic law is more problematic than in the context of a conventional lease because Shari'a requires that a single rent apply throughout the life of the lease.

CONCLUSION

As briefly illustrated in this article, Islamic finance vehicles, while diverse and continually evolving, are subject to basic structural and ethical requirements. These requirements, in addition to appealing to a highly liquid group of potential investors, in many cases, act to apportion risk and reward evenly among the parties to a transaction. Consequently, Islamic finance may provide structurally sound alternatives to conventional investment vehicles and an avenue to previously untapped funding sources, both attractive attributes in a tight global economy. As the Islamic finance industry and western jurisdictions continue to adapt to each other, these attributes could position Islamic finance to play an important role in the current global economic environment and give an incentive to issuers and arrangers alike to assess how such finance instruments can be utilized to support their business and commercial needs⁷. ■

NOTES

- 1 Some sections in this article are based in part on articles published previously by the author.
- 2 LLB, highest honors, University of Jordan Faculty of Law; LLM, honors, George Washington University. Partner in the Dubai office of Vinson & Elkins, LLP, an international law firm. The authors practice focuses, among other things, on advising clients on structuring and documenting Shari'a-compliant finance and investment transactions.
- 3 The author wishes to thank Todd Crosby, an associate in Vinson&Elkins LLP's Dubai office for his valuable contribution and assistance in the preparation of this article.
- 4 Regulators in some jurisdictions, such as Bahrain, the Dubai International Financial Centre and the United Kingdom issue different licenses to Islamic banks from those issued to conventional banks. This is in attempt to accommodate the novel issues that carrying out investment banking activities entail.
- 5 Muhammed Taqi Usmani, Sukuk and their Contemporary Applications, www.failaka.com/downloads
- 6 For more information on the transaction, see Ayman H. A. Khaleq and Christopher F. Richardson, "New Horizons for Islamic Securities: Emerging Trends in Sukuk Offerings", *Chicago Journal of Interational Law*, Vol. 7 No. 2, Winter 2007
- 7 This article is intended for educational and informational purposes only and does not constitute legal advice or services. If legal advice is required, the services of a competent professional should be sought. These materials represent the views of and summaries by the author. They do not necessarily reflect the opinions or views of Vinson & Elkins LLP, or of any of its other attorneys or clients. They are not guaranteed to be correct, complete, or current, and they are not intended to imply or establish standards of care applicable to any attorney in any particular circumstance.

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