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

Muslims in a Global Context

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Objective of this Presentation

- Consider the interaction of law, policy, *Sharīʿah* 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
  - *Ijmāʿ*
  - Nominate contracts
  - Bifurcated financing structures
  - Dow Jones *fatwā* of 1998
  - *Sukūk*
"We’ve agreed to count it as both a wave and a particle for tax purposes."
Background:
Law, Policy, *Sharīʿah*
What is the legal context?

Purely Secular Jurisdictions: the legal system takes no cognizance of the *Sharīʿah*

*Sharīʿah*-Incorporated Jurisdictions: the legal system takes some cognizance of the *Sharīʿah*

- A continuum
  - from the *Sharīʿah* being one element to be considered
  - through a point of the *Sharīʿah* being “a” primary source of law (with a wide range)
  - to a point of the *Sharīʿah* being the paramount law of the land
Purely Secular

Purely \(\text{Sharīʿah}\)
Sharīʿah-Incorporated Jurisdictions

Purely Secular

Purely Sharīʿah
Purely *Sharīʿah* Jurisdictions

Purely Secular

Purely *Sharīʿah*
Bifurcated Jurisdictions

Purely Secular

Purely \textit{Sharīʿah}
Purely Secular Jurisdictions

- Enforceability of the *Sharīʿah* using the law of the Purely Secular Jurisdiction as the governing law?

- Whether, when, and under what circumstances a secular court will apply the *Sharīʿah* 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 *Sharīʿah*)

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 *Sharīʿah* 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 Sharīʿah, and thus ineffective.

The general reference to principles of Sharīʿah in this case affords no reference to, or identification of, those aspects of Sharīʿah law which are intended to be incorporated into the contract, let alone the terms in which they are framed.

Consider: a compilation of Sharīʿah 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:

- *Sharīʿah* as general principles
- Different schools of Islamic jurisprudence (*madhahib*)
- No uniform statements of relevant *Sharīʿah* 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 *Sharīʿah* as public policy, particularly with respect to the New York Convention – Arbitral Awards)
- Enforcement of foreign judgments and arbitral awards
Policy
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 Sharīʿah 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
Policy

- 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 Sharīʻah principles?

Playing out at all levels: political, social, financial, legal
The Sharīʿah
What is the *Sharīʿah* in this context?

That question leads to the first conceptual division in considering the *Sharīʿah* (and the *Sharīʿah* as Islamic law): the division between:

- man’s affairs with man (*muʿāmalāt*) and
- man’s affairs with Allāh, including matters of ritual (*ibādāt*).

Our concern is with the former category.

It is *muʿāmalāt* that overlaps, in nature and scope, with other secular legal systems.
Islamic Sharīʿah

- Earliest connotations of sharīʿah 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 Qurʾān and the sunna.
Islamic Sharīʿah

- The Sharīʿah is ascertained through ‘ijtihād (“effort”) or legal reasoning using certain “roots” (uṣūl al-fiqh):
  - The Qurʾān, 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
  - Ijmāʿ, 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
Islamic Sharī‘ah

- 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
Islamic Sharīʿah

- Fundamental principle of the Sharīʿah, and the element that distinguishes Islamic finance from conventional Western interest-based finance pertains to the risk – reward system

- Under the Sharīʿah there is no entitlement to reward without appropriate exposure to risk

- Sharīʿah-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 Sharīʿah 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 *Sharīʿah*
  - Are enforceable under New York or English law
  - Are approved by the relevant *Sharīʿah* Supervisory Board as being, in substance, *Sharīʿah* compliant
The Western Context – Initial Perceptions

- Initial perceptions of Islamic finance and investment tend to focus on differences from interest-based Western financing.

- There are notable differences.

- But, a 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.
Commonality: Ethical Investing in the United States of America

- 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
Commonality: Structured Finance

- 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
Six Critical Developments

- Collateral security - *rahn*
- Nominate Contracts as building blocks – mid-1990s
- *Ijmāʿ* sought by small group of scholars - mid-1990s
- Dow Jones *Fatwā* – equity side of capital markets – 1998
- *Sharīʿah*-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
Timeline: Modern Islamic Finance and Investment

Figure 1: TIMELINE: MODERN ISLAMIC FINANCE AND INVESTMENT
Adapted from Yusuf Talal De Lorenzo and Michael J.T. McMillen, Law and Islamic Finance: An Interactive Analysis (2007), and Yusuf Talal De Lorenzo presentation, February 17, 2009, U.S. Treasury.

Inception of thinking: development of the *Shari'ah*; nominate contracts

Interregnum

Initial Modern Islamic Banking

Modern Islamic Finance

Post World War II independence and the devolution of the Muslim states

1950
1960
1970
1980
1990
2000
2010

1970s: Islamic banks and finance houses open in the Middle East; deposit focus

Modern Islamic Finance

1990s: Conventional banks open “Islamic windows” (deposit side focus); real estate, leasing, commodities

Gulf Investment House bifurcated US residential – Maconda Park, Truman Park

Saudi Chevron bifurcated *rahn-`adl*

Dow Jones Islamic Market Indexes *fatwā*

HSBC Amanah Global Properties Income Fund – real estate

East Cameron bankruptcy filing

*AAOIFI sukūk* standard

*AAOIFI sukūk* “clarification”

1996
1997
1998
1999
2000
2001
2002
2003
2004
2005
2006
2007
2008
2009
2010
2011

UBK IIBU equipment leasing funds – US operating leases

*İstisna‘* - *İjāra* *fatwā*

*İjāra* *fatwā*

Compliant short sales *fatwā*

East Cameron *sukūk* - US

Compliant assets on LME = US$ 100b

Islamic indices delist Enron, WorldCom, Tyco months before they fail

First *sukūk* issuances

First compliant ETFs and REITs; Aston Martin private equity

KFH and Wafara lease funds – US equipment operating leases; Investcorp conventional and residential fund

Arcapita Watermark Paddlesports – private equity

Modern Islamic “finance” begins – focus on investment side; move to *`ijmā‘*; nominate contracts as building blocks

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Collateral Security - Rahn
No Registration of Security Interests in Saudi Arabia

- 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
Saudi Chevron Petrochemical Project

- 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 “siló” approach, which was still dominant in 1996
Period of Revival and Recovery

- Historically, under the *Sharīʿah*, 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 hāsān*)
    - Gifts
    - Sales (*bāy*), such as *murābaha* (sale at a mark-up)
    - Leases – a type of sale of the usufruct (*ʾiǧāra*)
    - Joint ventures and partnerships (*sharīkāt, muḍāraba*)
    - Manufacture or construction contracts (*ʾıstīsnaʾ*)
    - 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.
Ijmāʿ
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 *ʾijāra fatwa* of December 2001, Karachi

Much greater consensus: Fiqh Academy of the Organization for Islamic Cooperation (formerly the Organization of the Islamic Conference), the *Sharīʿah* supervisory board of the Islamic Development Bank, AAOIFI

- Dow Jones deliberations: 1993 to 1998 – OIC Fiqh Academy

- Standards organizations: AAOIFI, IFSB, others
Bifurcated Structures
Leasing and Bifurcated Structures

- Early in the history of US transactions (late 1990s), the lease (ʿijāra) 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 Sharīʿah compliant.
  - *Sharīʿah* lease principles are quite similar to common law lease principles.

- It was familiar; it was not scary; it illustrated the similarities.
First *Sharīʿah*-Compliant Structures

- 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 *Sharīʿah* structures and conventional structures in an overall transaction that is determined to be *Sharīʿah*-compliant by the *Sharīʿah* scholars

- The first structures made use of the ʾijāra (lease) – basically a leveraged lease format – familiar to bankers and lawyers

- Those structures remain predominant throughout the world – adjusted for each jurisdiction
Bifurcated Structure

- Bank
- Investors
- Funding Company
- Project Company
- Occupational Tenants

Non-Compliant

Compliant

Conventional Loan Agreement
Other Loan Documents

Lease (‘ijāra)
Understanding to Purchase
Understanding to Sell
Managing Contractor Agreement

Occupational Tenant Leases
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
Disbursement – Repayment Mechanism

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
Reallocation of Provisions

**LEASE (‘IJĀRA) [CONSTRUCTION (‘ISTIŠNA’)]**

- 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

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

- Mandatory Prepayments
- Voluntary Prepayments

Acquisition transactions have no ‘istiṣnā‘ – that is for construction and development financings with multiple draws
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*
Permissible Impurity and Purification

- Prior to 1998, any violation of *Sharīʿah*, 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.
From 1993 to Inception in 1998

- 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
Importance of Dow Jones *Fatwā*

- 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
Investment Tests

- 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
Dow Jones Equity Investment Tests

**Test Level 1:** Permissible Instrument?
- No → No Investment
- Yes → Test Level 1: Permissible Business?
  - No → No Investment
  - Yes → Test Level 2: Impermissible Ribā?

**Test Level 2:**
- Total Accounts Receivable / Market Capitalization ≤ 33% [45%]?
  - No → No Investment
  - Yes → Test Level 2: Total Debt [Short and Long Term] / Market Capitalization ≤ 33%?
    - No → No Investment
    - Yes → Test Level 2: Sum of (Cash + Marketable Securities) / Market Capitalization ≤ 33%?
      - No → No Investment
      - Yes → Investment

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Evolutionary Step 1: Other Balance Sheet Equity Index Tests
Adjustments to Dow Jones 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 Standard 21 – A New Standard

- **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
AAOIFI Standard 21 – A New Standard

- 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?
AAOIFI Standard 21 – A New Standard

- 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
Hybrid Testing Arrangements

- 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
Operating Statement 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)
Operating Statement Tests

- 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

Test Level 1: Permissible Instrument?
Yes → Test Level 1: Permissible Business?
No → No Investment

Test Level 2: Impermissible Ribā?

Test Level 2:
Sum of \( (\text{Ribā Interest Expense} + \text{Ribā Interest Income}) / \text{Gross Revenue} \leq [23]\% [10] \%)?

No → No Investment
Yes → Test Level 2:

Test Level 2:
Total Ribā Interest Expense / Gross Revenue \leq [23]\% [10] \%?

No → No Investment
Yes → Test Level 2:

Test Level 2:
Total Ribā Interest Income / Gross Revenue \leq [23]\% [10] \%?

No → No Investment
Yes → Investment

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Evolutionary Step 3:
“Core Business” Principles in Non-Equity Contexts
Real Estate Variances

- 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 Variances

- 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
Real Estate Variances

- **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 Variances

- 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

- Project finance: single Islamic tranche transactions – assume an ʾijāraʿ

- Large conventional interest-based financing

- Smaller Sharīʿah-compliant tranche

- Some assets are isolated out for the Sharīʿah-compliant tranche

- Two leases: one for conventional tranche(s) and one for Sharīʿah-compliant tranche
Generic Single Islamic Tranche 'Ijāra' Structure

- Conventional Loan Agreement
- Other Loan Documents
- Collateral Security
- Lease (Ijāra)
- Understanding to Purchase
- Understanding to Sell
- Managing Contractor Agreement
- Participation
- Leases or Off-take Agreements
- Tenants or Offtakers

Non-Compliant
- Bank
- Funding Company
- Project Company

Compliant
- Bank
- Funding Company
- Project Company
Project Finance: Single Islamic Tranche

- Reality: projects are usually large, integrated and indivisible wholes from an operational standpoint

- Neither the conventional lenders nor the Sharīʿah-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 Sharīʿah-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).
Project Finance: Single Islamic Tranche

- 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 Sharīʿah-compliant tranche will end up securing the interest-bearing debt, and vice versa, either directly or indirectly

- Proceeds of collateral securing Sharīʿah can only be used to service principal, not interest, on conventional interest-bearing debt
Evolutionary Step 5:
Application Of Cleansing and Purification
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
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
Private Equity

- 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
AAOIFI Standard 17

- 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 Standard 17

- 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 (ʾijāra)
- An existing or to be acquired leasehold estate (ʾijāra)
- Presale of services (ʾijāra)
- Presale of the production or provisions of goods or commodities at a future date (salam)
- Funding cost of construction (ʾistisnāʿ)
- 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 (musraʿa), land management (muqarasa) or orchard management (musaqa) activities
Issuances Generally: to November 2008

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%)

# Issuances by Industry Sector

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

### Issuances by *Sharī`ah* Structure

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

Issuances Generally: 2011 Year-End Summary

- 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.

Source: Zawya Sukuk Monitor
Issuances Generally: 2011 Year-End Summary

- 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.

![Breakdown of Sukuk by Country (Mn$)](chart)

Source: Zawya Sukuk Monitor
Issuances Generally: 2011 Year-End Summary

- 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.
Issuances Generally: 2012

Sukuk Market Trend

Source: Islamic Finance Information Service (IFIS)
Issuances Generally: 2012

Regional Allocation

Source: Islamic Finance Information Service (IFIS)
 Issuances Generally: 2012

- 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)
Issuances Generally: 2012

GCC Breakdown - 2012

- Bahrain: 49%
- Qatar: 32%
- Saudi Arabia: 13%
- Other: 6%

Europe Breakdown - 2012

- Cayman Islands: 65%
- France: 16%
- Jersey: 13%
- Luxembourg: 5%
- Turkey: 1%
- UK: 0%

Source: Islamic Finance Information Service (IFIS)
Issuances Generally: 2012

International vs. Domestic sukuk
2012

Source: Islamic Finance Information Service (IFIS)
Issuances Generally: 2012

- 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

Source: Islamic Finance Information Service (IFIS)
Issuances Generally: 2011 and 2012

- 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 sukuk 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 ʾistisnāʿ obligations).
Conclusions
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.
Conclusions

- 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?*
Conclusions

- 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
Conclusions

- 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
Conclusions: Some Personal Opinions

- 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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