Islamic Finance

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When the world looks back at 2011, it will reflect on a time of global economic crisis, when job markets continued to suffer and the term bailout was commonplace. Entire countries and regions faced unmanageable debt and people's frustrations with the economic malaise sparked worldwide, grassroots movements against corporations and governments. The year 2011 also witnessed the Arab spring and numerous demonstrations against governments in Muslim-majority countries. Although news reports often mentioned the economic situation and high unemployment, Islamic finance is distinct from government policy and structure. The Islamic finance industry continued to flourish, while continuing to grace worldwide headlines as a mark of stability and opportunity in an otherwise unstable and anxious global marketplace. Its growing appeal to investors was highlighted in a prediction by Deutsche Bank that within five years, Islamic finance would double its assets.[1] While traditionally having a presence in Asian, Middle Eastern and North African markets, and continuing to expand there throughout the year, Islamic finance continued to make inward strides in the United States and other Western countries.

The Islamic finance industry is currently estimated at approximately US$1 trillion, with an increasing growth rate of approximately fifteen percent per annum.[2] This is not surprising since Islamic finance is distinguished from the conventional model as an asset-based financing method. Whereas the conventional model of investment and finance depends largely on speculation, the Islamic method prohibits transactions that do not give investors an existing security to attach to their investment.[3] This past year, investors were

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1. *See* Shaheen Pasha, *Islamic Finance May Double in Assets by 2016*, REUTERS, Nov. 15, 2011, http://www.reuters.com/article/2011/11/15/islamic-growth-deutschebank-idUSL5E7MF1Q920111115.

2. *See* Press Release, *Launches World's First Islamic Interbank Rate*, REUTERS, Nov. 22, 2011, http://www.reuters.com/article/2011/11/22/idUS55652+22-Nov-2011+HUG20111122.

3. *See generally* Hania Masud, *Takaful: An Innovative Approach to Insurance And Islamic Finance*, 32 U. PA. J. INT'L L. 1133, 1140 (2011) (discussing how the Islamic "rule of fiqh voids the sale of nonexistent or uncertain objects").

drawn to the stability found in Sharia compliant products because of the financial security rooted in the industry's core principles. Naturally, the more stable and secure the investment, the safer the return. This article will highlight several large transactions and events worldwide within the Islamic finance industry in 2011. These examples are key indicators to the marketplace that Islamic finance is becoming an industry in the forefront and not limited to a region or a religious belief.

I. Issuance of Sukuk

The first major sector of Islamic finance explored in this article is sukuk. Like other Sharia compliant products, it has experienced a great deal of growth recently, including this past year. Sukuk is the Arabic term for Islamic securities, commonly referred to as Islamic bonds. They are issued in accordance with specific financial restrictions as outlined under Shariah law, such as based upon contractual arrangements relating directly to existing Shariah compliant assets.[4] The current outstanding issuance of sukuk is estimated to be around US$50 billion.[5] This represents only an estimated one percent of outstanding global bonds.[6] The issuance of sukuk is not restricted to the Muslim dominated world.

Awareness of Sharia compliant investments is still growing in the West, but issuance of sukuk is neither unheard of, nor a novel concept. For example, Goldman Sachs is looking to issue a US$2 billion sukuk, which will be listed on the Irish Stock Exchange.[7] The interesting aspect of such a listing is that Shariah does not permit trading of a sukuk in a secondary market.[8] Typically, investors purchase sukuk and retain the security until the date of maturity.[9] However, the listing of this sukuk is novel to the Islamic finance marketplace.

Still, like the reality facing the conventional finance market, Islamic finance is not immune to a world in recession. Since the global economic crisis began, large sukuk issuances have narrowly missed the legal implications of insolvency, such as the Nakheel projects in Dubai, United Arab Emirates. In 2009, on the date of maturity of the Nakheel bonds, the Dubai government used US$ 4.1 billion from the Dubai Financial Support Fund to pay the sukuk obligations of Nakheel due upon that date.[10] The remaining issuances that were due in 2010 and 2011 were duly paid by the Dubai government, which protected Nakheel under the government owned parent company Dubai World, and no

4. For example, an issue of sukuk would not comply with sharia if it were secured with the still non-existent product it was meant to fund the production of. *See e.g.*, Praveen Menon and David French, *Emirates Airline Eyes Islamic Finance as European Banks Back Out*, AL ARABIYA NEWS, Nov. 8, 2011, http://www.alarabiya.net/articles/2011/11/08/176050.html (describing the complications of issuing sukuk to raise capital for the purchase of aircraft when the item the sukuk would normally be secured with, in this case the new planes, do not yet exist).

5. *See* Pasha, *supra* note 1.

6. *See id.*

7. *See* Mohammed Khnifer, *Goldman's Sukuk Will Help Islamic Finance Penetrate the West*, ZAWAYA, Nov. 1, 2011, http://www.zawya.com/sukuk/story.cfm/sidZAWYA20111101102757/Goldmans_sukuk_debut.

8. *See id.*

9. *See id.*

10. *Nakheel Bond to be Paid in Full*, GULFNEWS.COM, Dec. 14, 2009, http://gulfnews.com/business/economy/nakheel-bond-to-be-paid-in-full-1.553344.

legal actions were allowed to commence against the entity.[11] Therefore, many investors were left with no option other than to accept any conciliation provided by Nakheel.[12] Demonstrating the fragile state in which both private companies and government ventures exist, Dubai World finalized restructuring its own debt this past year.[13]

There are many legal issues related to sukuk that will be explored in 2012, such as the lack of proper assets securing the sukuk (*i.e.* Nakheel), sukuk reviewed under insolvency proceedings whether in a Shariah court or in secular courts, and the future of assets in new sukuk issuances.[14] This sector of Islamic finance is underdeveloped and its growth will open a window to many new legal issues that will require interpretation and analysis by Shariah scholars and jurists. This may especially be the case in places like Dubai where foreign ownership of property is not permitted in all areas.

Several European countries used the past year to amend legislation to enable the issuance of sukuk in their marketplace, including the United Kingdom, Luxembourg, and France.

In 2009, an amendment to article 2011 of the French Civil Code was proposed by the legislature and passed by the French Senate and subsequently the French National Assembly.[15] This proposal was meant to foster the development of Islamic finance within the country and assist in the structuring of Shariah compliant products offered in the financial marketplace.[16] Further legislation relating to tax arrangements was amended to facilitate the financial markets' ability to offer competitive murabaha and sukuk structures.[17] In May 2011, news sources reported that France benefited from the broadening of the market place to include Islamic financial structures, which includes approximately three billion euros invested through Islamic structures in the French real estate market.[18] The total real estate marketplace interested in the development of Islamic structures is estimated to be approximately 120 billion euros.[19]

For Luxembourg, 2011 marked a year of clarifying tax treatment for various Islamic finance structures as well as the promotion of Islamic finance principles.[20] Currently, Luxembourg is leading Europe as the domicile of shariah compliant investment funds, numbered currently at about forty regulated funds, with assets valued at approximately US$500 million.[21] This does not include the real estate assets that are financed through

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11. *See id.*
12. *See id.*
13. *See* Aya Lowe, *Dubai World Signs Final Debt Restructuring Deal*, GULFNEWS.COM, Mar. 23, 2011, http://gulfnews.com/business/general/dubai-world-signs-final-debt-restructuring-deal-1.781486.
14. *See* Menon, *supra* note 4.
15. *See France Changes its Civil Code to Attract Islamic Finance*, NORTON ROSE, http://www.nortonrose.com/knowledge/publications/france-changes-its-civil-code-to-attract-islamic-finance-23125.aspx (last visited Nov. 20, 2011).
16. *See id.*
17. *See* Mushatk Parker, *Civil Code Amendment to Help the Sukuk Market Take off in France*, ARAB NEWS, Oct. 5, 2009, http://archive.arabnews.com/?page=6&section=0&article=127082&d=5&m=10&y=2009.
18. *See UAE/France: Dubai to Increase Islamic Finance Products to France*, EURASIANFINANCE, May 4, 2011, http://eurasianfinance.com/2011/05/uaefrance-dubai-to-increase-islamic-finance-products-to-france/.
19. *See id.*
20. *See* Pierre Weimerskirch, *Islamic Finance at a Crossroads: How Can Luxembourg Help?*, ERNST & YOUNG, July 2011, http://www.ey.hu/LU/en/Newsroom/PR-activities/Articles/article_2011_july_islamic_finance_0711.
21. *See id.*

unregulated Shariah investments or the sukuk market, both valued at approximately US $9 billion.[22] Although the Islamic finance industry in Luxembourg has experienced some stagnation, the future is bright, partially because of the stability inherent in the industry. Luxembourg has and will continue to grow into a unique role as a portal for the industry to expand and develop within the West.

II. Murabaha Cross Border Transactions Begin to Engage Conventional Financial Institutions

A second interesting transaction in 2011 was a murabaha financing transaction that was entered into on a cross border basis and even found roots from several US financial institutions. A murabaha financing is a form of a credit sale contract that is acceptable under Shariah guidelines. It is important to understand that Islamic financing contracts are not simply a facility agreement drafted and completed with the relevant pledge or security document. Rather, Islamic finance documents, such as a murabaha, have several detailed steps requiring the completion of the documentation in accordance with the appropriate Shariah principles. A simple murabaha agreement may be accomplished in accordance to six phases, which are as follows:

1) The first phase in this transaction is the master financing agreement between the lender and the borrower. This initial agreement identifies the type of financing to be assumed and the broad scope of the arrangement;
2) The second phase requires the appointment of the borrower as an agent of the lender. In this type of financing arrangement the borrower is acting as an agent of the lender seeking the goods to be purchased and later purchasing the assets from the lender;
3) The third phase entails the borrower acting as the agent and purchasing the requisite assets as identified per the relationship between the parties;
4) After the assets are identified (which practically speaking are identified prior to the financing arrangement is entered into) the lender disperses the agreed amount to the agent to purchase the asset;

5-6) It is in the fifth and sixth phase where the borrower seeks to purchase the asset from the lender directly and agrees to the terms of repayment.

An important aspect in any financing contract is its enforceability, and that issue was forefront in 2011 as some Islamic finance contracts required enforceability. The multiple stages and requirements special to murabaha and other Shariah compliant products and instruments necessitates that a great amount of due care be taken when executing the creating documents. One must ensure that the finance agreements are properly secured as required under Islamic finance principles, otherwise the entire agreement may be disqualified.

Among the largest murabaha transactions this year was one involving ACWA Power International, a private company incorporated in the Kingdom of Saudi Arabia and a major "developer, investor, co-owner and operator of plants capable of producing 12,000 MW of power and 2.3 Mm3/day of desalinated water with an investment value in excess of

22. *See id.*

US$15.2 billion and providing employment to more than 2,300 people."[23] The interesting aspect of this transaction is that it was internationally supported. Several major international financial institutions were key in securing the success of this transaction. These financial institutions include, JP Morgan Chase, Standard Chartered Bank, Citi, and Bank of America Merrill Lynch.[24] The total structured facility entailed US $300 million.[25] This is not the first international transaction relating to a murabaha structure. Rather these transactions have occurred previously and are commonplace in the Islamic Finance arena, however, the direction of many US financial institutions in growing their Islamic Finance interest is a newer direction in light of the current economic decline.

III. Islamic Interbank Rate

Another interesting mark in the Islamic finance sector for 2011 is the launch of the world's first Islamic interbank rate.[26] According to a press release on November 22, Thompson Reuters announced the launching of the first Islamic interbank rate in collaboration with several leading finance institutions.[27] Persons unfamiliar with Islamic finance may not realize that under the basic principles of Islamic finance, an interest rate is not charged to a borrower. In fact, such an arrangement would deem the agreement void.

There are several theories and understandings behind such a regulation. A critical principal is that the borrower is expected to understand and acknowledge all of the obligations under the agreement, which includes the amount to be paid directly by the borrower and all other financial and non-financial obligations. Therefore, an interbank lending benchmark was never available. Many financial institutions were dependent on interbank lending rates from the conventional industry.

The development of this new rate was done in collaboration with recognized Islamic finance pioneers such as the Islamic Development Bank (IDB), Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI), the Bahrain Association of Banks (BAB), and Hawkamah Institute for Corporate Governance.[28] The new benchmark may be used to determine the pricing of various Islamic finance products, which include overnight to short-term treasury investment and financing instruments (*i.e.* murabaha, wakala and mudaraba), retail financing instruments (*i.e.* property and car finance), and sukuk and other Shariah-compliant fixed income instruments.[29] This new benchmark can also be used for the pricing of corporate finance and investment assets.[30]

This new development will be interesting as the Islamic finance industry is a cross border industry and independently regulated within each jurisdiction. The mere launch of this bench rate is not a clear sign whether it will be adopted within all the various jurisdictions.

23. Press Release, ACWA Power, *ACWA Power Closes On US$300 Million Maiden Corporate Murabaha Facility*, (Nov. 13, 2011), *available at* http://www.zawya.com/story.cfm/sidZAWYA20111113083633/ACWA_Power_Closes_300m_Maiden_Corporate_Murabaha_Facility.

24. *See id.*

25. *See id.*

26. *See* Press Release, *supra* note 2.

27. *See id.*

28. *See id.*

29. *See id.*

30. *See id.*

IV. Conclusion

The global economic crisis requires a long-term solution, however, for now many markets are finding the stability of Islamic finance as a potential solution. Several European Governments, as well as financial institutions, are looking for dependability in a market at a time when such a word is evasive. Islamic finance is providing the necessary security and peace of mind to a timid marketplace with its method of asset based transactions. For these reasons, European governments are undertaking the necessary requirements to foster the growth of Islamic finance by adjusting their banking laws to accommodate Shariah compliant transactions. The interesting query is whether a similar direction will be taken within the United States to aid in building a stronger financial marketplace.