Commercial and legal risk profiles of Islamic finance products when considering regulatory issues

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What are the main sources of the Shari‘ah?

- The Holy Qur‘an
  - The word of God revealed upon Prophet Muhammad (peace be upon him) through Angel Gabriel over a period of about 23 years (610-623 G.)
    - The Qur’an has 6236 Verses (sentences) in 114 Surahs (chapters) in 30 Juz’ (divisions)
    - Topics. Qur’an has injunctions on all aspects of human life, including topics such as forms of worship, finance, marriage, divorce, inheritance
- The Sunnah
  - A collection of Hadith, Ahadith (statements), fi’l, Af‘al (actions) taqrir (confirmations) and Qada (judgments) of Prophet Muhammad (PBUH)
    - Six major Sunni collections containing thousands of statements attributed to the Prophet
    - Four major Shi‘a sources of collections of the Prophet
Shari’ah Rules - Traditional Sources

- **Sunni Schools of Law**
  - **Hanafi** (Founder Imam Abu Hanifa - d. 767 G.)
    - Followers in India, Pakistan, Bangladesh, Afghanistan, Central Asia, Southern Russia, the Caucasus, parts of the Balkans, Iraq and Turkey
  - **Maliki** (Founder Imam Anas ibn Malik – d. 795)
    - Followers in most of Africa except lower Egypt, Zanzibar, Uganda and Horn of Africa
  - **Shafi’i** (Founded by Imam Muhammad ibn Idris ash-Shafi’i – d. 820)
    - Followers in Indonesia, Lower Egypt, Malaysia, Singapore, Somalia, Jordan, Lebanon, Syria, Kerala, Sri Lanka, Palestine, Uganda, Yemen and Kurds
  - **Hanbali** (Founded by Imam Ahmad ibn Hanbal – d. 855)
    - Followers in Saudi Arabia

Shari’ah Rules, Traditional Sources (C’td)

- **Shi’a Schools of Law**
  - 15% of the Muslim world population is Shi’a
  - Ithna ‘Ashari (The Twelvers) - 85% of all Shi’as
  - Ja’fari School of Law (founded by Imam Ja’far bin Muhammad al-Sadiq b. 720 G.)
    - Followers, majority in Iran, Azerbaijan, Iraq, Bahrain and minorities in other Muslim countries
  - Zaidi, followers of Imam Zaid ibn Ali (695-740 G.)
    - Followers in parts of Yemen
  - Ismailis, followers of Imam Isma’il ibn Ja’far (721-725)
    - Followers in part of Afghanistan, Pakistan, India, Uzbekistan, China and Saudi Arabia
Modern Sources of Shari’ah Rules

- National Supervisory Shari’ah Boards – e.g., Malaysia, Sudan, Pakistan. Located at Central Banks. Their decisions are binding.
- Shari’ah Supervisory Boards of Islamic Financial Institutions.
- Shari’ah Board of the Accounting and Auditing Organization of Islamic Financial Institutions (AAOIFI) in Bahrain
  - Most relevant body for Islamic finance. 19 members. A range of Standards
  - Resolutions are non-binding but very persuasive
- International Islamic Fiqh Academy, OIC, Jeddah.
- Islamic Fiqh Council, Muslim World League, Makkah.
- Islamic Financial Service Board (IFSB), Malaysia.

Is Islamic finance safer than conventional banking?

- The proposition: Shari’ah-compliant finance can be regarded as safer than conventional banking because of some of the fundamental Shari’ah principles on which it is based.
- The main Shari’ah principle: freedom of contract subject to certain restrictions which are based on a statement of the Prophet (pbuh):
  "Believers are bound by their agreement to accept a stipulation which forbids that which is forbidden and permits that which is permissible".
- The main limits or prohibitions can be classified into three categories – sinful industries, riba and gharar – but do any of these prohibitions make Islamic finance inherently safer?
Three main prohibitions

- Sinful activities include things like harmful drugs, alcohol, pornography, etc. The aim is to avoid activities which harm other persons. Clearly an ethical aim – but does it make Islamic finance safer in terms of economic risks?
- Riba (which covers interest) is also prohibited. Riba is seen as an instrument of unjust enrichment. Present if there is a return on funds when there is no risk sharing in a Shari'ah compliant manner. Not burdening people with a crushing interest debt means they are more likely to honour their financial commitments. But returns on some Islamic finance products are structured by reference to a conventional interest rate benchmark – weakens this argument in favour of Islamic finance?

Three main prohibitions (C’td)

- Gharar (‘uncertainty’). A contract or a provision which suffers from excessive gharar will be void under Shari'ah principles. Gharar can also be said to cover the prohibition on speculation (maisir).
- Gharar should be avoided so the subject matter and the parties’ obligations are sufficiently clear to avoid disputes. Shari’ah principles encourage the avoidance of disputes because disputes do not promote social harmony.
- It is for this reason that Shari'ah scholars did not allow Islamic finance to move, in any significant way, into derivatives (including derivatives based on sub prime debt) which they view as being tainted by gharar and maisir.
- The prohibition on gharar helped shield Islamic finance from transactions that are not based on real trading or investment activities, but just based on risk.
Some of the common structures

- Murabaha
- Ijara
- Musharaka
- Mudaraba
- Sukuk

Murabaha

Payment of Purchase Price

Customer acting as agent (usually undisclosed) of Islamic financier in purchase of goods from supplier
Commodity Murabaha

Broker 1 (Supplier) → commodities → Broker 2 (Supplier)

Islamic financier (Seller) → Spot sale → Customer (Buyer)

Cost + Pre-agreed profit (paid at deferred payment date) → Murabaha Agreement

Price Spot sale commodities commodities Spot sale Price

Ijara (lease)

CUSTOMER/THIRD PARTY (as seller)

SALE AGREEMENT

asset leasing

ISLAMIC FINANCIER

Purchasing undertaking

SALE UNDERTAKING

ISLAMIC FINANCIER

rent

CUSTOME (as lessee)

SERVICE AGENCY AGREEMENT
Musharaka and Mudaraba

- The classical mudaraba or musharaka means the Islamic financier is a partner or investor in the underlying business/investment. It is not guaranteed a return – this depends whether the activity is profitable.
- With a musharaka, Islamic financiers must be diligent when researching the proposed business or asset. It is likely to have to take on greater responsibilities than a conventional lender – i.e., representation on a board of directors/partners to oversee its investment. Being this involved means both its nominees and itself may face greater risks than a conventional lender would face.
- But what often happens in practice?

Musharaka (sharikat al aqt)

INVESTMENT/ENTERPRISE

INVESTOR A

INVESTOR B

Profit (pre agreed ratio)
capital

Joint Venture

Profit (pre agreed ratio)
capital

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Musharaka (sharikat ul-milk)

- Islamic Investors
- Management Agreement
- Customer

Assets

Mudaraba

- Investor 1
- Mudarib

Investment

Profits (less Mudarib Profit Share)

Capital/ownership expertise

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Sukuk – the Islamic finance equivalent of bonds?

Investors 

Declaration of Trust over Sukuk assets 

Investment Monies 

Issuer (normally a "widows & orphans" SPV) 

Payments to investors based on performance of Shari'ah-compliant investments 

Proceeds (Rent, profit, etc) generated from investment 

Investment of Sukuk proceeds, i.e.: 
- purchase of asset / land and a subsequent lease (Ijara) to generate rent 
- investment of funds in a mudaraba 
- use of Sukuk proceeds as equity contribution in a musharaka or purchase of a co-ownership interest in assets

The asset side of an Islamic financial institution’s balance sheet

The asset side of an Islamic financial institution's balance sheet can be said to fall into four categories:

a) inventory;  
b) asset-backed transactions;  
c) profit-sharing transactions; and  
d) fee based services

(See "Islamic Finance and Global Financial Stability", April 2010 issued by the Task Force on Islamic Finance and Global Financial Stability)
Asset backed transactions

- Asset-backed transactions can be said to cover murabaha (cost plus financing), ijara (leasing arrangements), istisna’ (manufacture or construction of assets) and salam (forward delivery of assets).
- With these products the Islamic financier is, at some stage in the transaction, the owner of an asset. Any return (i.e. profit or rental) it receives is predicated upon it being the owner of that asset.
- While it is true that the Islamic financier is the owner of the asset, that ownership interest does not necessarily mean, as some in the Islamic finance industry maintain, that any financial risk is self-mitigating.

Additional risks for Islamic financiers

- The Islamic financier faces risks which are not faced by a conventional bank, such as:
  - Sale or rental of the assets – there may be statutory warranties that cannot be excluded by contract.
  - Defects liability – there may be statutory liabilities, such as decennial liability for buildings, that also cannot be contractually excluded.
  - For some types of assets there may be significant ownership risks associated with personal injury (i.e., aircraft) or environmental damage (i.e., oil rigs).
  - If a customer defaults, the value of the asset may have declined.
Transactional risk profile issues which can impact regulatory issues

- Murabaha transactions – while the Islamic financier owns the asset or commodities, it will only do so for a short while.
- The credit risk faced by an Islamic financier is the same as a conventional bank. It has a debt which may or may not be paid. The need for careful credit checks on the customer is, therefore, just as critical as it is for a conventional bank.

Transactional issues – Ijara issues

- Leasing arrangements (ijara) – under Shari’ah principles the Islamic financier as the owner/lessor must remain responsible for major maintenance, property insurance and ownership taxes.
- Structures are usually adopted so the lessee acts as its agent to perform and pay for these functions. Usually done for good reasons because the customer will have the necessary skill to undertake these things (and in particular major maintenance).
- The lessor, as principal, must re-imburse the lessee for amounts that it pays on its behalf.
- The lease includes additional rental which equals that reimbursement obligation. The two amounts are set off - in the end, the lessee bears the financial consequences of these activities.
Transactional issues – Ijara issues including re-characterisation issues

- The risk for the Islamic financier as lessor, is whether, in the relevant jurisdiction, the set off provisions will work on the insolvency of the lessee.
- If the lessee is obliged to purchase the leased assets (on a default) or has the right to purchase, there will normally be separate undertakings. In the first case the lessee provides a purchase undertaking in favour of the lessor and, in the second case, the lessor provides a sale undertaking.
- A court may re-characterise a lease if it considers the lease together with all the other associated documents such as the undertakings. Recently a Dubai court re-characterised an ijara financing as a sale by instalments. This can have significant legal and risk consequences for an Islamic financier.

Transactional issues – purchase undertakings

The use of purchase undertakings

- A purchase undertaking is a unilateral promise to undertake some action (usually the purchase of an asset from the Islamic financier) for a specified price.
- Commonly been used to create mechanisms so the Islamic financier knows that, if there was an event of default, it would recover the financed amounts.
- The effect has been to shift the focus away from the value of the assets to the credit status of the customer (lessee/partner/mudarib) – arguably the outcome is similar to when dealing with a conventional bank.
- Shari‘ah scholars now frown on their use with musharaka and mudaraba financings (unless by reference to a price fixed at the time of exercise).
Transaction issues – incentive fees

**Incentive fees**
- With mudaraba and musharaka arrangements, the customer is often paid incentive fees (as the *mudarib* or the managing partner). Shari'ah principles allow incentive fees.
- However, they have often been structured so that, after they have been paid, the profit entitlement of the Islamic financier is similar to a return payable under a conventional financing.
- The use of incentive fees, therefore, can affect the economic profile of a musharaka or mudaraba which, on the face of them, are vehicles in which Islamic financiers share the risk of losses as well as profits.

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Transaction issues - Sukuk

- Conventional bondholders have a covenant to pay. It is a debt obligation.
- Sukuk are issued on the basis that the holders of the Sukuk certificates have an ownership interest in the assets which are acquired with their investment proceeds.
- When Sukuk first became prevalent about 10 years ago in the international markets, the investors who showed an appetite for this instrument wanted some certainty about the returns that they would receive – i.e. in effect they were fixed income investors.
- They were not the type of investors that wanted to subscribe to a securitisation issue where, whether or not you get paid, depends on the performance of the assets.
Transactional issues – Sukuk (C’td)

- A purchase undertaking was usually used to deal with events of default. This required the obligor to buy back the Sukuk assets from the issuer for an exercise price. That exercise price would normally equate to the unpaid face value of the Sukuk certificates.
- While a Sukuk is different from a conventional bond the credit focus and chances of repayment are usually dependent on the financial health of the obligor and not the underlying assets.
- There are now problems using purchase undertakings with musharaka or mudaraba.

With most of the Sukuk there will usually be an express term in which the Sukuk certificate holders agree that any rights they might have to the Sukuk assets are limited to the exercise of their rights under the purchase undertaking.
- This structure means that Sukuk certificate holders ultimately merely have a claim for a debt on the obligor and do not have the ability to freely sell the assets to recover their investment. In many ways this is similar to the position of a conventional bondholder.
Transactional issues – Sukuk (C’td)

- Limited number of "securitisation" Sukuk where the Sukuk certificateholders do have rights to the underlying assets and where there is no purchase undertaking. Whether or not they get paid depends solely on the performance of those assets.
- The recent credit crisis has highlighted that Sukuk investors need to be clearer as to whether they want to be “fixed income investors” or "securitisation investors". They also need to carefully consider the terms and conditions of Sukuk. Sukuk with purchase undertakings may end up with a risk profile being similar to a conventional bond (i.e., a claim for a debt on the obligor).

Some other issues that could impact regulatory considerations – Shari’ah Supervisory Boards

Shari’ah supervisory boards and their members

- Still a limited number of qualified and experienced Shari’ah scholars. Great demand for the leading and most respected Shari’ah scholars – means they are on many supervisory boards.
- The role of the Shari’ah co-ordinating departments within Islamic financial institutions is now extremely important. Interface between the Islamic financial bankers and the Shari’ah supervisory board.
- Possible conflicts of interest with Shari’ah scholars sitting on so many Shari’ah supervisory boards. Malaysia, for example, passed legislation so that a Shari’ah scholar can only be on the Shari’ah supervisory board of one Malaysian Islamic financial institution.
Other issues – asset concentration

Asset concentration

- A fundamental principle is the Islamic financier should own an asset or ownership interest as part of the transaction. Real estate and buildings is an obvious asset class. Many Islamic financial institutions, especially in the Middle East, became heavily involved in real estate financing. However, many Islamic financial institutions concentrated too much on this sector. Many have faced significant problems with the severe downturn in the real estate market.
- This is an example of how Islamic finance is not necessarily safer than conventional finance; whether it is conventional financing or Islamic financing, the failure to undertake proper risk assessments of the proposed financing or to set and abide by prudent risk parameters (i.e., by sector, geographical etc.) can result in financial problems.

Other issues – Shari'ah convergence

Shari'ah convergence

- Ongoing debate within the Islamic finance industry about standardisation of documents.
- Modern Islamic finance is relatively new. There are various initiatives underway to try and develop standard documents - but this will take time to achieve.
- Different schools of thought within both Sunni and Shia Shari'ah law. Can be viewed as making the task of standardising documents and the views of the Shari’ah scholars more difficult. Another view is that this makes Islamic finance more flexible in coming up with solutions.
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