



Law, Policy and Islamic Finance in Middle Eastern Jurisdictions: Interactions

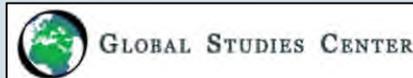
Muslims in a Global Context

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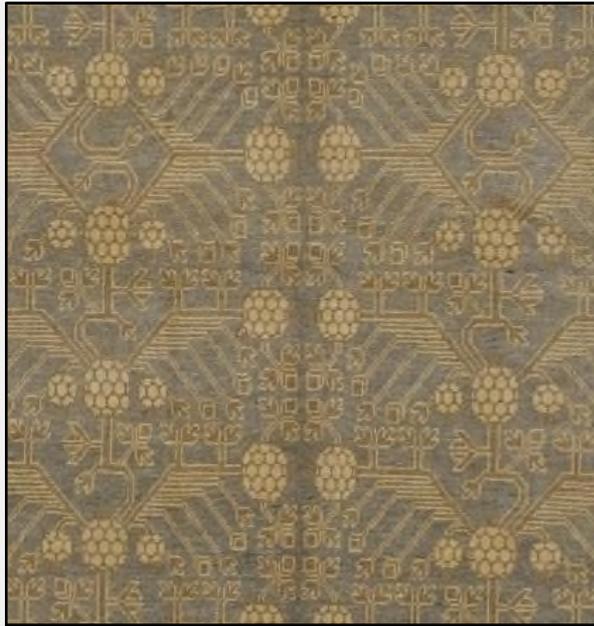
- Consider the interaction of law, policy, *Shari'ah* and Islamic finance in the Middle East

- By surveying the development and implementation of six critical factors in the growth of Islamic finance:
 - Collateral security
 - *Ijmā'*
 - Nominate contracts
 - Bifurcated financing structures
 - Dow Jones *fatwā* of 1998
 - *Sukūk*

Perspective

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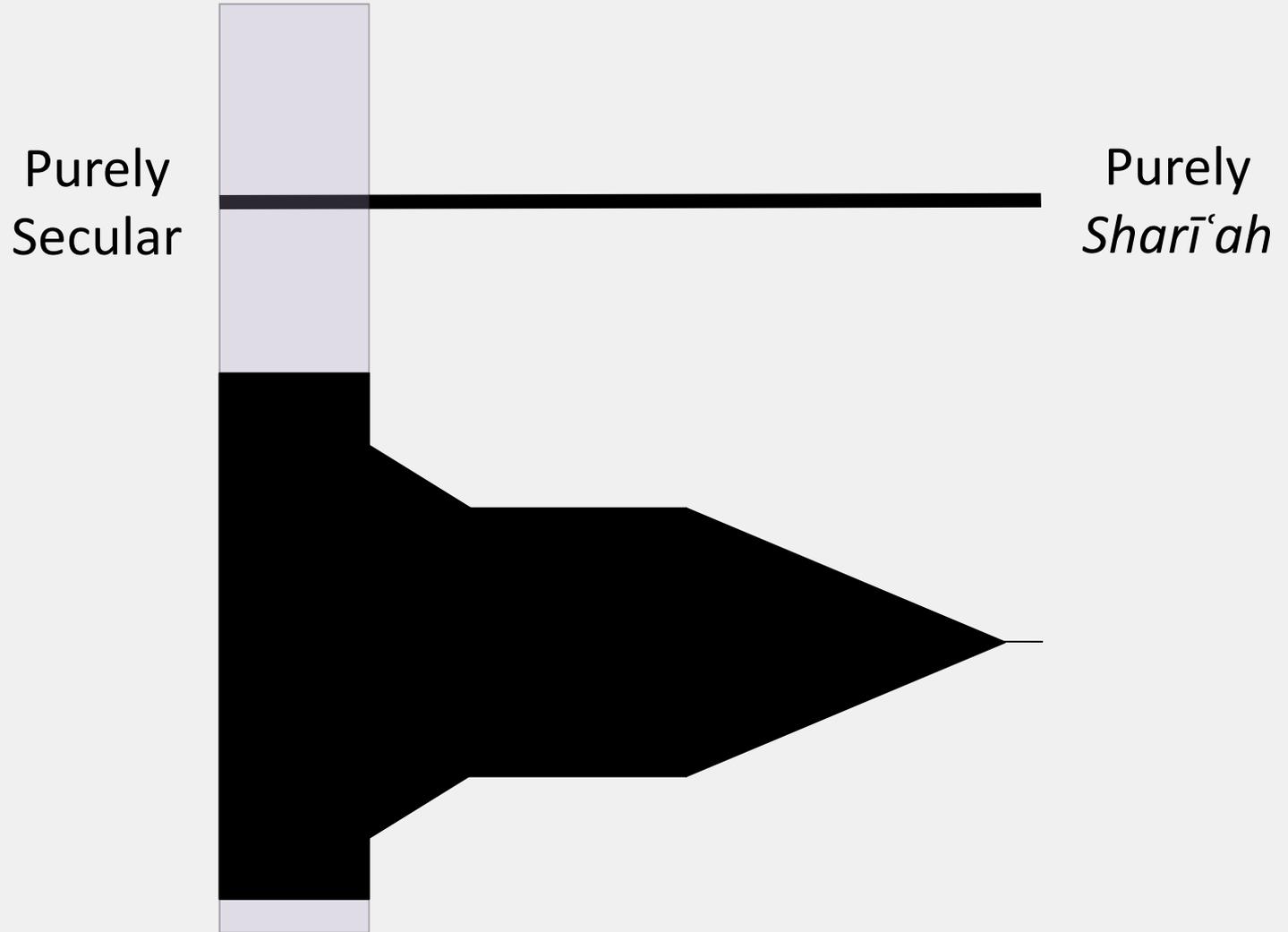


**Background:
Law, Policy, *Sharī'ah***



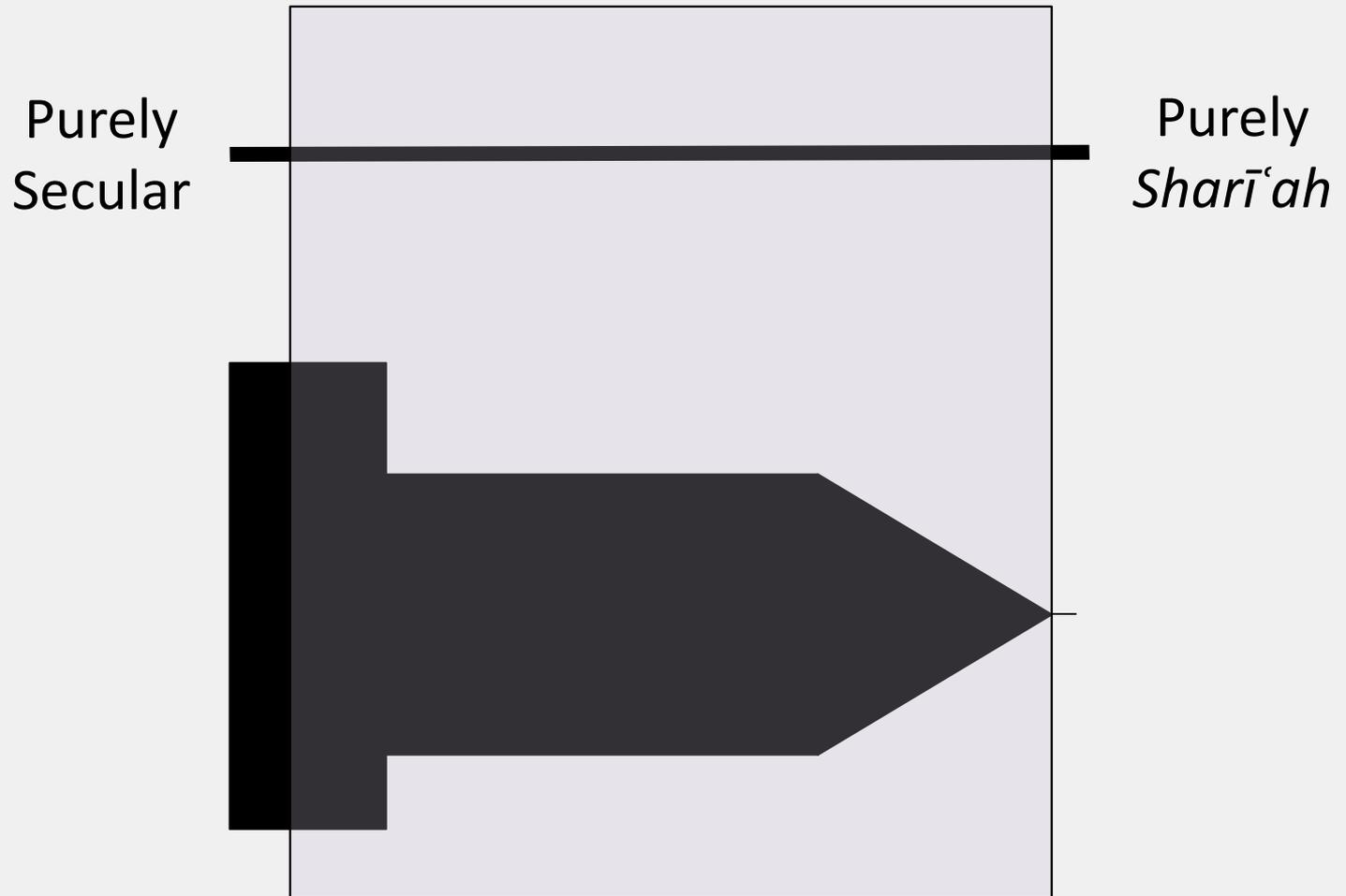
Law

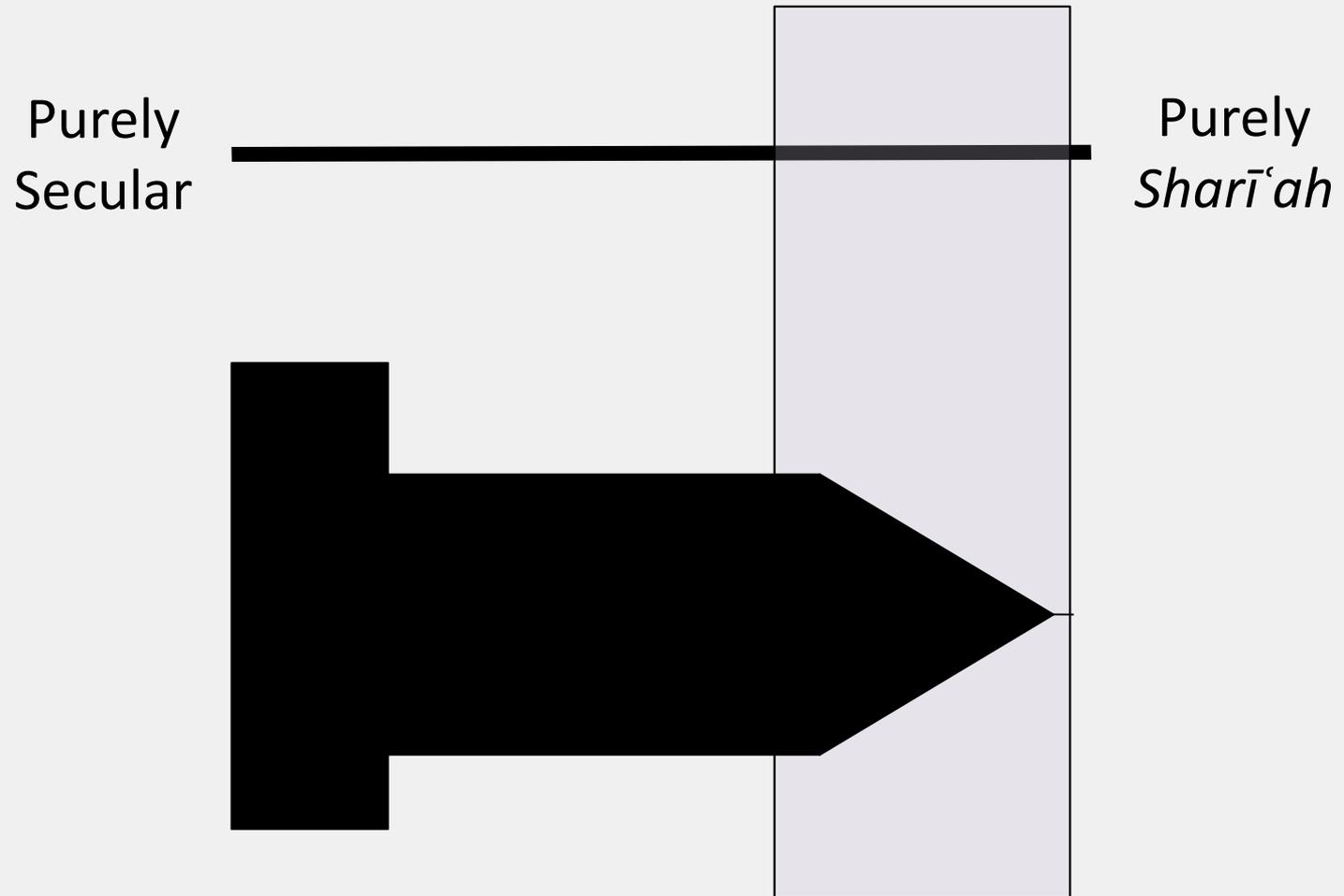
- What is the legal context?
- Purely Secular Jurisdictions: the legal system takes no cognizance of the *Sharī'ah*
- *Sharī'ah*-Incorporated Jurisdictions: the legal system takes some cognizance of the *Sharī'ah*
 - A continuum
 - from the *Sharī'ah* being one element to be considered
 - through a point of the *Sharī'ah* being “a” primary source of law (with a wide range)
 - to a point of the *Sharī'ah* being the paramount law of the land

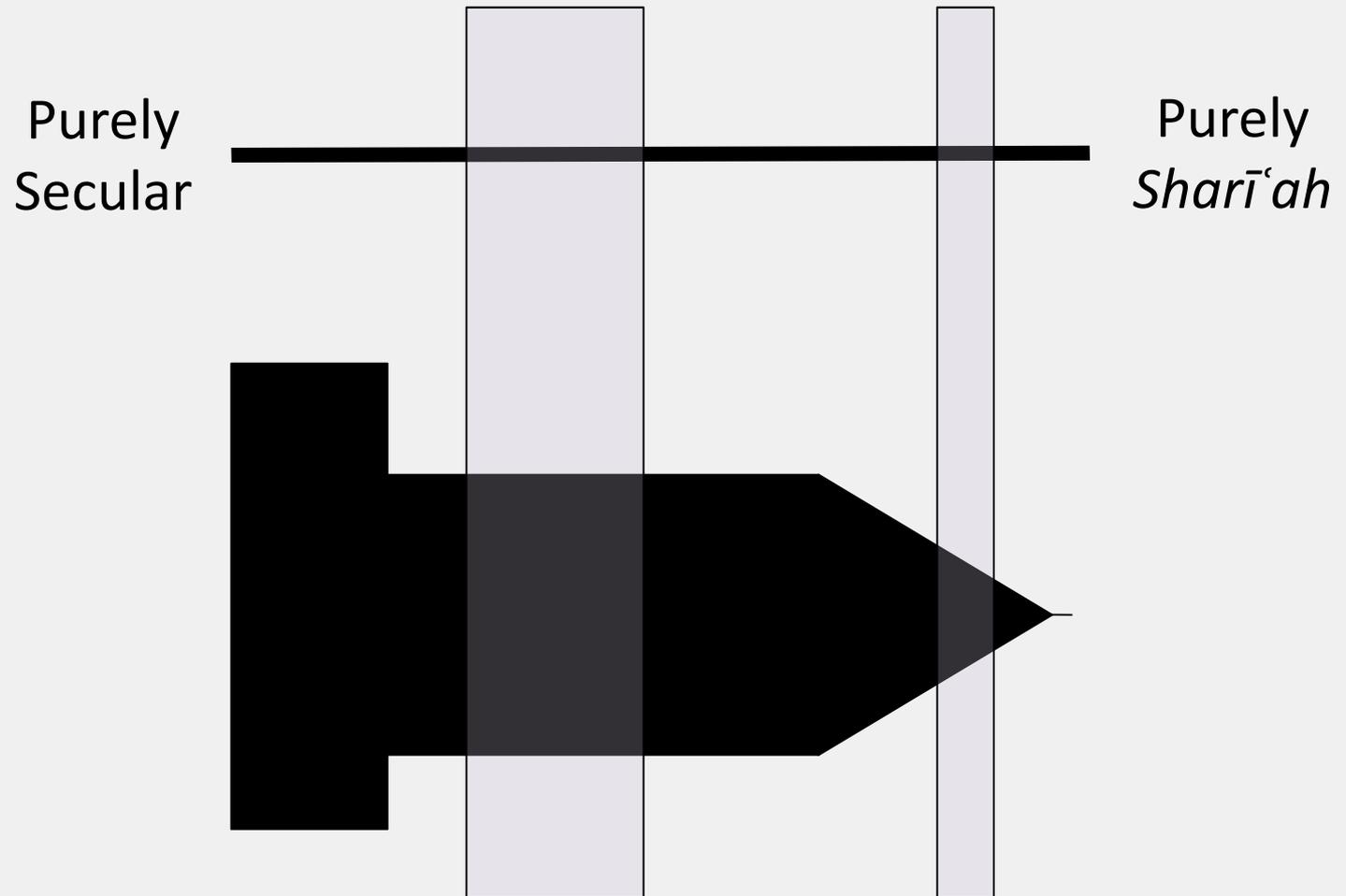


Purely
Secular

Purely
Shari'ah







- ▣ Enforceability of the *Sharī‘ah* using the law of the Purely Secular Jurisdiction as the governing law?

- ▣ Whether, when, and under what circumstances a secular court will apply the *Sharī‘ah* in interpreting the contracts involved in that transaction.

- ▣ English cases:
 - *Shamil Bank of Bahrain E.C. (Islamic Bankers) v Beximco Pharmaceuticals Ltd and Others* (“*Shamil Bank v. Beximco*) – litigation context
 - *Musawi v RE International* – arbitration context

- ▣ There can be only one law governing enforceability of the provisions of the contracts at issue
- ▣ That must be the law of a country (*e.g.*, England, not both England and the *Shari`ah*)
- ▣ The Rome Convention has the force of law in the United Kingdom, and the Rome Convention allows the parties to a contract to chose the law applicable to that contract
- ▣ The *Shari`ah* is a set of “Islamic religious principles” and “religious and moral codes”, rather than laws of a nation
- ▣ The contract may incorporate provisions of another foreign law or a set of rules as terms of the contract whose enforceability is to be determined by such national law

- ▣ The generality of the incorporation of contractual terms, if any, pursuant to the phrase “[s]ubject to the Glorious Sharia’a” is insufficient to identify specific black letter provisions of the *Sharī’ah*, and thus ineffective
- ▣ The general reference to principles of *Sharī’ah* in this case affords no reference to, or identification of, those aspects of *Sharī’ah* law which are intended to be incorporated into the contract, let alone the terms in which they are framed.
- ▣ Consider: a compilation of *Sharī’ah* principles in the nature of the Uniform Codes

- Different degrees of incorporation of the *Sharī'ah*: the incorporation continuum previously noted
 - reflective of financial and legal systems that are built on interest-based principles and trying to accommodate the recognition and role of the *Sharī'ah*
- Different schools of jurisprudence (*madhahib*): which are applied?
- Civil law base (not common law)
 - does not recognize the trust
 - consider Bahrain and Oman recognizing the trust

- Enforcement mechanisms struggle to accommodate both interest-based and *Sharī'ah*-based institutions
 - The *Sharī'ah* is the paramount law of the land in Saudi Arabia
 - Board of Grievances: commercial disputes; application of the *Sharī'ah*
 - *Sharī'ah* Courts: broader general jurisdiction; application of the *Sharī'ah*
 - SAMA Committee: disputes between a bank and its customers; agreement of the parties
 - Negotiable Instruments Office (NIO): negotiable instruments; four corners of the document
 - Committee for Resolution of Securities Disputes (under the Capital Market Law): securities matters; unclear

- Structural and systemic factors in OIC jurisdictions
 - No *stare decisis*
 - Opinions (sometimes laws) not published
 - Predictability and stability of outcome
 - Time frame for dispute resolution
 - Enforcement of foreign judgments and awards
 - Choice of law issues – unclear to barely existent
 - Underdeveloped (sometimes absent) substantive law as to critical matters: bankruptcy and insolvency as an example
 - Existing laws frequently recent and untested
 - Enforcement mechanisms

- Difficulty in obtaining legal opinions, particularly enforceability opinions

- To date, legal opinions have taken broad qualifications for other factors as well:
 - *Sharī'ah* as general principles
 - Different schools of Islamic jurisprudence (*madhahib*)
 - No uniform statements of relevant *Sharī'ah* principles (Uniform Laws approach) even as a base reference – IFSB initiative; *Shamil Bank v Beximco*
 - Degree of discretion in the court
 - Binding precedent issues and publication of decisions
 - Remedies enforcement (consider the *Sharī'ah* as public policy, particularly with respect to the New York Convention – Arbitral Awards)
 - Enforcement of foreign judgments and arbitral awards

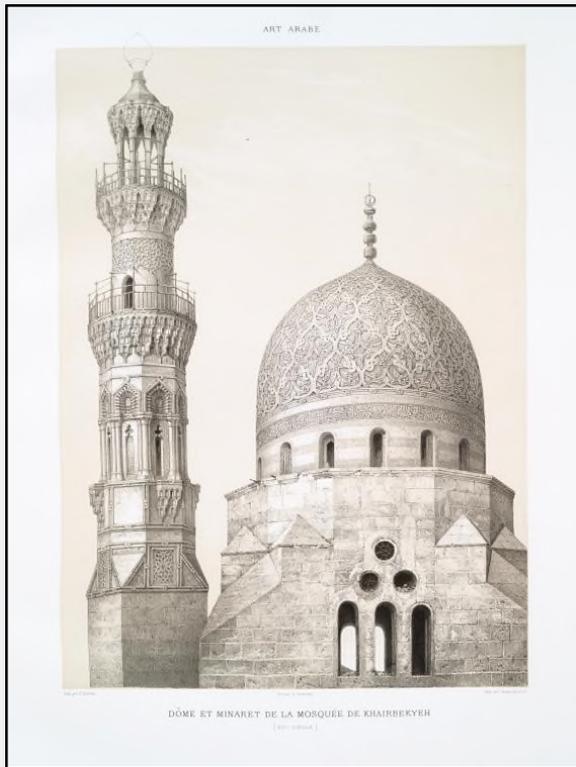


Policy

- Will return to this in later discussions.
- Post World War II devolution from imperial control and focus on building Muslim states
- Trend toward greater *Sharī'ah* compliance
- 1970s: Islamic banking – deposit side of the equation
- Interregnum effects
 - Shortage of scholars
 - Academic orientation
 - Collegiality
 - Nominate contracts
- Mid-1990s: investment side of the equation – the beginning of modern Islamic finance

- Oil wealth in some jurisdictions:
 - use of proceeds issues – domestic use
 - issues regarding diversification away from the oil based economic model
- Pressing infrastructure needs – all types of infrastructure (water, education, housing, transportation)
 - population growth – birth rates
 - urbanization rates
- Example of an issue: low rate of home ownership in Saudi Arabia – no mortgage recordation – no financing except for wealthy – population not sufficiently invested in their own society

- Conflicted opinions regarding the movement away from the interest-based system that dominates in a world that has fewer and fewer borders from the financial perspective
- Where and how to incorporate *Sharī'ah* principles?
- Playing out at all levels: political, social, financial, legal



The *Sharī'ah*

- What is the *Sharī'ah* in this context?
- That question leads to the first conceptual division in considering the *Sharī'ah* (and the *Sharī'ah* as Islamic law): the division between:
 - man's affairs with man (*mu'āmalāt*) and
 - man's affairs with Allāh, including matters of ritual (*ibādāt*).
- Our concern is with the former category.
- It is *mu'āmalāt* that overlaps, in nature and scope, with other secular legal systems.

- Earliest connotations of *sharī'ah* were to the path by which a camel is led to water, to the source of life
- Thence the term came to mean the “path” or guide by which a Muslim leads his or her life, in every particular
- It is religion, ethics, morality and “law”
- It is the divine, perfect, immutable word of Allāh as set forth in the Qur'ān and the *sunna*

- The *Sharī'ah* is ascertained through *'ijtihād* (“effort”) or legal reasoning using certain “roots” (*uṣūl al-fiqh*):
 - The Qur'ān, the divine word of Allāh as embodied in the holy book of Islām
 - The *sunna*, being the practices and examples, the dicta and decisions, of the Prophet Mohammed
 - *Ijmā'*, being consensus, particularly the consensus of scholars
 - *Qiyās*, or analogical deductions and reasoning
- Compare *fiqh* : human understanding of the divine law
- It is comprehensive in its application and applies to all aspects of existence, including commercial and financial matters

- Our focus: the part that might be recognized as “law”, in particular the *Sharī'ah* as applied to commercial and financial activities
- The *Sharī'ah* is a set of principles and precepts, rather than a precise legal code or precise legal injunctions
- It has been explicated and developed over 1400 years through:
 - Scholarship
 - *Fatāwā* (the plural of *fatwā*) – opinions
 - Very few attempted codifications: the *Majelle*
- Has evolved very much like the common law has evolved, through application of principles and precepts to discrete factual inquiries

- Fundamental principle of the *Sharī'ah*, and the element that distinguishes Islamic finance from conventional Western interest-based finance pertains to the risk – reward system
- Under the *Sharī'ah* there is no entitlement to reward without appropriate exposure to risk
- *Sharī'ah*-compliant finance (Islamic finance) is a profit and loss sharing system – emphasis on “sharing”
- Preferential or guaranteed returns are not permissible
- Consider *ribā* doctrines (commonly known as prohibitions on the payment or receipt of interest – debate about exactly what types of interest should be prohibited, but it is irrelevant in current practice)
- Trading and partnerships as the *Sharī'ah* paradigms

- As with any body of law, there are different schools of interpretation, or schools of jurisprudence
- The four main Sunnī *madhāhib* of Islamic jurisprudence are:
 - Hanafī
 - Hanbalī
 - Mālikī
 - Shāfī'ī
- Thus, the *Sharī'ah* as applied in practice, the application of the relevant principles and precepts of the *Sharī'ah*, will vary somewhat from school to school



Islamic Finance in the Global Context

- Islamic finance and investment industry must accommodate to the dominant system in a manner that is cost efficient

- What is “accommodation” in this context?

- In practice, this has meant contracts that:
 - Make no mention of the *Sharī‘ah*
 - Are enforceable under New York or English law
 - Are approved by the relevant *Sharī‘ah* Supervisory Board as being, in substance, *Sharī‘ah* compliant

- Initial perceptions of Islamic finance and investment tend to focus on differences from interest-based Western financing
- There are notable differences
- But, more constructive approach is to focus first on the similarities and commonalities – and there are more similarities than there are differences
- Clearly, in the West there are preconceptions that embody misconceptions
- That observation is only slightly less true in the Middle East
- The perception factors affect transaction costs more than any other
- Without the participation – buy-in – of conventional, interest-based financial institutions, there will be no Islamic finance and investment industry

- Substantively: Islamic finance is “ethical investing”
- Consider: Lutheran funds, Roman Catholic funds, “green” funds, university investment programs (WARF-UW; UC-Berkley)
- No investments in:
 - Production or distribution of alcohol for human consumption
 - Gambling
 - Prostitution and pornography
 - Defense and weapons
 - Pornography

 - Production of tobacco for human consumption - ?S
 - Defense and weapons - ?S
 - Production of pork for human consumption - S
 - Interest-based financing - S

- Structurally: Islamic finance is “structured finance”
- Using that phrase in reference to the structuring of cash flows and collateral security for legal and economic purposes, and not in the context of its references to derivatives
- The most frequently used structure in complex Islamic investing is the lease (the *'ijāra*)
- The *'ijāra* structure is nearly identical to the leveraged lease structure that is so widely used in Western interest-based financings (later slides)
- Transactional structures in Islamic finance were designed, from inception, to address each and every risk addressed by conventional transactions.

- Modern “Islamic finance” actually means activities and transactions of:
 - finance and
 - [particularly] investment and
 - [sometimes] banking
 - each in accordance with the *Sharī‘ah*
- Finance: capital markets and banking; capital markets are becoming more important in Islamic infrastructure finance: *sukūk*
- Conventional banking is dominant, so the “finance” portion is often conventional interest-based lending through a “bifurcated structure”



Six Developmental Factors



Collateral security - *rahn*



Nominate Contracts as building blocks – mid-1990s



Ijmā' sought by small group of scholars - mid-1990s



Dow Jones *Fatwā* – equity side of capital markets – 1998



Sharī'ah-compliant structures for Western transactions – “bifurcated structures” - 1999



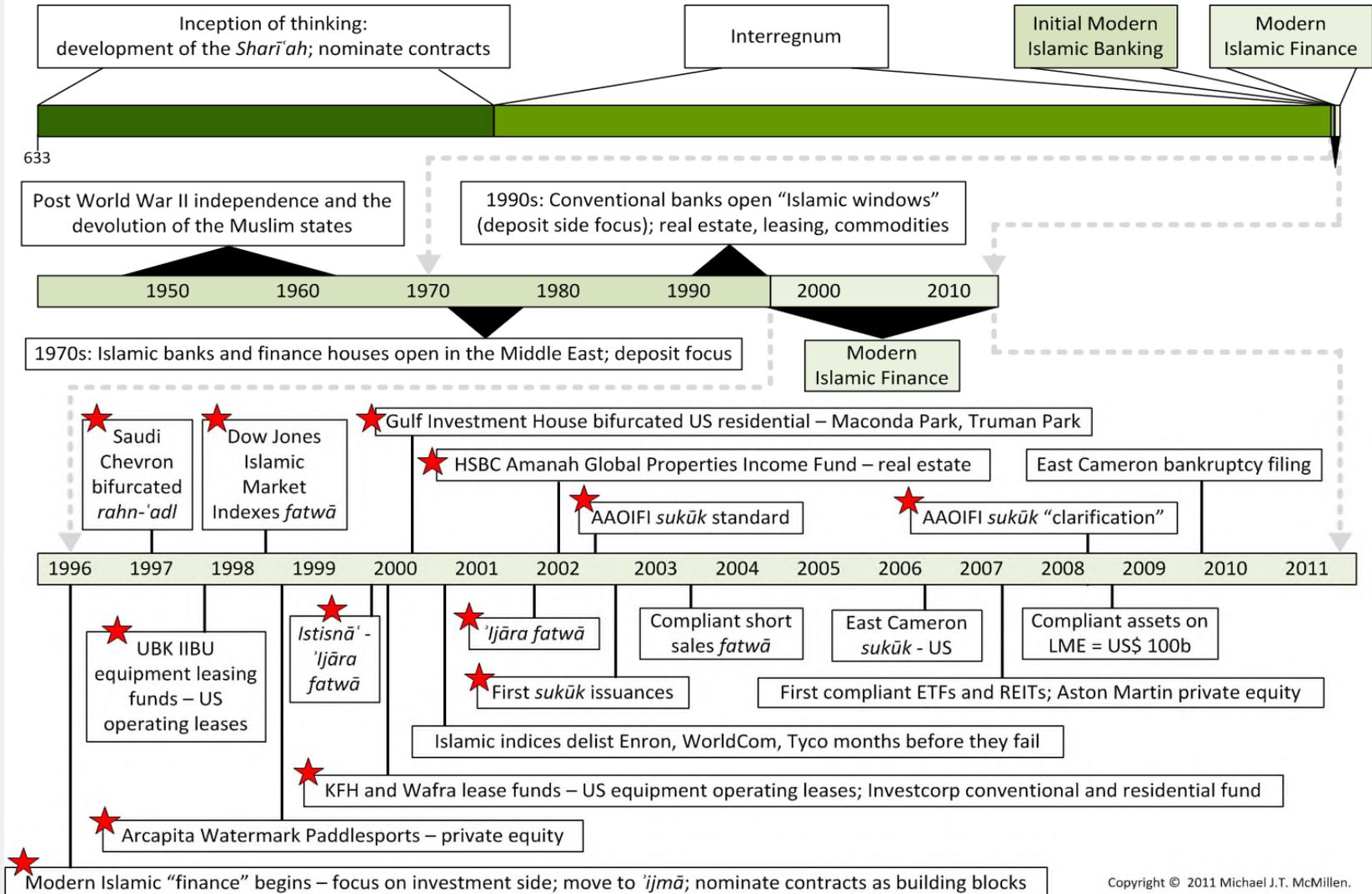
Sukūk – finance or “debt” side of capital markets - especially after 2003



The red stars in the history section

Figure 1: TIMELINE: MODERN ISLAMIC FINANCE AND INVESTMENT

Adapted from Yusuf Talal DeLorenzo and Michael J.T. McMillen, *Law and Islamic Finance: An Interactive Analysis* (2007), and Yusuf Talal DeLorenzo presentation, February 17, 2009, U.S. Treasury.



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Collateral Security - *Rahn*

- An example: collateral security in Saudi Arabia – 1996 to the present
- Law – no system for recordation of security interests, but could record in land registry for Saudi Industrial Development Fund, Public Investment Fund
- Policy – Ministry of Justice will not record security interests because they are thought to secure interest-bearing loans
- Result:
 - No limited recourse project financings
 - Home ownership limited to wealthy – others (e.g., middle class) cannot obtain financings, limiting their investment in their society
 - Most other financings – highly restricted to personal guarantee scenarios

- Build the model for the project financing to the Saudi Arabian legal and regulatory system and enforcement mechanisms – rather than traditional US or English model

- Difficult to convince lenders and other participants – never previously done – and first project financing in Saudi Arabia

- Focused on first principles under the *Sharī'ah* – an 18-month study of camels and date palms
 - Model for collateral security structures in Saudi Arabian financings since 1997
 - Model for new Saudi mortgage registration law
 - An impetus for many to reconsider the possibilities of advancing Islamic finance and rethinking the methods of implementing Islamic finance



Nominate Contracts as Building Blocks

- No existing code – *Majelle*
- But there was the ability to reason and to view the Islamic system as something akin to Anglo-American common law – case-by-case determinations
- ★ The scholars turned to the “nominate contracts” – the “silo” approach, which was still dominant in 1996

- Historically, under the *Sharī'ah*, there were a limited number of contractual transactional forms for the conduct of business – the “nominate contracts”
- There are dozens of them
- These were trade-based structures – quite rigid
- They included:
 - Loans (*qard hassan*)
 - Gifts
 - Sales (*bay*), such as *murābaha* (sale at a mark-up)
 - Leases – a type of sale of the usufruct (*'ijāra*)
 - Joint ventures and partnerships (*sharikāt, muḍāraba*)
 - Manufacture or construction contracts (*'istisnā'*)
 - Agency (*wakāla*)
 - Others

- ★ Scholars and practitioners began moving away from a conception of the nominate contracts as being immutable and rigid silos, moving toward a more flexible conception of these structures
- ★ The scholars allowed the use of more than one nominate contract in a single transaction
 - This changed the world – allowed development of sophisticated financial structures and instruments that could compete with conventional structures and instruments
 - Consideration: the combination of contracts cannot defeat the essence underlying any of the nominate contracts used
 - That gives rise to debate – less now, but still a factor





Ijmā'

- *Ijmā'* – consensus of the community of scholars
- Mid-1990s consensus of a leading group of *Sharī'ah* scholars in bringing the four main Sunnī *madhahib* into agreement on structures and documentation
- An example:
 - the process of developing financial structures, products and instruments for sales across all OIC jurisdictions – i.e., that were compliant with the *Sharī'ah* as interpreted by each of those schools, and
 - the associated transaction costs and time frames
 - which were such that an Islamic finance industry (even regionally) was not practicable

- Scholars sought ways to issue *fatāwa* that approved a structure, product or instrument as compliant under all four schools without forsaking the principles of any single school
 - e.g., footnote 3 of *’ijāra fatwa* of December 2001, Karachi
- Much greater consensus: Fiqh Academy of the Organization for Islamic Cooperation (formerly the Organization of the Islamic Conference), the *Sharī‘ah* supervisory board of the Islamic Development Bank, AAOIFI
- Dow Jones deliberations: 1993 to 1998 – OIC *Fiqh* Academy
- Standards organizations: AAOIFI, IFSB, others



Bifurcated Structures

- Early in the history of US transactions (late 1990s), the lease (*'ijāra*) was chosen as the preferred transactional structure

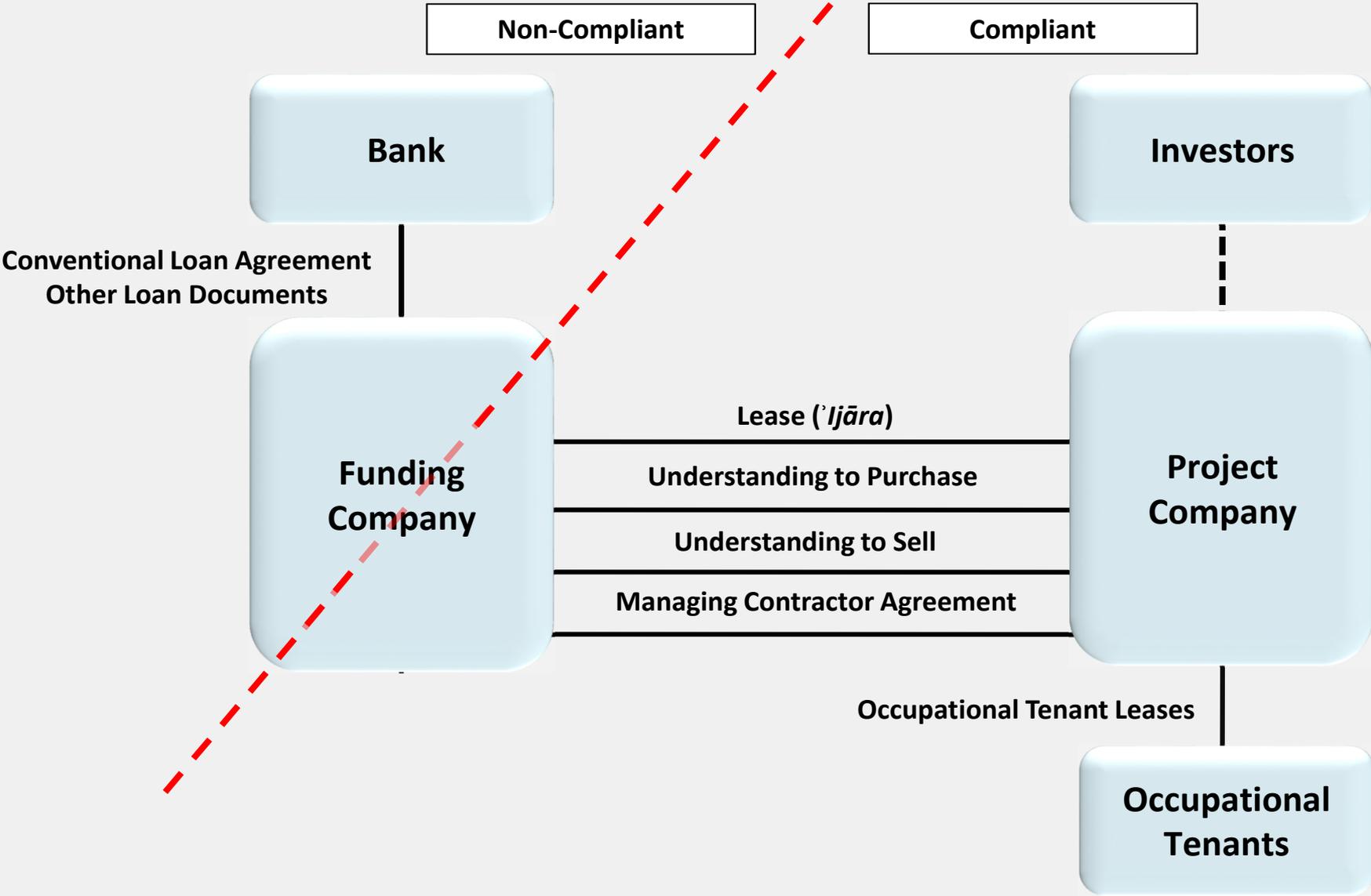
- Why?
 - Every banker, lawyer and accountant is familiar with lease financing
 - The law of lease financing – all aspects – is well developed
 - Leases are flexible
 - Leases are *Sharī'ah* compliant
 - *Sharī'ah* lease principles are quite similar to common law lease principles

- It was familiar; it was not scary; it illustrated the similarities

- Size, complexity, risk diversification and political considerations, among other factors, result in the need for both conventional and Islamic financing for most real estate (and other) projects
- These banks would only make conventional interest-based loans
 - Familiarity
 - Credit and underwriting
 - Regulatory and tax
 - Other reasons
- Bifurcated structures making use of both *Sharī'ah* structures and conventional structures in an overall transaction that is determined to be *Sharī'ah*-compliant by the *Sharī'ah* scholars
- The first structures made use of the *'ijāra* (lease) – basically a leveraged lease format – familiar to bankers and lawyers
- Those structures remain predominant throughout the world – adjusted for each jurisdiction



Bifurcated Structure



LOAN AGREEMENT

- Commitment to Lend
- Disbursement Mechanics
- Conditions Precedent
- Representations and Warranties
- Rate Calculations
- Amortization
- Mandatory Prepayment
- Voluntary Prepayment
- Covenants
- Events of Default
- Remedies
- Indemnities

LOAN AG

- Commitment to Lend
- Disbursement Mechanics
- Conditions Precedent
- Representations and Warranties

REEMENT

- Rate Calculations
- Amortization
- Mandatory Prepayment
- Voluntary Prepayment
- Covenants
- Events of Default
- Remedies
- Indemnities

LEASE ('IJĀRA) [CONSTRUCTION (*'ISTIṢNĀ'*)]

- Commitment for Construction
- Disbursement Mechanisms
- Conditions Precedent
- Representations and Warranties
- Covenants

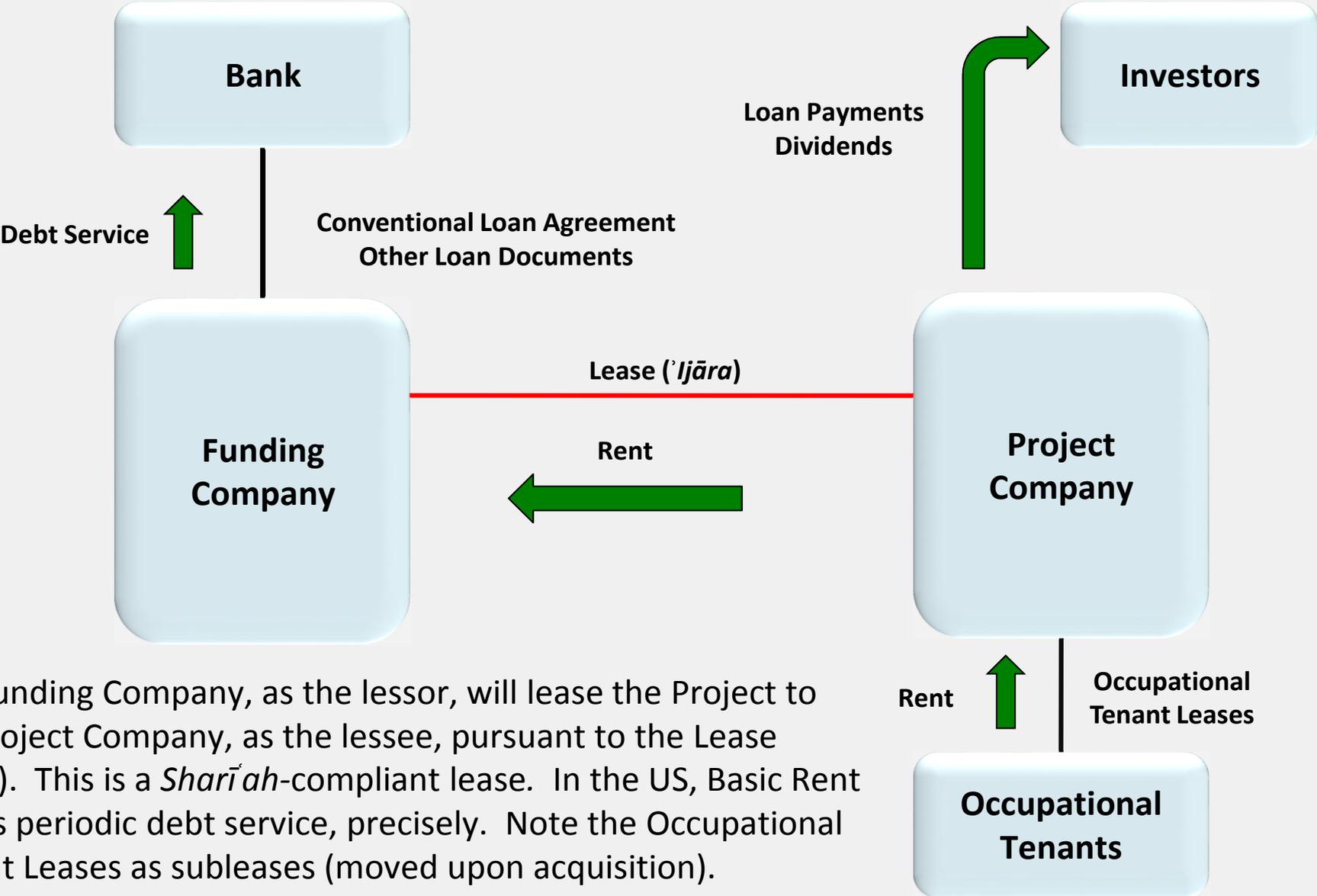
LEASE (*'IJĀRA'*)

- Rent Rate Calculations
- Periodic Rent
- Covenants
- Representations and Warranties
- Events of Default
- Remedies
- Indemnities

Acquisition transactions have no *'istiṣnā'* – that is for construction and development financings with multiple draws

UNDERSTANDINGS TO SELL AND PURCHASE: “PUT” and “CALL” OPTIONS

- Mandatory Prepayments
- Voluntary Prepayments



The Funding Company, as the lessor, will lease the Project to the Project Company, as the lessee, pursuant to the Lease (*'Ijāra*). This is a *Sharī'ah*-compliant lease. In the US, Basic Rent equals periodic debt service, precisely. Note the Occupational Tenant Leases as subleases (moved upon acquisition).



Dow Jones *Fatwā*

- Prior to 1998, any violation of *Shari'ah*, however slight, rendered the transaction impermissible
- Prior to 1998, a totally observant Muslim could not purchase a share of stock – *ribā* being a major constraint

★ Dow Jones Islamic Indexes *fatwā* of 1998 (amended 2003)

- The tests: permissible business (“core” business), permissible instruments, and permissible impurity and financial tests
- Institutionalization of a degree of “permissible impurity” or “permissible variance”
- Institutionalization of cleansing or purification

★ Cleansing and purification – small amounts of impermissible interest income could be cleansed or purified by donation to charity

- Issue in 1993: inability to invest in any equity security anywhere if *Sharī'ah* interpreted in absolute terms
 - Every company paid or received interest
 - Conglomerates ownership of limited impermissible businesses: *e.g.*, manufacturing company that owns a credit company
 - Debate: 1993 to 1998: is *Sharī'ah* absolutely preclusive and intolerant of even negligible impurities?
- Context in which the Dow Jones *fatwā* was considered and issued:
 - non-controlling investments in equity securities
 - that had some degree of impermissible interest income or expense and/or engagement in some impermissible business activity

- Institutionalization of a degree of “permissible variance” or “permissible impurity”
- Institutionalization of “cleansing” and “purification” (small amounts of impermissible interest income could be cleansed or purified by donation to charity)
- Addressed issues pertaining to “permissible business purpose” for conglomerates and multi-business companies: “core business”
- Enabled the development of Islamic equity markets
- Principles have evolved and been applied in many other areas – a primary enabler of the development and growth of the Islamic finance and investment industry

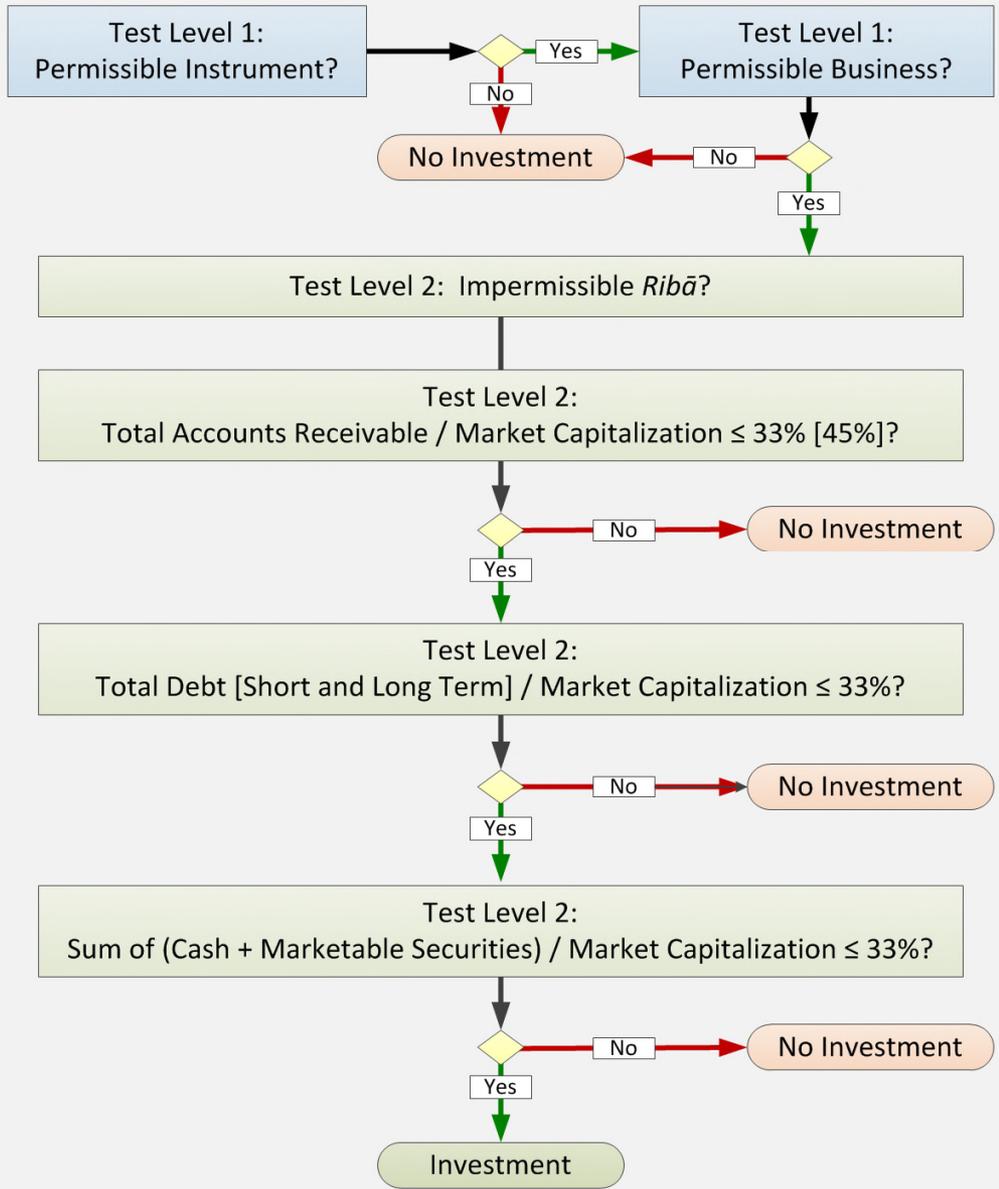
- Tests regarding whether an equity investment can be made in compliance with the *Sharī'ah*:
 - **Level 1: First: Is the instrument itself prohibited?**
 - Consider preferential returns and fixed returns: no preferred stock, for example
 - **Level 1: Second: Is the entity in which the equity investment is to be made in a permissible business?**
 - No pork, alcohol, interest-based finance, pornography, etc.
 - **Focus on the “core” business of the entity**
 - **Level 2: Does such entity have impermissible *ribā* elements?**
 - **Some interest income and expense is tolerated based upon the financial tests - balance sheet tests**

- Financial Tests:
 - Total Accounts Receivable / Market Capitalization < 45%
 - Total Debt (Short-Term and Long-Term) / Market Capitalization < 33%
 - Sum of Cash + Cash Equivalents + Marketable Securities / Market Capitalization < 33%

- Market capitalization: 12-month trailing average

- Continuing, on-going, periodic review (market movements, mergers, acquisitions, divestitures, bankruptcies, etc.)

- Use more precise tests if available



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**Evolutionary Step 1:
Other Balance Sheet
Equity Index Tests**

- Why balance sheet basis of Dow Jones: available information
- Tests using the same balance sheet principles as were used in the Dow Jones *fatwā*
 - Adjustments to Dow Jones principles – total accounts receivable / market capitalization test moved to 33% (from 45%)
 - Market capitalization as a denominator during dot.com and subsequent volatilities in interest rates

- *AAOIFI Shari'a Standard No. 21: Financial Paper (Shares and Bonds)*
- Equity transactions covered:
 - Acquisitions
 - Investments
 - Trading
- Total Debt (Short-Term and Long-Term) / Total Assets not > 30%
- Note the denominator is total assets (not market capitalization)
- Income from haram activities not > 5% of total income

- Manner in which prohibited income is generated is relevant:
 - Investment in shares or other instruments
 - Prohibited activities
 - Ownership of prohibited assets
 - Others
- No separate tests for:
 - Accounts receivable
 - Cash, cash equivalents and marketable securities
- Failure to meet tests: must dispose of investment
 - What is the permissible time frame and what are the conditions for disposal?

- Cleansing and purification:
 - Not required for sales of shares prior to end of financial period
 - Not required for agent, intermediary or manager to deduct haram income from fees, commissions or wages
 - Impure income calculated at end of defined finance period on per-share basis

- Use combinations of some Dow Jones principles, some operating statement principles and some AAOIFI Standard 21 principles
 - FTSE Bursa Malaysia Hijrah Shariah Index: similar to Dow Jones
 - FTSE Bursa Malaysia EMAS Shariah Index:
- Revenue from clearly unlawful activities (*ribā* from interest-based banks, liquor, gambling, pork) may not be > 5% of total revenue
- Revenue from less clearly unlawful activities may not be > 10% of total revenue
- Revenue from share trading, stock brokering, hotels and resorts that serve alcohol to non-Muslims, and similar activities, may not be > 24% of total revenue
- Denominator is revenue
- Source of income is critical
- Accounts receivable test not used

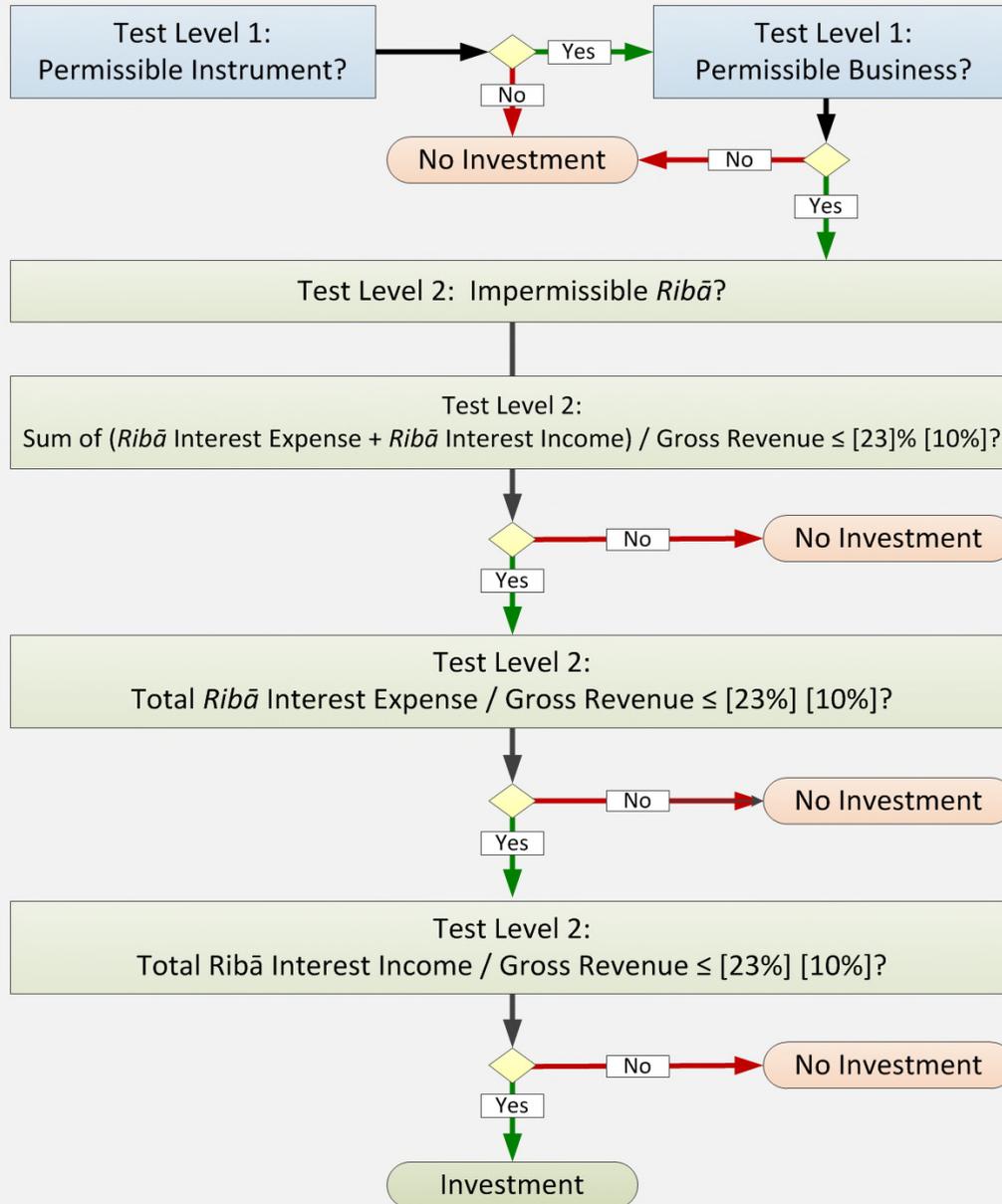


**Evolutionary Step 2:
Operating Statement
Equity Index Tests**

- Evolution of financial disclosure: EDGAR (Electronic Data Gathering, Analysis and Retrieval of the United States Securities and Exchange Commission – fully implemented only in 1996) system and beyond
- Opinion: I do not think that debt / market capitalization test was designed to allow trading in debt, and the operating statement tests are one example of why (there are others)
- Availability of operating statement information
- Operating statement tests
 - Actual interest income and actual interest expense; not estimations using total debt (note that the Dow Jones tests do not use an interest calculation – the balance sheet informational basis means that there is no knowledge as to the interest rate on any debt)
 - Denominator: total revenue (rather than market capitalization)

- Variations in tests: what percentage figures:
 - $(\text{total interest income} + \text{total interest expense}) / \text{gross revenue}$ not $> X\%$
 - $(\text{total interest income} / \text{gross revenue})$ not $> Y\%$
 - $(\text{total interest expense} / \text{gross revenue})$ not $> Y\%$
- Impermissible business income tests (e.g., not $> 5\%$ or 10% of gross revenue)
- Source of income: some scholars take the position that certain types of haram income are never permissible (at any percentage level), other types of haram income are sometimes permissible
- Variations from one scholar to another
- What is the basis in *fiqh*?
- Accounting considerations: treatment of an '*ijāra*' under international accounting standards and generally accepted accounting standards

OPERATING STATEMENT EQUITY INVESTMENT TESTS



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**Evolutionary Step 3:
“Core Business”
Principles in
Non-Equity Contexts**

- Real estate: types of non-compliance:
 - Permissible activity at the premises by tenant where parent or tenant as a larger entity has non-compliant activities at other locations
 - Non-compliant activity at the leased premises
 - Non-compliant occupational tenant leases (next evolutionary step)

- Real estate examples: permissible tenants
 - ATM owned by interest-bearing bank as only variant activity in commercial office building
 - Supermarket that sells pork and/or beer
 - Check processing activities of interest-based bank
 - Restaurants that serve alcohol or pork
 - Micro-brewery in isolated commercial office complex with no other restaurants

- Factors
 - Nature of non-compliant activity
 - Square footage of non-compliant rental unit and its relative relationship to the square footage of the entirety of the property
 - Amount of rent derived from the space in which the non-compliant activity is conducted and its relationship to the total rent for the property
 - Whether the service is an essential or elective service
 - If an elective service, its relative importance to the property
 - The tenant population and the surrounding community
 - Whether the business serves a commercial or a residential client base
 - The availability of equivalent or complimentary services in the immediate and broader vicinity
 - Many others



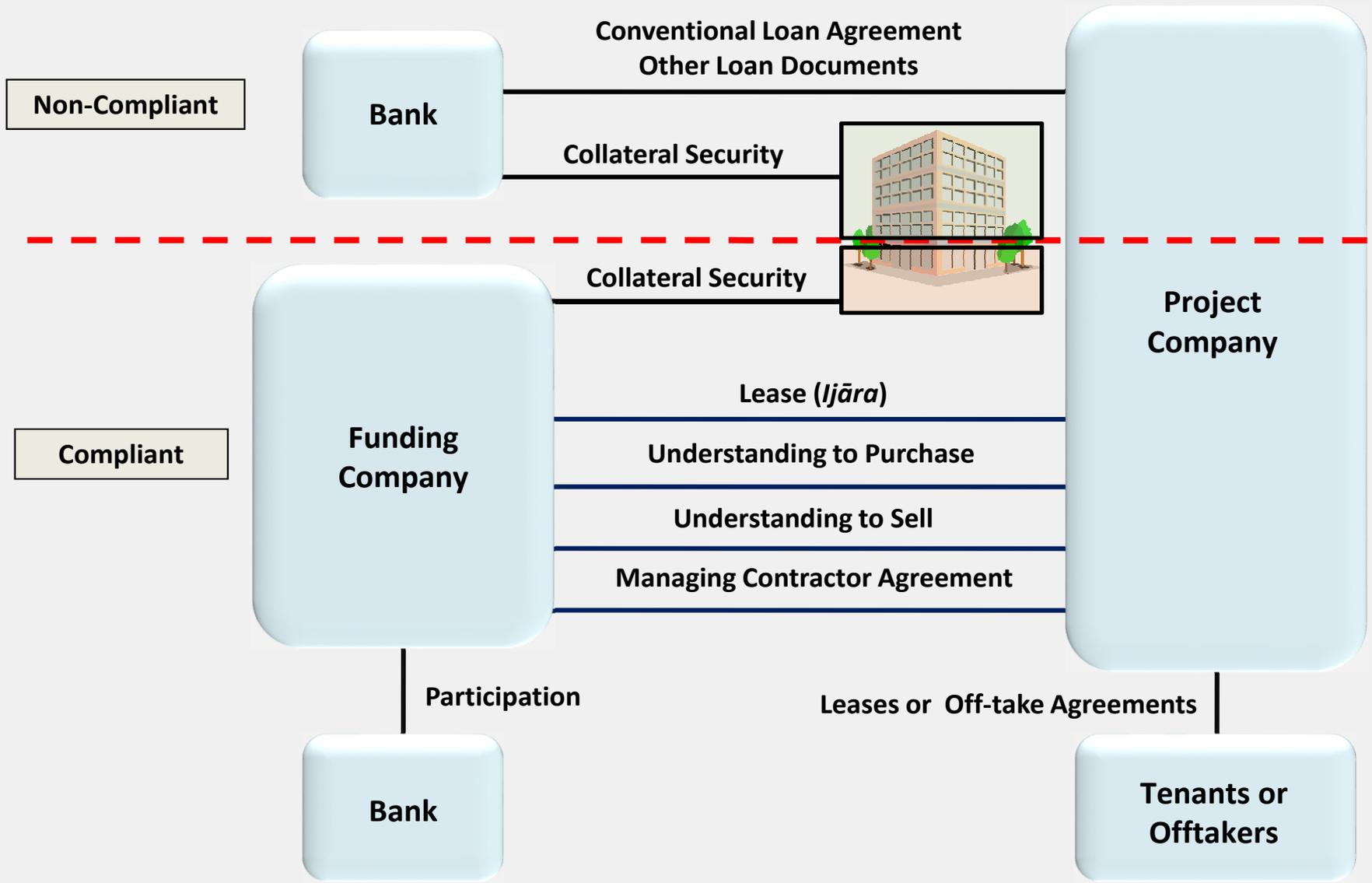
Evolutionary Step 4:

**Variance Principles
Not Set Forth In
Dow Jones *Fatwā***

- Real estate: tenant leases and market standards and practices
 - Maintenance and triple net leasing; structuring (managing contractor agreement)
 - Casualty insurance; structuring (managing contractor agreement)
 - Late payment and default interest; purification
- Impermissibility at acquisition, with elimination at renewal or re-leasing

- Project finance: single Islamic tranche transactions – assume an *'ijāra'*
 - Large conventional interest-based financing
 - Smaller *Sharī'ah*-compliant tranche
 - Some assets are isolated out for the *Sharī'ah*-compliant tranche
 - Two leases: one for conventional tranche(s) and one for *Sharī'ah*-compliant tranche

Generic Single Islamic Tranche 'Ijāra' Structure



- Reality: projects are usually large, integrated and indivisible wholes from an operational standpoint
- Neither the conventional lenders nor the *Sharī'ah*-compliant financiers
 - can have effective security because neither can operate the project or facility without the assets allocated to the other group of financiers
 - will allow the other transaction to be in default when their transaction is not in default; must have simultaneous defaults without cross defaulting the *Sharī'ah*-compliant tranche to the conventional tranche(s)
 - will allow the other group of financiers to be paid except when both are being simultaneously paid (unless there is express subordination, which is unlikely)

- Remedies:
 - Neither group of financiers will allow the other group to exercise remedies without participation by the first group and extensive coordination and sharing
 - Neither group of financiers will allow the other to control the exercise of remedies on all indebtedness
 - Interests of different types of financiers (convention and *Sharī'ah*-compliant) may differ significantly (especially if assets securing one type are not fully available to, and shared with, the other)

- Collateral value – outstanding principal mismatches: assets allocated to one tranche or type of financier will likely not have a collateral value equal to the amounts secured under that tranche or by that type of financier
- Intercreditor agreements
- Collateral sharing, meaning assets from the *Sharī'ah*-compliant tranche will end up securing the interest-bearing debt, and vice versa, either directly or indirectly
- Proceeds of collateral securing *Sharī'ah* can only be used to service principal, not interest, on conventional interest-bearing debt

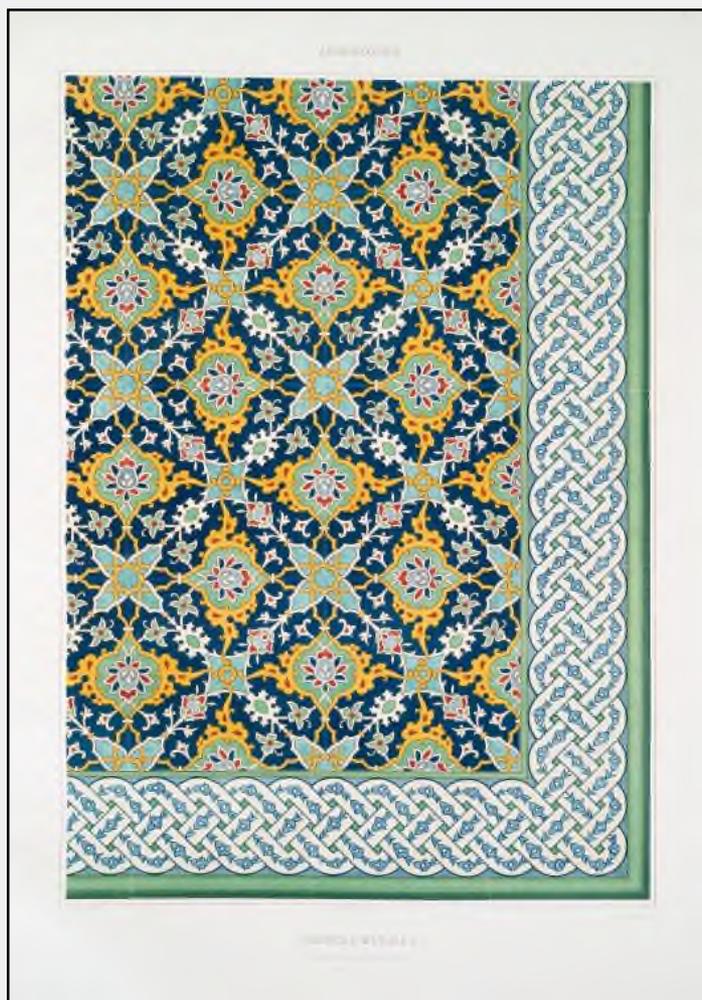


Evolutionary Step 5:

**Application Of
Cleansing and
Purification**

- Who is to cleanse impure income:
 - company
 - investor recipient

- A real estate example involving a micro-brewery and donation of rent:
 - lunch availability and travel studies
 - percentage profit from alcohol and trade association figures
 - donation of entire rent or pro rated rent



**Evolutionary Step 6:
Private Equity**

- Complete information through due diligence
- Can therefore use actual figures, with no need to estimate
 - Actual interest income
 - Actual interest expense
 - Actual amounts of impermissible income with full source knowledge

- Controlling interest, in the usual case
- Previous standards are inapplicable as everything will have to be (or become) compliant
- Many scholars allow much greater variation because all will be made compliant over time:
 - Degree of non-compliance at inception?
 - Time frame for bringing company into compliance?



Sukūk

- Common parlance: “Islamic bonds”
- They are not bonds
- They are either (a) asset securitizations or (b) whole business securitizations
- AAOIFI definition: certificates of equal value put to use as common shares and rights in tangible assets, usufructs and services or as equity of a project or investment activity
- Most rapidly growing area of Islamic finance

- AAOIFI (Accounting and Auditing Organization for Islamic Financial Institutions) *sukūk* standard
- 14 acceptable categories of transactions (generally and conceptually speaking, some are “bond” structures and some are “asset securitization” structures)
- 2003 to the present – massive increase in volume – fastest growing area of Islamic finance
- Most issuances to date have been bonds, and most of those issuances have had a sovereign credit involved as the ultimate credit
- Two asset securitization structures
- Corporate *sukūk*

- Securitization of:
 - An existing or to be acquired tangible asset (*'ijāra*)
 - An existing or to be acquired leasehold estate (*'ijāra*)
 - Presale of services (*'ijāra*)
 - Presale of the production or provisions of goods or commodities at a future date (*salam*)
 - Funding cost of construction (*'istisnā'*)
 - Funding acquisition of goods for future sale (*murābaha*)
 - Capital participation in a project or business (*muḍāraba* or *mushāraka*)
 - Various asset acquisition and agency management (*wakāla*), agricultural land cultivation (*musra'a*), land management (*muqarasa*) or orchard management (*musāqa*) activities

Total Issuances: US\$ 87,955.22 million

Total Offerings: 596

Sovereign Issuances: 35%

Corporate Issuances: 65%

Malaysia

Issuances: 267 (44.80%)

Total Volume: US\$ 37,696.72 million (42.86%)

Bahrain

Issuances: 150 (25.17%)

Total Volume: US\$ 6,149.78 million (7.00%)

UAE

Issuances: 34 (5.70%)

Total Volume: US\$ 26,977.48 million (30.67%)

Total Number: Malaysia + Bahrain: 69.97%

Total Volume: Malaysia + UAE: 73.53%

Compare: Gambia: 36 (6.04%) and US\$ 11.49 million (0.0%)

Source: Michael J.T. McMillen and John A. Crawford, *Sukuk in the First Decade: By The Numbers*, Dow Jones Islamic Indexes Newsletter, Issue 3, 2008.

Issuances by Industry Sector

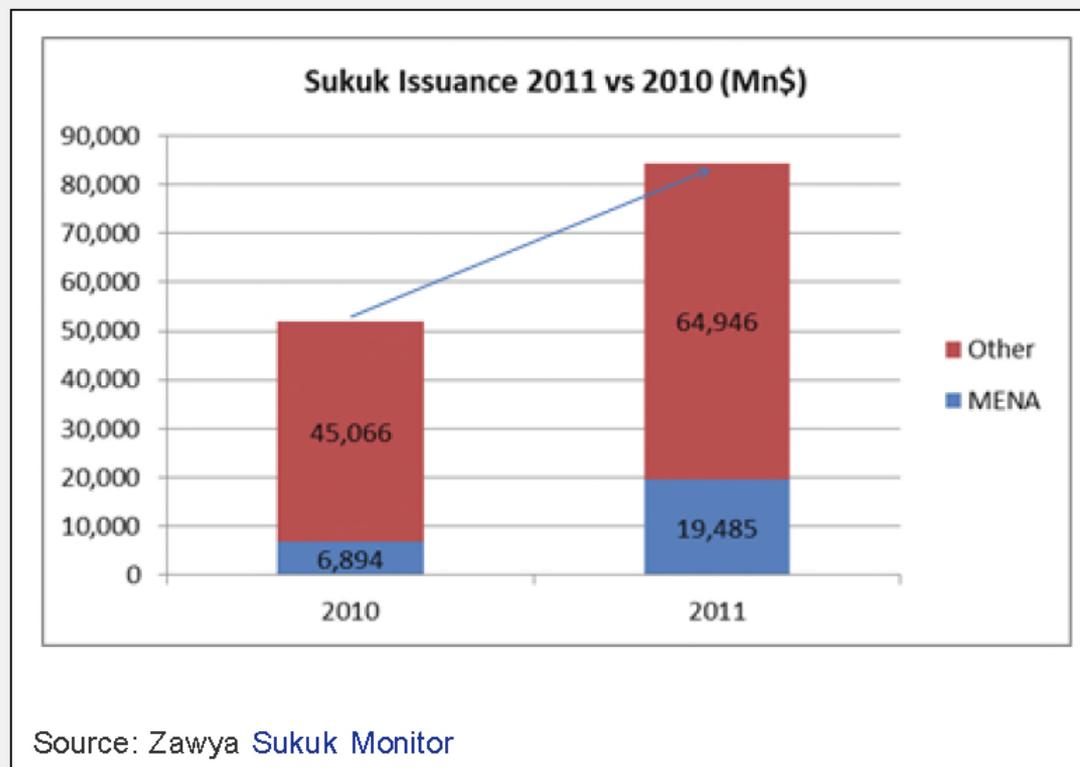
INDUSTRY	Volume (US\$—millions)	% Total Volume	Offerings	% Total Offerings	Average Issuance (US\$—millions)
Financial Services	21,712.92	24.7%	69	11.6%	314.68
Real Estate	19,368.73	22.0%	67	11.2%	289.09
Transport	12,004.63	13.6%	40	6.7%	300.12
Power & Utilities	9,054.77	10.3%	22	3.7%	411.58
Oil & Gas	6,338.12	7.2%	20	3.4%	316.91
Government	7,340.65	8.3%	197	33.1%	37.26
Construction	4,254.04	4.8%	34	5.7%	125.12
Services	2,088.67	2.4%	7	1.2%	298.38
Telecoms & IT	1,836.32	2.1%	28	4.7%	65.58
Industrial Manufacturing	1,090.30	1.2%	21	3.5%	51.92
Conglomerates	1,014.88	1.2%	7	1.2%	144.98
Agriculture & Food	767.55	0.9%	52	8.7%	14.76
Consumer Goods	347.64	0.4%	11	1.8%	31.60
Mining & Metals	306.65	0.3%	4	0.7%	76.66
Basic Materials	169.10	0.2%	7	1.2%	24.16
Healthcare	128.08	0.1%	3	0.5%	42.69
Automotive	127.51	0.1%	6	1.0%	21.25
Travel & Tourism	4.69	0.0%	1	0.2%	4.69

Source: Michael J.T. McMillen and John A. Crawford, *Sukuk in the First Decade: By The Numbers*, Dow Jones Islamic Indexes Newsletter, Issue 3, 2008.

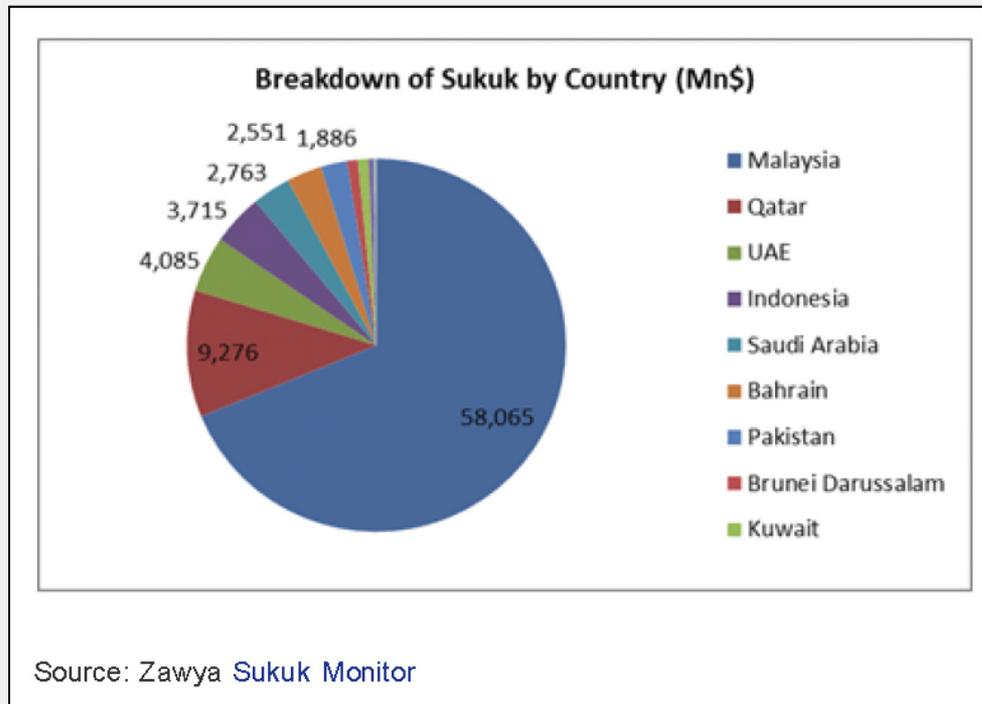
STRUCTURAL TYPE	Volume (US\$—millions)	% Total Volume	Offerings	% Total Offerings	Average Issuance (US\$—millions)
Ijarah	29,567.07	33.7%	225	37.8%	131.41
Musharaka	27,339.01	31.2%	78	13.1%	350.50
Modarabah	10,305.37	11.8%	33	5.5%	312.28
Murabaha	8,065.00	9.2%	112	18.8%	72.01
Istisnaa	5,022.20	5.7%	16	2.7%	313.89
Al-Istithmar	4,332.87	4.9%	4	0.7%	1083.22
Al Salaam	2,337.73	2.7%	126	21.2%	18.55
Other	650.00	0.7%	1	0.2%	650.00

Source: Michael J.T. McMillen and John A. Crawford, *Sukuk in the First Decade: By The Numbers*, Dow Jones Islamic Indexes Newsletter, Issue 3, 2008.

- US\$ 84.4 billion of *sukūk* issued globally.
- Increase of 62% over 2010 (US\$ 52 billion issued in 2010).
- Global market: US\$ 182 billion outstanding.

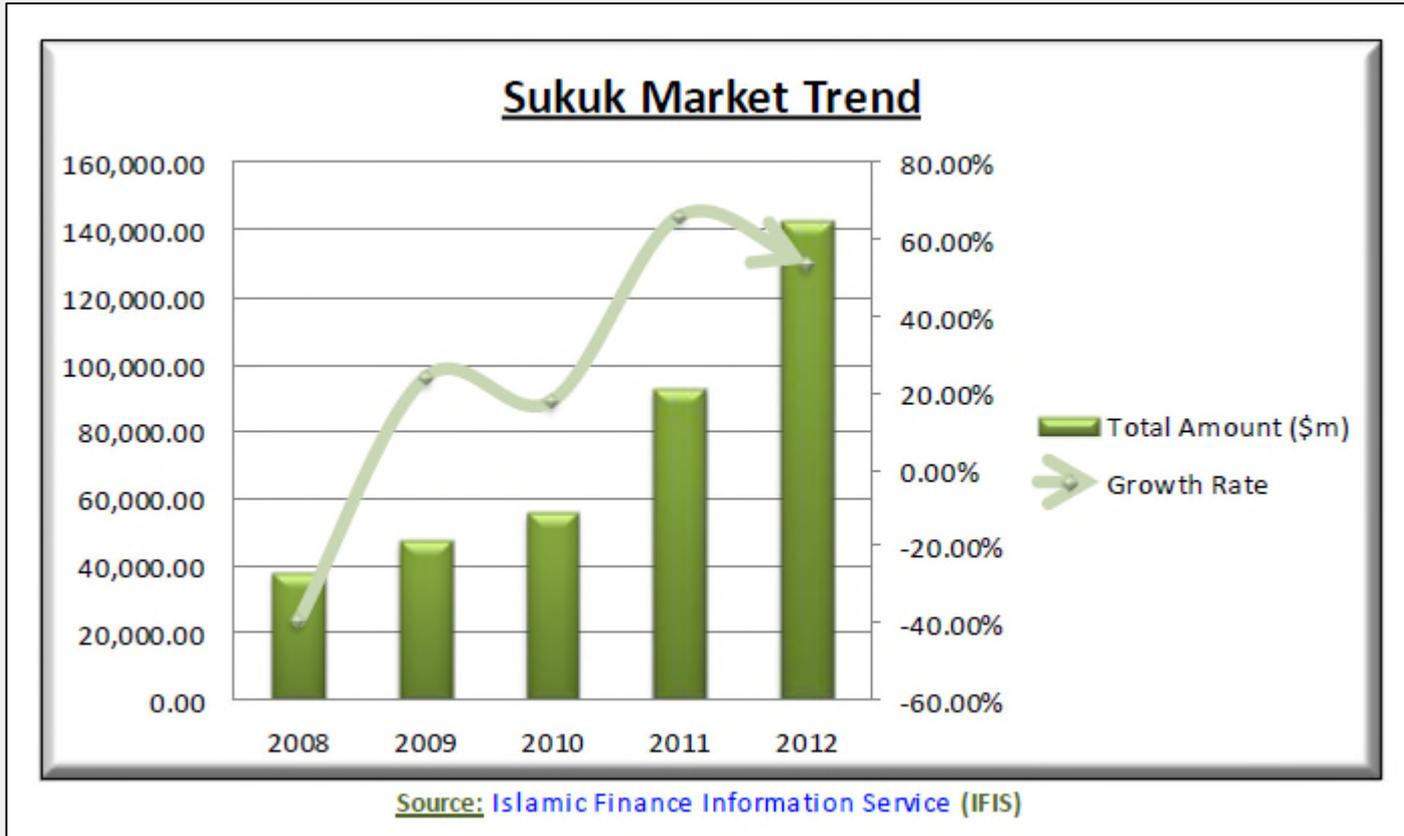


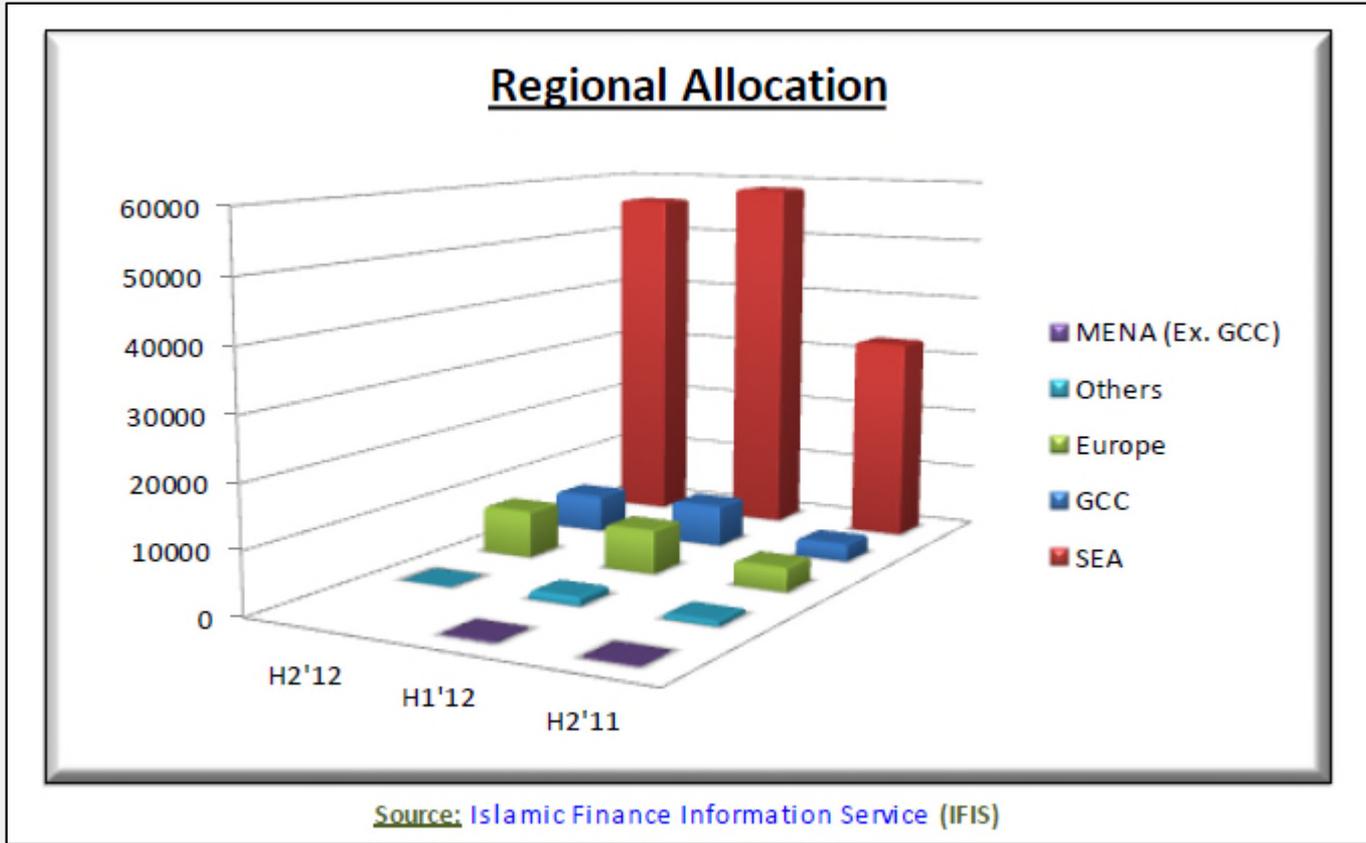
- Of the US\$ 84.4 billion of *sukūk* issued globally:
 - US\$ 58 billion or 69% were issued out of Malaysia
 - US\$ 19 billion or 23% were issued out of the GCC
- New issuers: Yemen, Iran and Jordan.

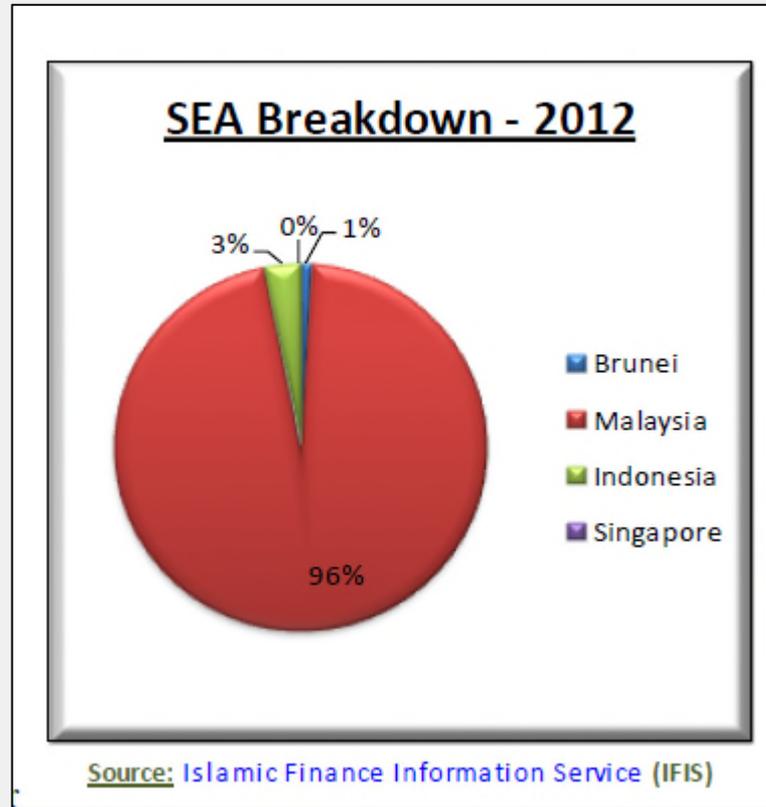


- Government institutions issued 66% of all *sukūk*, US\$ 56 billion.
- Financial services was second with 17.5% or US\$ 15 billion.
- Most were domestic issuances (89% of the total, at US\$ 75.8 billion), but there were 14 international issuances (US\$ 8.6 billion, up from 11 international issuances worth US\$ 5 billion in 2010)

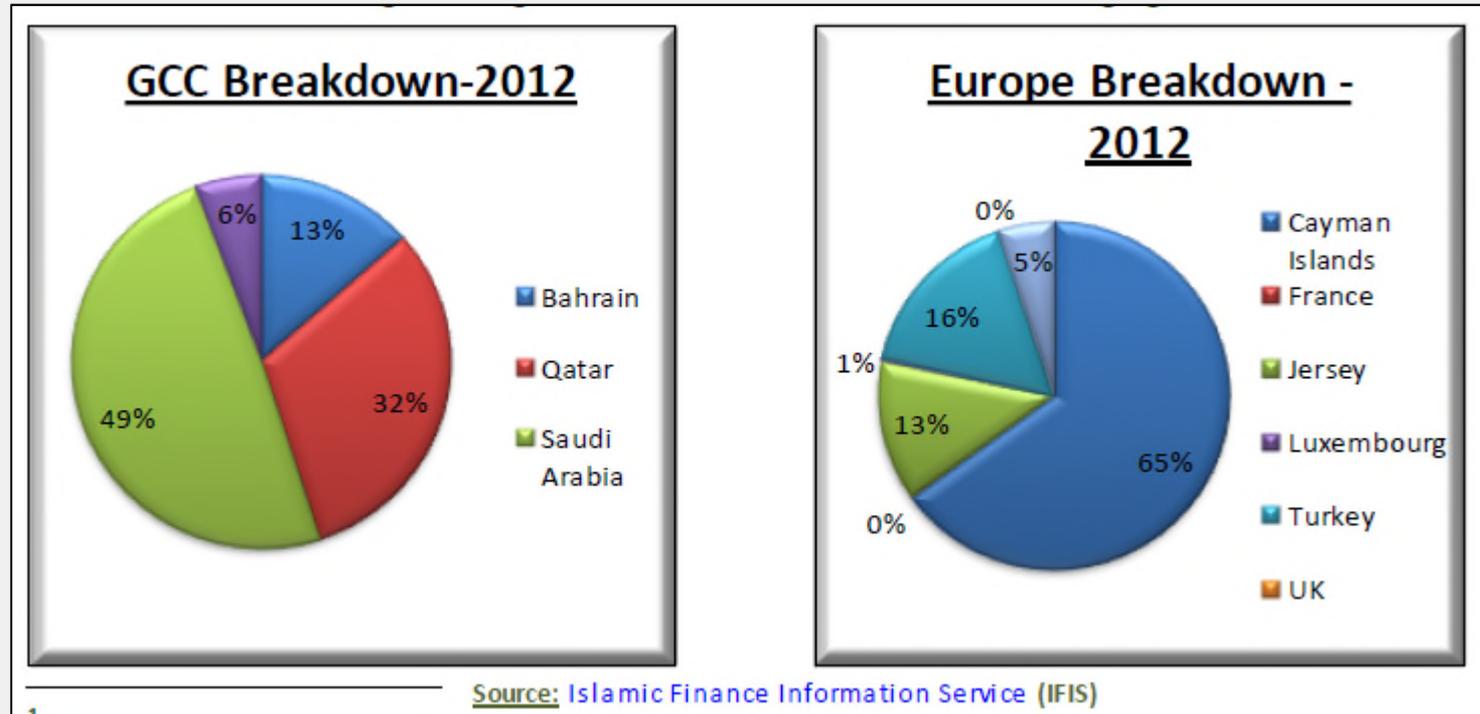
- In the first 9 months of 2012, US\$ 63 billion of *sukūk* were issued globally
- Malaysia issued 69% of all *sukūk* in the period.
- Issuances from Gulf Cooperation Council (the “GCC”) jurisdictions were:
 - 2009: US\$ 7.6 billion
 - 2010: US\$ 6.1 billion
 - 2011: US\$ 85 billion
 - 2012: US\$ 143.4 billion
- Now more *sukūk* issuances than conventional bond issuances in the countries of the Gulf Cooperation Council



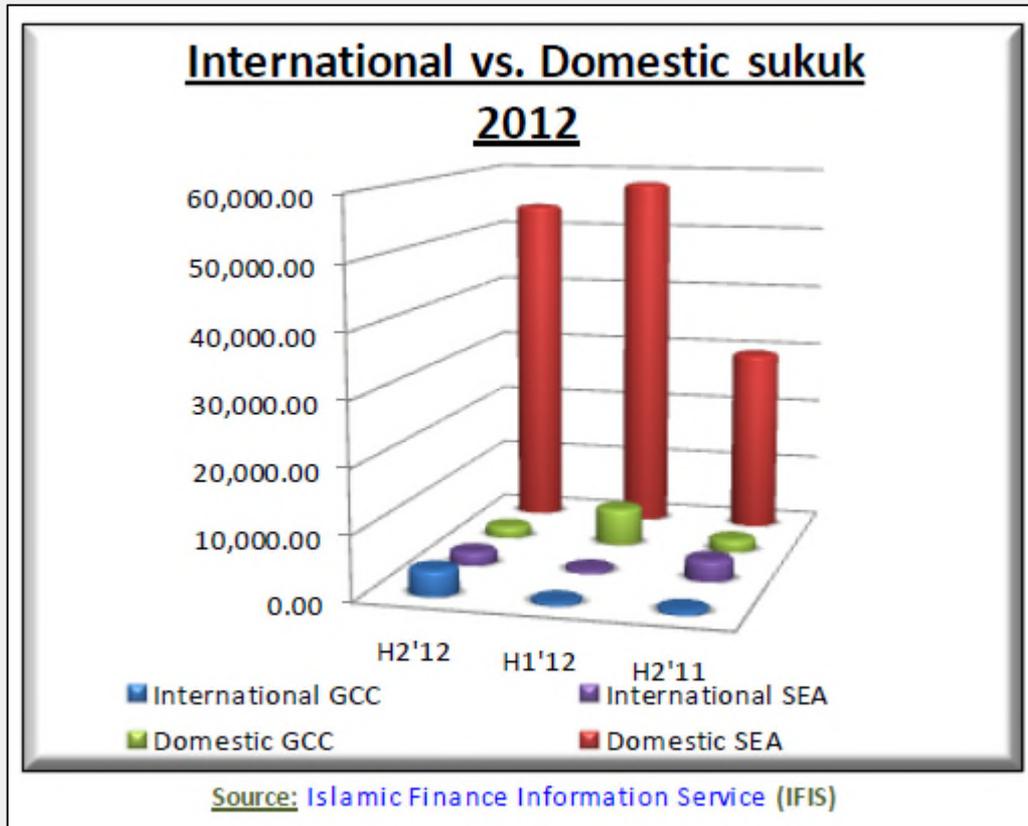




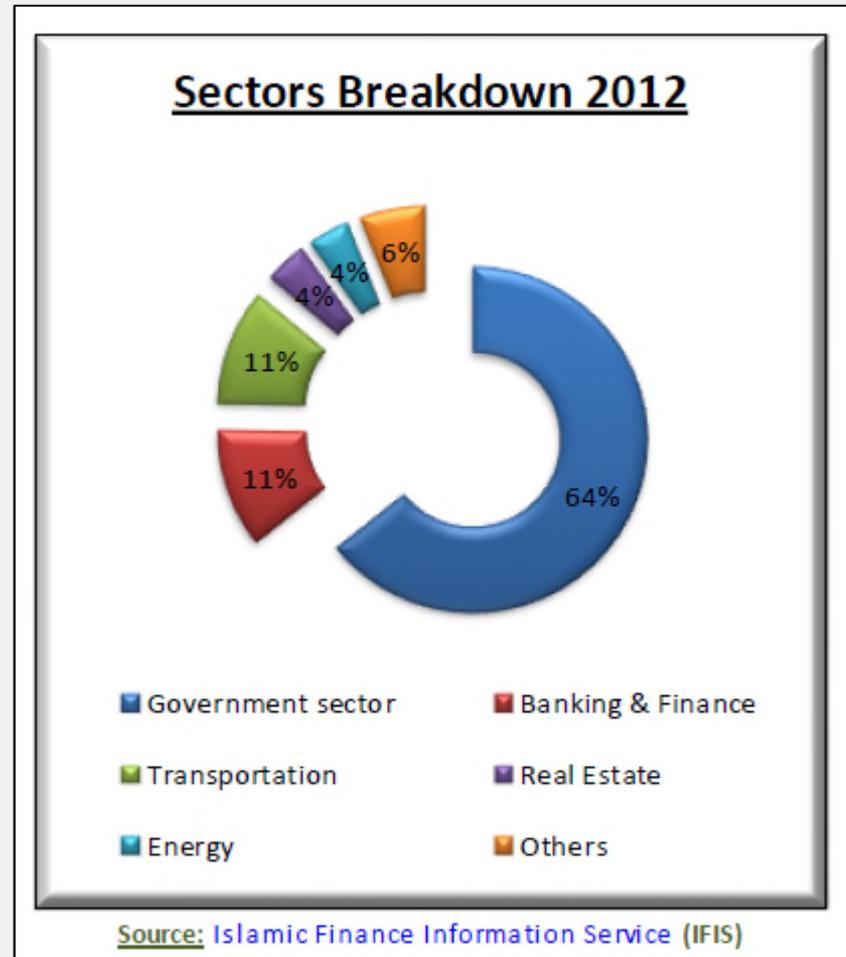
- SEA – US\$ 114.55 billion or 79.82% of total market (a 61.2% increase from 2011)
- Malaysia: 96% of SEA at US\$ 109.8 billion (77% of global *sukūk* market)



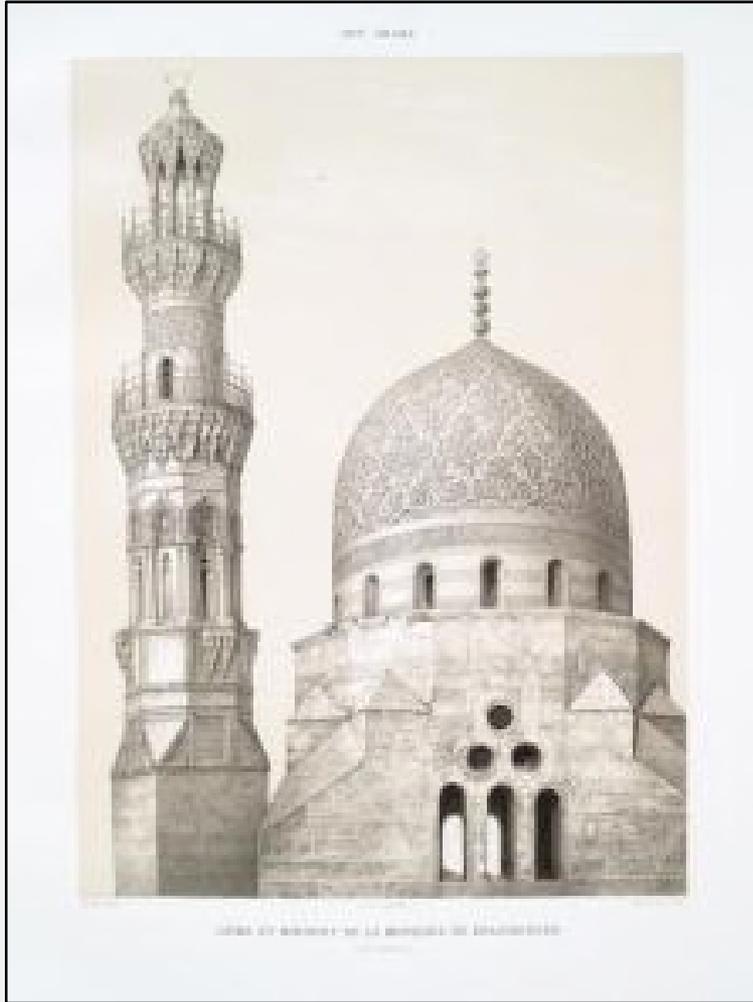
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- Government sector: US\$ 92.41 billion (64% of total market, down from 71% in 2011)
- Banking sector: US\$ 15.81 billion (11% of total market, up 94% from 2011)
- Transportation: US\$ 15.53 billion (11% of total market, up 794% from 2011)
- Real estate: US\$ 5.66 billion



- Three structures are predominant at the present time and the use of another structure is increasing.
- *Mushāraka* and *murābaha* structures are favored in Malaysia and their use is increasing (in both number and volume).
- *ʾIjāra* structures remain commonplace.
- Use of the *sukūk al-wakāla* seems to be increasing: this structure is acceptable in both the GCC and Malaysia and allows incorporation of structures that cannot be traded on secondary markets (e.g., *murābaha* and *ʾistisnāʾ* obligations).



Conclusions

- Finance and investment activity throughout the world is dominated, at present, by interest-based principles
- Interest-based principles form the basis and substrate for legal, accounting, finance, underwriting and other structures and procedures
- Islamic finance and investment industry cannot presently exist without integration with the broader interest-based economy
- It is desirable to have integration with the broader interest-based economy

- As stated in the Dow Jones *fatwā*, and in numerous other *fatāwā* that have acknowledged and accepted variance:
 - must move to less variance over time
 - the tests must evolve to squeeze the variance out of the system
 - **Is that happening? Where, when and to what extent should it happen?**

- Evolutionary process involving on-going, diligent and penetrating substantive discussion and monitoring
 - Many ramifications, such as for standardization
 - Standardization is effective where the roles of and the risk allocations among the transactional parties are defined and agreed – where the evolutionary process has played out to a significant degree (and where there are repetitive transaction)
 - Risk allocations and acceptance have not occurred in many areas of Islamic finance and investment.
 - Are the needs of those with no bargaining power adequately represented (it is in transactions with respect to these people that standardization first occurs).
- That is not the case in many areas in the field of Islamic finance and investment

- These are early stages; progress has been significant:
 - conventional markets have acknowledged the existence and legitimacy of Islamic finance and investment principles
 - conventional markets have taken steps to incorporate those principles into the institutional, legal and regulatory frameworks
 - awareness of Islamic finance and investment has increased among the popular press and the broader public

- Acceptance of variance principles has been a major factor in the development of Islamic finance and investment and achieving the foregoing progress.
- The industry should:
 - encourage and guide the evolutionary process with regard to variance principles
 - with cognizance of the realities of competition with the conventional interest-based paradigm
 - with vigilance as to the circumstances in which variance is appropriate and as to the degree of permissible variance
 - and with the goal of decreasing the amount of variance over time.

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