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Structuring Islamic Finance Transactions in the United States

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Agenda

- Overview and History of Islamic Finance
- Substantive Principles under Islamic Finance
  - Source and Derivation of Islamic Law
  - Primary Texts on the Prohibition of Usury
    - Quran
    - Old Testament
    - New Testament
- Structuring a Sharia-Compliant Transaction
- Islamic Finance Transactions in the United States
  - Murabaha
  - Ijara and Bai al-Ijara
  - Musharaka
  - Istisna
  - Mudaraba

What is Islamic Finance?

- Islamic finance is a type of financing that complies with the tenets of the religion of Islam
- It is often called "**business with ethics**,"* similar to the principles behind Lutheran funds, Roman Catholic funds, "green" funds, university investment programs and other impact investing
    - o Think of the "consumer protection code" being incorporated into the substantive legal principles from the outset

* *See generally* Yusuf Talal DeLorenzo and Michael McMillen, Joint Address at the National Council on U.S.-Arab Relations Conference: Islamic Finance and the Global Economic Crisis (Feb. 17, 2009).

History of Islamic Finance

- The principles of Islamic finance began with the advent of Islam and the Islamic legal system in the 7th century, C.E.
  - While the main tenets of Islam are its five pillars (testimony of faith, 5 daily prayers, charity of at least 2.5%, fasting in the month of Ramadhan and holy pilgrimage to Mecca), as a 1,400 year old legal system, Islam addresses every one of the same topics that is addressed by any other legal system, including prescriptions on financing transactions
- In medieval times until the prominence of Florentine banking and interest-based lending, the general financial principles under Islamic law were shared amongst Muslims and Europeans
- As the differences increased and as financial transactions became more complicated in the modern era, the modern Islamic finance industry emerged in Egypt in 1963 with one bank, the Mit Ghamr Savings Bank
- Since then, modern Islamic finance has grown tremendously
  - The 2018 Global Islamic Finance Report reported that the Islamic finance industry grew 6% from US$2.29 trillion in 2016 to US$2.43 trillion in 2017
  - However, 2017 was the fourth consecutive year that the industry registered a single digit growth and the fifth consecutive year that the growth rate has been on a declining trend as compared to prior periods

Principles of Islamic Finance

- The principles of Islamic finance that are different from those underlying conventional interest-based finance include:
  - o Prohibition on the payment or receipt of interest / usury (*riba* in Arabic)
    - One cannot get something for nothing, therefore unearned profit (i.e., profit without expected, normal business risk) is forbidden
    - Income must be proportional to actual profits (not fixed), and losses must fall on partners in proportion to their capital contributions, without regard to profit shares
  - o Prohibition on contractual uncertainty (*gharar* in Arabic)
    - Jurists agree that excessive gharar (or contractual uncertainty) is not permitted (i.e., certain derivative transactions, short selling and speculation), but minimal gharar is
  - o Requirement of a tangible asset in transactions (other than IP)
    - In order for something to be properly the subject of a contract, it must be considered property (i.e., either tangible or a usufruct, the legal right of using and enjoying the fruits or profits of something belonging to another)
      - o Thus, for example, one cannot transact in (i) what one does not own, (ii) derivatives (with limited exceptions) or (iii) purchases and sales of debt above or below par
  - o Prohibition on deriving profit from prohibited (*haram* in Arabic) businesses like drugs, alcohol or tobacco for human consumption, pornography, weapons, gambling, prostitution, pork for human consumption and interest-based financing (the last two are unique to Islam)

Sources of Principles of Islamic Finance

- Islamic law (*fiqh* in Arabic) is not the same as "sharia," which is what Islamic law is incorrectly translated in the media
  - Fiqh is distinguished from sharia by the fact that the latter is God's divine revelation and ineffable law, whereas fiqh is the human interpretation or extraction of God's divine will as expressed in the Quran and sunna (defined below), but in the form of manmade law
- The four main sources of Islamic law:
  - Quran – the holy book for Muslims, believed to be the word of God
  - Sunna – normative statements of action of the Prophet Muhammad (p.b.u.h.),* whereas the actual verbal statements are called "hadith"
  - Qiyas – analogy
  - Ijma – consensus of the Islamic scholars or "ulema" over time (quite rare to achieve such consensus)

* "p.b.u.h." stands for "peace be upon him," a phrase used by Jews and Muslims to refer to certain deceased people of significant importance, such as prophets.

Process of Deriving Islamic Law

- Level 1 – Primary Sources (Quran and sunna)
  - Only 350 out of the 6200 verses in the Quran are legally oriented
  - Therefore, the large corpus of sunna is more instrumental in expounding upon the divine rules or sharia
- Level 2 – Manmade Extraction
  - Ijtihad – verb used to describe the extracting of legal rules from the primary sources (qiyas or analogy is the most prominent tool)
  - Usul-ul-fiqh – noun describing the methodology above
- Level 3 – Books of Law
  - All the derived legal rules are collected in books of fiqh or treatises
  - There are four major Sunni schools of thought (Hanafi, Shafi, Maliki, and Hanbali) that each have their own usul-ul-fiqh and their own books of fiqh. Each school of thought is considered independently correct

Quran on Usury

"Those who (in charity) spend of their goods by night and by day, in secret and in public, have their reward with their Lord: on them shall be no fear, nor shall they grieve. Those who devour usury will not stand except as stand one whom the Evil one by his touch Hath driven to madness. That is because they say: "Trade is like usury," but Allah hath permitted trade and forbidden usury. Those who after receiving direction from their Lord, desist, shall be pardoned for the past; their case is for Allah (to judge); but those who repeat (the offense) are companions of the Fire: They will abide therein (forever). Allah will deprive usury of all blessing, but will give increase for deeds of charity: For He loveth not creatures ungrateful and wicked. Those who believe, and do deeds of righteousness, and establish regular prayers and regular charity, will have their reward with their Lord: on them shall be no fear, nor shall they grieve. O ye who believe! Fear Allah, and give up what remains of your demand for usury, if ye are indeed believers. If ye do it not, Take notice of war from Allah and His Messenger: But if ye turn back, ye shall have your capital sums: Deal not unjustly, and ye shall not be dealt with unjustly. If the debtor is in a difficulty, grant him time till it is easy for him to repay. But if ye remit it by way of charity, that is best for you if ye only knew. And fear the Day when ye shall be brought back to Allah. Then shall every soul be paid what it earned, and none shall be dealt with unjustly."

The Holy Quran, 2:274-281 (Abdullah Yusuf Ali trans., 3rd ed. 1946)

Old Testament on Usury

"Thou shalt not lend upon usury to thy brother; usury of money, usury of victuals, usury of anything that is lent upon usury. Unto a stranger thou mayest lend upon usury; but unto thy brother thou shalt not lend upon usury: that the LORD thy God may bless thee in all that thou settest thine hand to in the land whither thou goest to possess it."

Deuteronomy 23:19-20 (King James)

Further texts demand a resettling of land, debts and property every 7 years, and total resettlement every 49 years

New Testament on Usury

"And if ye lend to them of whom ye hope to receive, what thank have ye? For sinners also lend to sinners, to receive as much again. But love ye your enemies, and do good, and lend, hoping for nothing again; and your reward shall be great, and ye shall be the children of the Highest: for he is kind unto the unthankful and to the evil."

Luke 6:34-35 (King James)

St. Thomas Aquinas abhorred the vice of usury

Structuring Sharia Compliant Transactions

- Several elements make a structure sharia-compliant:
  - o Judgment or fatwa by a sharia supervisory board ("SSB"), which is often a group of three or more recognized Islamic law scholars
    - Fatwas are specific to a single matter, no precedential value (akin to an opinion or treatise by law professors in the United States)
    - Example of a fatwa – Dow Jones Islamic Indices Fatwa of 1998 (amended 2003)
      - o Permissible business (is "core" business haram?)
      - o Permissible instruments (are there any fixed returns or preferred stock?)
      - o Financial tests (is there a permissible level of impurity?)
        - Total accounts receivable / market capitalizations ≤ 33% (originally 45%)
        - Total debt (short-term and long-term) / market capitalization ≤ 33%
        - Total cash plus marketable securities / market capitalization ≤ 33%
  - o Standardization requirements from the Islamic Financial Services Board ("IFSB," based in Malaysia), Accounting & Auditing Organization for Islamic Financial Institutions ("AAOIFI," based in Bahrain) and others
  - o Investor decides if they are comfortable with it, i.e. personal convictions
    - Despite arguments against Islamic finance for merely being form over substance, many investors see Islamic financial products as "more compliant than present practices" or "the lesser of two evils"

History of Sharia Compliant Transactions

- Transactional structures in Islamic finance were designed, from inception, to address each and every risk addressed by conventional transactions
- Historically, under Islamic law, there were a limited number of contractual transactional forms for the conduct of business – the “nominate contracts”
- The nominate contracts were at first rigid, but with time, have become flexible and are now the “building blocks” of modern Islamic finance. They allow for bifurcated structures in which both conventional and Islamic finance tranches can coexist
- Consensus started developing around these structures

Types of Islamic Finance Transactions

- Forms
  - Debt-Based: most used are synthetic loans, such as a murabaha
  - Asset-Based: most used are leases (*ijara* in Arabic)
  - Equity-Based: most used profit-sharing vehicles are mudaraba and musharaka
- Types
  - Trade Transactions
    - Ijara (Lease)
    - Bai Muajjal (Credit Sale)
    - Salaam (Advance Purchase for Futures/Forwards)
    - Rahn (Pledge)
  - Financing Transactions
    - Murabaha (Cost Plus Basis)
    - Bai al-Ijara (Sale-leaseback)
    - Istisna (Construction Contract)
    - Sharikat Mahasa (Joint Venture)

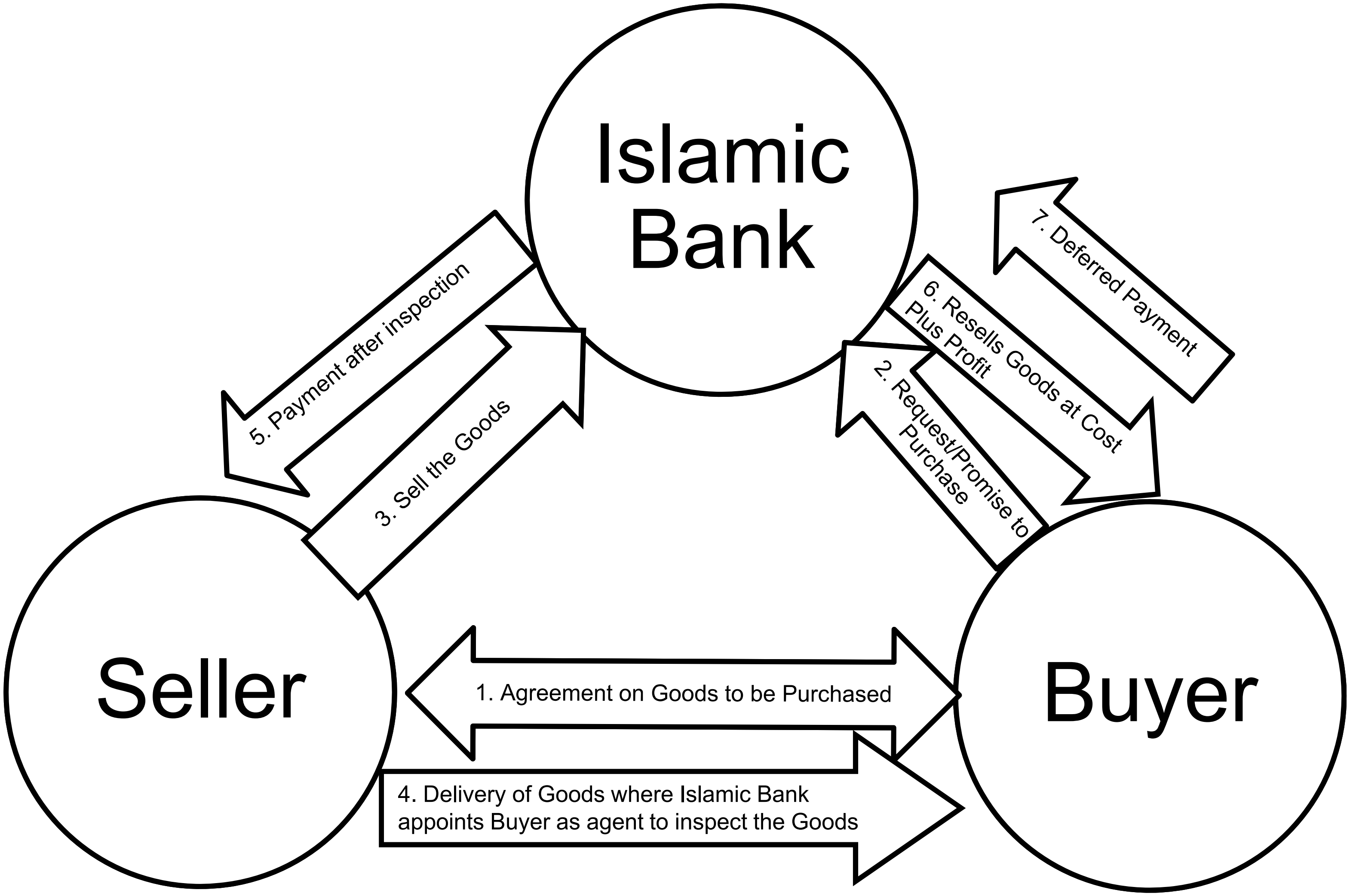
Types of Islamic Finance Transactions (cont'd)

- Types (cont'd)
  - o Intermediation Transactions
    - Mudaraba (Venture Capitalism)
    - Musharaka (Pure Partnership)
    - Wakala (Agency)
  - o Capital Markets Transactions
    - Sukuk (Bond)
    - Arboon (Deposit Sale for Derivatives)
    - Tahawoot (Hedging)
    - Wad (Promise for Forwards Contracts)
  - o Social Welfare Transactions
    - Qard Hasana (Interest-free Loan)
    - Waqf (Endowed Trust or Charity)
    - Takaful (Mutual Insurance)

Murabaha

- A customer requests a bank to purchase a good on its behalf. After the bank purchases the good, the bank resells it to the customer for the cost plus a profit, hence "cost-plus basis"
  - This profit margin is not considered interest because the financial institution owns the good before transferring title to the customer. Temporary ownership carries risk, which justifies profit in Islam
- The subject of the sale must exist at the time of the deal and must be clearly known. The asset must have value and cannot be haram. The price must be clearly articulated, along with expenses and markup features. If there are defects in the commodity, the seller must tell the buyer. The delivery process must be certain, not contingent. The bank must have physical possession of the object and be legally responsible for it (i.e., take title), which makes it sharia-compliant

Murabaha (cont'd)



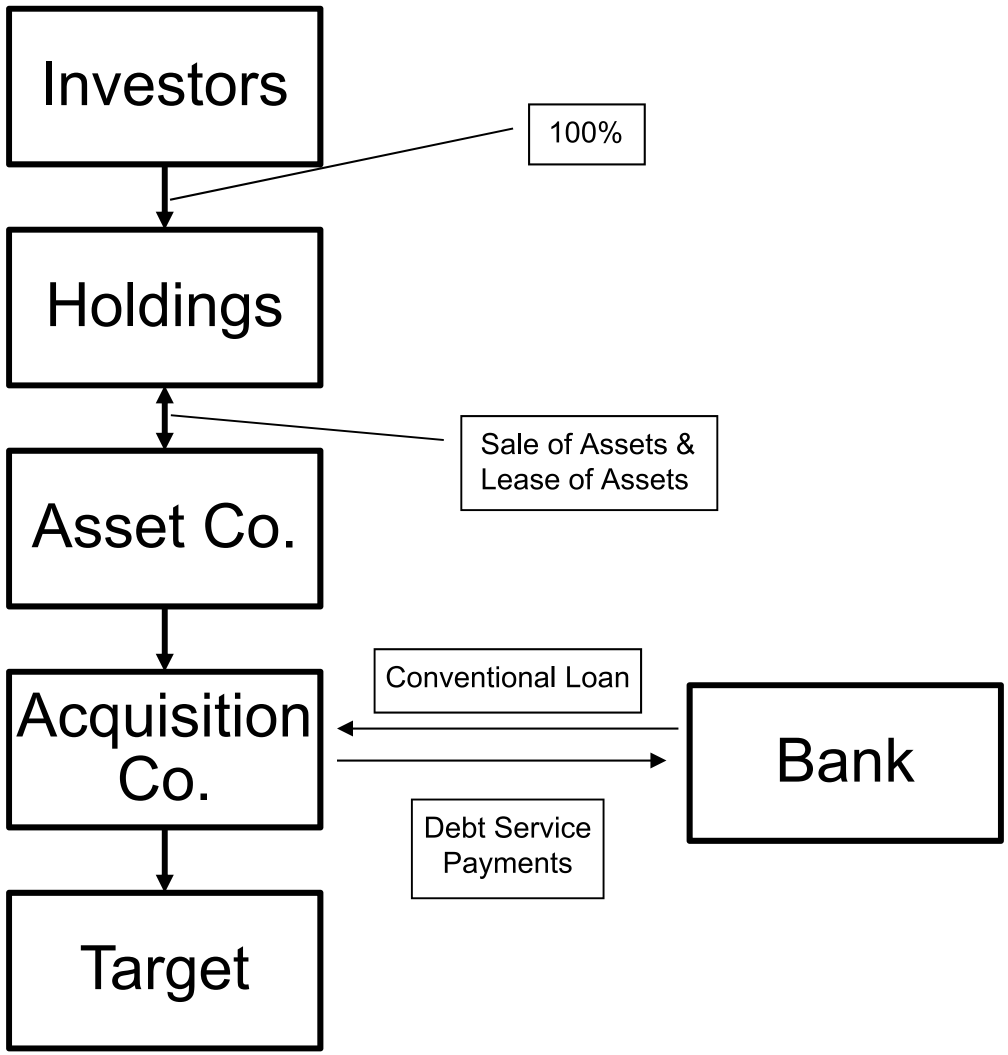
Ijara and Bai al-Ijara

- The most frequently used structure in complex Islamic investing is the ijara (a lease). A lease is defined as the sale of a usufruct. When the lease is combined with a sale through a bai al-ijara (a sale-leaseback), it is the functional equivalent of a secured loan
  - Both rent and usufruct must be determined with sufficient specificity at the time of lease to survive scrutiny for prohibition against aleatory contracts, but floating rate leases indexed to LIBOR are routinely used
- Here, the bank purchases an asset, usually equipment, and leases it to a client. The bank owns the asset throughout the lease period while the customer pays a fixed rental fee

Ijara and Bai al-Ijara (cont'd)

- The ijara structure is nearly identical to the leveraged lease structure that is so widely used in Western interest-based financings
- Three differences:
  - Ijara commences the day the asset is delivered to the customer, not the day the contract is signed
  - Lessee is not liable for the full rent if the asset is destroyed because the bank bears the risk of destruction
    - In practice, the bank takes out insurance on the asset and factors the cost of insurance into the fixed rent
  - Lessee is technically not required to purchase the asset at the end
    - In practice, lessee may be forced to purchase the asset if the bank exercises its put option (ijara wa iqtina)
- Duration and rent fees for the ijara must be calculated in advance

Ijara (cont'd)



Investors
100%
Holdings
Sale of Assets & Lease of Assets
Asset Co.
Conventional Loan
Acquisition Co.
Bank
Debt Service Payments
Target

Musharaka

- Profits are shared like in a general partnership. The profit-loss sharing proportions are agreed upon in advance:
  - The Hanafi school of thought permits the parties to specify contractually the share of profits without regard to capital contribution, while the other schools do not
  - However, there is consensus that all losses must be borne in proportion to the partners' respective capital contributions
  - Accordingly, if A, B and C each have a 1/3rd interest in a venture, it is permissible to give A 50% of the profits under the Hanafi school, but each must bear 33% of the losses. In other words, partners can contractually agree to vary distribution of profits, but not losses under the Hanafi school
- Investor and entrepreneur engage in joint profit sharing and decision-making powers. Both parties must provide capital and sweat equity in the form of management efforts and "know-how"

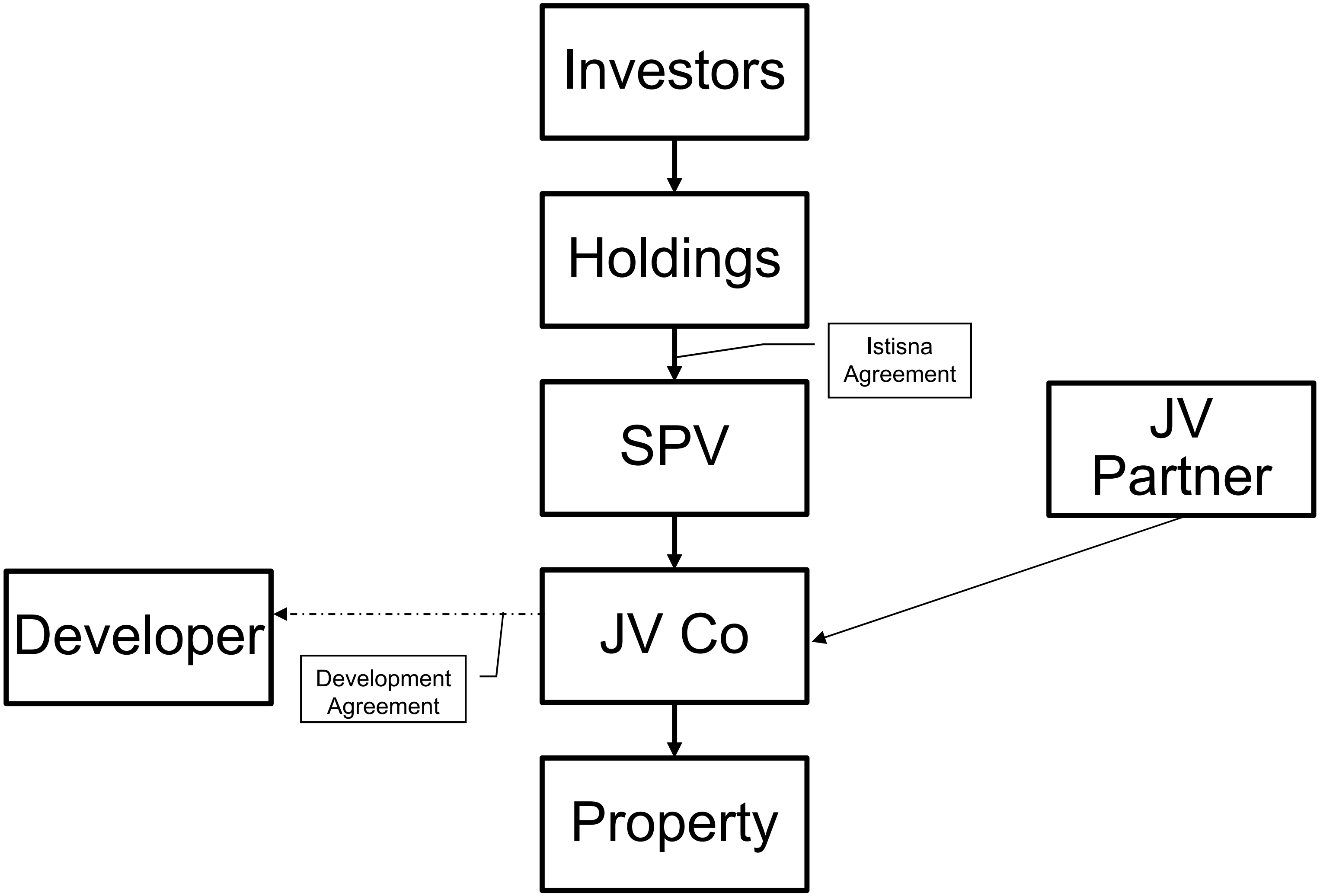
Mudaraba

- One partner gives money to another for investing it in a commercial enterprise. The investment comes from the first partner who is called the “rabb-ul-mal” while the management and work is an exclusive responsibility of the other, who is called the “mudarib”
- The rabb-ul-mal has several obligations. The capital is provided solely by the rabb-ul-mal . The rabb-ul-mal gets no guarantee but can secure the mudarib's management. Finally, the rabb-ul-mal bears the expenses of losses unless there is negligence by the mudarib
- On the other hand, the mudarib is in charge of all operations and is not liable for losses (however, the mudarib will indemnify the rabb-ul-mal against infringement, default, and breach of contract); the mudarib is only obligated to pay the rabb-ul-mal and does not receive any remuneration for services provided

Istisna

- A sale where a commodity is transacted before it comes into existence (highly relevant in project finance for construction contracts when the asset is not yet constructed or where one party buys goods that the other party undertakes to manufacture according to specifications in the contract)
- The assets must be specifically identified, including who is going to create and produce it, as in the parties must describe the manufacturer and all sub-contractors
- The istisna is typically between the bank and the contractor, not between the client and the contractor like in conventional finance
  - Thus, the bank is liable to pay for construction

Istisna (cont'd)



Final Thoughts

- The United States (after the United Kingdom) is one of the largest Islamic finance markets outside of Muslim countries and is a leader in the development of sophisticated structures for Islamic finance
  - As more U.S. institutions provide Islamic financial products for their own clients, the Islamic finance field grows in the United States. Therefore, it is important to understand this space and the greatest opportunity comes in the form of increased dialogue, understanding and appreciation
- Risks to Consider
  - Sharia compliance, commercial risk (i.e., returns may not be known), liquidity risk, political risk and foreign exchange risk
- Solutions
  - Mitigate risk through standardized processes, transfer risk with swaps or other permissible derivatives and manage risk through collateral, third party guarantees, high loan loss reserves, etc.

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Questions & Answers