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Briefing note

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Introduction to Islamic finance

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$1.14 trillion, having grown by approximately 33% between 2010 and 2012. Despite the rapid growth, the global Islamic finance market only represents about 1% of the worldwide financial services industry. 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.

The techniques and structures developed for Islamic investments are based on traditional techniques and structures that have been available for centuries but which have evolved and been refined, within the parameters of Islamic jurisprudence, to accommodate modern financial institutions and modern banking.

This article provides an overview of the Islamic finance industry and seeks to identify the more common Islamic financing structures and demystify some of the terms.

Main Features of Islamic Banking

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* (the living tradition of the Prophet Mohammed (pbuh). 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 include:

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 something has been gained by chance rather than by productive effort. Of course this distinction presents practical difficulties. The distinction between general commercial speculation in genuine commercial trading and speculation regarded as gambling is not very clear. In each case the commercial substance of the transaction must be analysed to evaluate whether or not it is permissible under *Shari'a*.

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 English law.

Key Topics

- Main features of Islamic Financing
- Shari'a Board/Committee
- Islamic Financing Structure
- Legal and Practical Issues
- A Global Industry

Interest (*riba*)

Under *Shari'a*, money is regarded as having no intrinsic value and no time value and is seen merely as a means of exchange. Since, 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, the payment and receipt of interest (*riba*) under Islamic law is prohibited and any obligation to pay interest is considered void.

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 examining the intention and/or conduct of the parties, *Shari'a* requires absolute certainty on all fundamental terms on its face. Secondly, the *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.

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 and maintain an overall review of its financing methods and operations. 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. The reason for this, quite simply, is that there are not enough scholars to go around. The alignment of a single scholar to a number of institutions which compete in the same industry may of course create commercial sensitivities but the shortage of scholars, who are required not only to be knowledgeable in matters of *Shari'a* but also to have an understanding of modern banking, finance and economics, is a reflection of an industry which has grown rapidly within a very short period of time.

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 are as follows:

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.

Tawarruq/Reverse Murabaha

This product is one of the few methods whereby the customer will end up with cash. In general terms, 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 then 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 a cash amount 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 like 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 it would be expected to assume under a conventional loan facility. Under the 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 the customer risk. The *tawarruq* facility

therefore enables Islamic banks to provide funding for customers who require a cash sum to be advanced to them.

Ijara (lease)

This is Islamic financing's equivalent of leasing and may be seen as a hybrid between conventional operational and finance leases. Rental payments under an *ijara* will reflect an agreed profit element and comparisons with rentals on conventional leases (where interest considerations would often be relevant) can readily be made. 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*. Unlike a finance lease, the obligation to insure and undertake any major maintenance to the leased asset remains with the lessor. Further the lessee is only responsible for payment of rent whilst the use of the asset continues. So 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.

Istisna'a (construction financing)

An *Istisna'a* is used for the advance funding of major industrial projects or large items of equipment such as ships or aircraft where the financier funds the supplier, acquires title to the equipment on completion and immediately passes title to the purchaser on agreed deferred payment terms or leases the asset to the developer under an *ijara-wa-iktina*.

Bai salam (forward financing)

This technique may be used to provide working capital. Essentially *bai salam* financing is 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 when providing a pre-export facility.

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.

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.). Approximately US$84.4 billion of *sukuk* were issued in 2011 which represents an increase of 62% from the US$52 billion issued in 2010. 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.

Further information on *sukuk* is outlined in our "*Introduction to sukuk*" client briefing.

Musharaka (equity financing)

The financier and the investor provide financing for a project in agreed proportions in the form of either cash contributions or contributions in kind. In general, the financier and investor share equally in the profit and loss of the project in proportion to their initial investment. The party providing the management or technical expertise may charge a fee. A variation of this is the *diminishing musharaka* where the investment participation of the financier decreases gradually over time as its ownership interest is transferred to the investor.

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.

Legal and Practical Issues

Risks and Liabilities

The contracts and techniques used in Islamic financing, such as *ijara and Murabaha*, may give rise to additional risks and liabilities for the financier or for the transaction that need to be assessed and, if appropriate, mitigated. However, many of these arise in conventional financing structures, such as traditional leasing, and are not unique to Islamic finance. For example:

- ownership liability may be incurred if the financier owns an asset for a period before transferring it to the end-user, such as liability for death or injury or environmental damage. Although typically a financier would seek to ensure that it does not own the asset for any prolonged period of time so as to avoid this risk, this may not be avoidable in instances where the asset is to be leased by the financier to the end-user. Although the financier may seek insurance to protect itself, the insurance must ideally take the form of Islamic insurance (*takaful*) and not conventional insurance;
- tax liability e.g. do taxes arise on the acquisition or on-sale of an asset? What are the income and capital gains tax consequences for a financier? How can the transaction be made tax neutral?;
- warranties e.g. is the financier, as owner or seller of an asset, making any warranty (e.g. as to its title to the asset or the condition or usability of the asset) which it would want to disclaim?;
- effectively interposing a third party between a supplier and an end-user may give rise to issues e.g. can the end-user receive the benefit of a supplier's warranties?; and
- loss or destruction or delays in the production or construction of the asset may be an issue for the Islamic financier: if there is no 'deliverable' asset, can it claim any payments from the end-user? In other words, can it pass on the asset risk to its customer?

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 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.

A Global Industry

As Islamic finance continues to grow, many governments have taken, or are taking, steps to accommodate the asset based nature of Islamic financing to ensure equal treatment, particularly from a tax perspective, between Islamic and conventional forms of finance. Examples of jurisdictions that have introduced legislation targeting the Islamic finance industry are set out below.

United Kingdom

Traditionally, the United Kingdom took no steps to accommodate Islamic financing within its body of laws. This has changed significantly in the last decade as the government has sought to position London as a main international hub for Islamic finance.

The UK has now become the leading western centre for Islamic finance, with approximately £10 billion of reported assets held in Shari'a complaints funds. The United Kingdom's stated aim is to create a "*level playing field*" between Islamic and conventional finance through the passing of several pieces of legislation, including the provisions set out in Chapter 6 of Part 6 of the Corporation Tax Act 2009 (passed on 1 April 2009) and the Finance Act 2009 (passed on 21 July 2009). All of these legislative changes have helped reduce tax barriers which, in the past, have made Islamic products less tax efficient than their conventional counterparts.

The combined effects of the legislation are that Islamic financing arrangements (including *sukuk*) will be treated as 'loan relationships'. 'Loan relationships' are, broadly, loans to which a company is party and are, generally, taxed or relieved (under Part 5 of the Corporation Tax Act 2009) as income in accordance with their treatment in the company's accounts, assuming the company follows generally accepting accounting practice (as defined). As such, the return under the Islamic structure is treated as if it were interest payable under the relevant loan relationship. All references in the relevant legislation to a "*loan relationship*" are now stated to include references to "*alternative finance arrangement which captures Islamic products*".

France

On 25 February 2009, the French tax authorities published, in the Official Tax Bulletin, circulars 4 FE/09, 3 CA/09, 5 FP/09, 6 IDL/09 and 7 E/09 commenting on the tax treatment of *murabaha* and *sukuk*. Amongst other things, the circulars make it clear that, in the case of a *murabaha*, the assets acquired by the financier are generally not to be taken into account in the calculation of business tax, and, in the case of a *sukuk*, that a *sukuk* should be treated as a debt instrument for the purpose of corporate income tax calculations.

Further information on France and the tax treatment of *murabaha* and *sukuk* structures is outlined in our "*Islamic finance – French tax rules clarified*" Client Briefing.

Japan

Under the Banking Law of Japan, Japanese Banks are prohibited from purchasing assets (other than certain asset classes such as securities). As such, Japanese banks have historically been prohibited from entering into *Shari'a*-compliant structures. However, subsidiaries of Japanese banks have enjoyed a relatively wider scope of business and an amendment to the Japanese banking laws has provided such subsidiaries with the freedom to participate in the Islamic finance industry. The enactment of Article 17-3.2.(ii)-2 of the Amendment to the Ordinance on the Enforcement of Banking Law, which became effective on 12 December 2008, expressly provides that a subsidiary company of a Japanese bank (or bank holding company) which engages only in Financial Related Businesses (as defined in the Banking Law) or the securities business may also engage in Islamic finance transactions.

There have historically also been a number of other factors that have made it difficult to structure *Shari'a*-compliant financing structures in Japan, including the tax treatment of the distribution of profits to overseas Islamic investors. However, a recent amendment to the Japanese Asset Securitisation Law together with certain tax reforms which came into effect on 24 November 2011 have made investing in Japan in a *Shari'a*-compliant manner more attractive and have helped to level the playing field between conventional financing and Islamic financing for such investments in Japan.

Further information on Japan and the Islamic finance industry is outlined in our "*Islamic Finance – an opportunity for Japanese banks*" and "*Islamic Finance – Japanese law reforms*" Client Briefings.

United Arab Emirates

Many provisions of the Civil Code of the United Arab Emirates are founded in Islamic law rules and principles, and Islamic finance is no exception. The Civil Code describes many of the Islamic financing structures referred to above, including *murabaha* (article 506), *bai salam* (article 568), *musharaka* (article 654), *mudaraba* (article 693), *ijara* (article 742) and *Istisna'a* (article 872).

Concluding Remarks

The Islamic finance industry has grown exponentially over the last few years and Islamic structures are no longer specific to the Middle East or other traditional Islamic financial centres. This growth, which is expected to continue at its current rate, is only likely to be inhibited by flaws in the industry itself such as a failure to invest adequately in resources both in terms of regulation and personnel. It is therefore to be expected that other jurisdictions will enact legislation to provide a friendly environment for Islamic finance investments.

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NOTES:

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