

# *International* Securitization & Finance Report

*A Twice-monthly Review of Innovative Tax-Effective and Asset-Backed Financing Transactions*

December 15, 2008

Volume 11, No. 22

## Opportunities in the Islamic Finance Market

BY SONYA VAN DE GRAAFF AND BRIAN P. GALLOGLY  
(BROWN RUDNICK LLP)

### Introduction and Background

With the current global economic crisis deepening and conventional sources of financing and investment seeming to be all but drying up, sellers of assets and borrowers need to consider all available options. Amongst these is the Islamic Finance market. What does this market have to offer to a non-Muslim person and how viable is it for a non-Muslim person to tap the Islamic finance market? This article endeavors to map out how a non-Muslim person requiring new money or refinancing might approach Islamic financing, and how a non-Islamic institution requiring investors for an asset might avail itself of Islamic investors.

The Islamic law prohibition on interest-bearing debt financing has effectively prevented Islamic institutions investing in almost all of the products that have contributed to the current crisis (including sub-prime RMBS, CLOs and CDOs). Partly for this reason, Islamic financial institutions are not directly affected by the current economic crisis. However, it is also partly due to this

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## European Commission Priorities for Action on Dominant Companies

BY THOMAS JANSSENS, MJ MOLTENBREY AND JOANNA GOYDER  
(FRESHFIELDS BRUCKHAUS DERINGER LLP)

On 3 December 2008 the European Commission adopted its 'Guidance on the Commission's Enforcement Priorities in Applying Article 82 EC Treaty to Abusive Exclusionary Conduct by Dominant Undertakings'. Commissioner Kroes stated that this 'should leave dominant undertakings in no doubt that they will find the Commission in their way wherever their conduct risks increasing prices, limiting consumer choice or dissuading innovation' and that such rules are crucial 'in times of economic difficulty such as these'.

To describe this document as 'long-awaited' would hardly do justice to its gestation period. Despite, or perhaps because of, this it is a considerably shorter and less detailed text than was originally expected when the review process opened formally in 2005. While some parts inevitably will be contro-

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#### REMINDER TO OUR READERS:

We will be publishing only one issue of *International Securitization & Finance Report* in December. Our twice-monthly schedule will resume with the January 15, 2009 issue.

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## *Islamic Finance Market, from page 1*

very reason that the Islamic capital markets are under-developed, thereby creating challenges for seekers of financing or capital in this market (see 'Islamic Finance: The Sub-Prime Mortgage Crisis and 'Credit Crunch'' by Hassan Khan and Dan O'Donoghue, *The Khan Partnership: Bloomberg European Law Journal*, Vol.2. No.12).

**Islamic Finance is one of the world's fastest growing sectors, with most sources agreeing on an annual average growth in 2005, 2006 and 2007 of 15% - 20%. Islamic financial services can now be found in 75 countries with 614 institutions providing Islamic financial services and Islamic assets total approximately US\$700m worldwide.**

Statistically, Islamic Finance is one of the world's fastest growing sectors, with most sources agreeing on an annual average growth in 2005, 2006 and 2007 of 15% - 20%. Islamic financial services can now be found in 75 countries with 614 institutions providing Islamic financial services and Islamic assets total approximately US\$700m worldwide. The UK has US\$18billion of Shariah compliant assets, being the largest outside of the Islamic world, and has several fully Shariah compliant banks including the Islamic Bank of Britain and European Islamic Investment Bank (see HM Treasury's paper: 'The development of Islamic finance in the UK: the Government's perspective, December 2008').

### **Background to Islamic Law and Islamic Finance Principles**

To qualify for funding from an Islamic entity, the transaction or product in question must be compliant with Islamic law ('Shariah law'), since Islamic institutions must generally conduct their business in accordance with Shariah law. Likewise, a Muslim person who wishes to conduct the financial aspects of his life in accordance with his faith will require his investments and other financial products and services to be executed and performed in accordance with Shariah law.

A transaction or product which is Shariah compliant must satisfy both the laws of the ju-

risdiction to which the transaction is stated as being subject (eg English law), as well as Shariah law. For a variety of reasons including the disparate jurisprudence surrounding it, Shariah law would not ordinarily be the choice of law to govern a transaction (see discussion on this topic in *Beximco Pharmaceuticals Ltd v Shamil Bank of Bahrain*, EC [2004] EWCA Civ 19), particularly a transaction which is, in all other aspects, outside of the Islamic world. The most transparent way of incorporating Shariah principles into a transaction and obtaining the required fatwa (as discussed below), is to embed Shariah principles into the transaction from a structural perspective. This means that the Court which, under the terms of the contract, is given jurisdiction to determine disputes under the contracts, can simply refer to the 4 corners of the contract and not have to enquire as to external Shariah jurisprudence. The UK government, in its legislative recognition of Shariah principles, recognizes this as being the clearest approach (see discussion below).

Shariah is not a codified system and is perhaps best regarded as providing Muslims moral guidance for all aspects of their day-to-day activities and includes, relevantly for these purposes, the following principles:

- Interest ('riba') on principal is prohibited. Therefore US or English style mortgage loans would be void;
- Connected with riba is that a person may not profit from money alone; a risk must be taken. Further, to finance an asset or earn a profit from money, a legal or equitable interest in that asset or endeavor must pass to the lender;
- Preventable uncertainty of any fundamental term, outcome or subject matter of a contract is prohibited. This would generally apply to void a financial derivative instrument (such as a forward contract or future agreement) or a conventional insurance contract since there is no certainty as to whether the insured event will ever occur;
- Speculation which is in the nature of gambling or speculative exchange of money for debt, without an underlying asset transfer, is prohibited (general commercial speculation is acceptable);
- Unethical investment is prohibited. Investments may only support practices or products that are permitted and ethical according to Shariah law. Forbidden products or investments include alcohol, casinos, adult entertainment and consumption of pork;

- Transactions must be asset based: all financial transactions should be underpinned by an identifiable and tangible underlying asset.

For a transaction to achieve Shariah compliant status requires the issuance of a fatwa by a Shariah board, comprising a group of eminent Islamic scholars appointed by one or both of the parties. There are dozens of Shariah boards around the world and their opinions on the proper interpretation of Shariah principles often differ and they do not consider themselves to be bound by precedent, thereby often making it difficult to predict whether a transaction will achieve due sanction. However, there have been recent efforts to address this lack of standardization: in the UK, the government has legislated on various forms of Shariah compliant transactions, and the Islamic Financial Services Board has been established by central banks and national monetary authorities to serve as an international standard-setting body to achieve certainty within the Islamic finance industry.

**Some Categories of Islamic Finance Transactions**

The main categories of Shariah compliant transactions listed below reflect the above stated principles, and they can each fairly easily be understood by reference to their conventional

equivalents. There are variations on each of the categories and they can be adapted to bespoke situations as required.

Thus, a person looking to raise finance for a new enterprise or find a buyer for his assets will need to structure to his proposal within one of these basic frameworks. For a refinancing of an existing conventional asset portfolio, there is likely to be required a re-structuring of the underlying assets and a release of any existing security, thereby potentially making a Shariah refinancing impractical and expensive. In all cases, depending on the location of the assets and any other factors affecting jurisdictional questions, stamp duty, general taxation, over-all risk profile, counter-party credit risk and insolvency implications will need to be considered.

The UK government, in its ambitious drive to be the jurisdiction of choice for Islamic finance in the West, has recognized these issues and has passed various iterations of The Finance Act 2003, 2006 – 2008 (and as contemplated in the 2009 bill) to ensure that mudaraba, musharaka, diminishing musharaka, murabaha and sukuks (each of which are discussed below) are treated on an equivalent basis as regards stamp duty and general taxation and regulatory protections as their conventional equivalents. This means for example that there is no substantive impediment to a Shariah compliant

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**The Islamic Financial Services Board has been established by central banks and national monetary authorities to serve as an international standard-setting body to achieve certainty within the Islamic finance industry.**

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## *Islamic Finance Market, from page 21*

securitization now occurring in the UK. The FSA and HM Treasury are still discussing some of the finer aspects of regulatory treatment and capital gains aspects of sukuk. The UK government is planning (once the right market conditions arrive!) to issue its first sukuk as a show-starter for the UK Islamic capital markets. The Government has specifically stated that Islamic finance in the UK is to be accessible to all consumers and investors whether Muslim or non-Muslim and it has recognized the added liquidity that this market can provide.

**True conventional style securitizations have been rare in Shariah compliant transactions. Rated and asset only recourse Shariah compliant securitizations have, to date, occurred only in Islamic jurisdictions.**

The following are the main categories of Shariah compliant transactions:

- **Mudaraba** [joint venture or profit sharing arrangement] – two parties collaborate on a project or transaction, involving one party providing the expertise and the other providing the capital. They share in the profits in accordance with terms agreed in the contract.
- **Musharaka** [imitates equity financing / another type of joint venture arrangement / general partnership arrangement] – an investor and entrepreneur agree to collaborate on a project or transaction, both contributing equity in agreed proportions. The contract sets out the arrangements for the sharing of profits and losses.
- **Diminishing musharaka** [similar to a declining balance partnership] – regularly used for property acquisition transactions. The ownership of the asset is divided into units which one party, by paying rent and a premium, gradually buys from the other, thus incrementally increasing their share until the full ownership of the asset is transferred. An example is the UK Government's Home Purchase Plans.
- **Murabaha** [imitates the performance of a loan, purchase and resale contract or financing on a cost plus basis] – the customer approaches the bank and requests that the bank purchase an asset on its behalf. After the purchase, the bank resells the asset to the customer for the

cost plus a profit margin.

- **Ijara** [imitates the performance of a lease] – Ijara separates ownership and use rights of an asset. The owner of the asset bears all the risks associated with ownership (including the duty to maintain and repair), and the user of the asset pays a fixed price for the benefit of use. The user of the asset pays rent for the use, and in some arrangements he will pay a regular premium to enable him to gradually acquire equity in the asset (Ijarah wa iqtina).
- **Sukuk or Shariah securitization** [imitates the performance of a bond or other debt instrument or securitisation] – in a standard sukuk issuance, an asset originator issues sukuk backed by Shariah compliant assets (e.g. ijara or musharaka). The sukuk holders each own a tradable investment certificate, representing an undivided share of a proprietary interest in the assets. The sukuk holders will receive a proportional share of the income from the assets and the repayment of the principal amount. Sukuks may be listed and rated and pay periodically. Although sukuk are structurally asset-based, they have most often also been structured with a corporate or sovereign guarantee or backing. These types of Sukuk issuances reached US\$14bn for 2008 as at 31<sup>st</sup> August and expectations are for the amount to increase to US\$25bn by end of 2008. Standard & Poors has rated about 30 sukuk or sukuk programs in both Muslim and non-Muslim countries. Issuers include corporates, financial institutions and sovereigns.

A sukuk may also be structured similar optically to a securitization: an SPV issuer uses the proceeds of the sukuk issuance to purchase an interest in tangible and income-generating Shariah compliant assets. The Issuer declares a trust over its assets for the benefit of the sukuk holders and the sukuk holders thereby own undivided proprietary interests with one another in the underlying assets. The sukuk holders share in the income generated by those assets in accordance with their respective proprietary interests and their income depends on the performance of the assets.

### **Shariah Compliant Securitizations to Date**

True conventional style securitizations have been rare in Shariah compliant transactions. Rated and asset only recourse Shariah compliant securitizations have, to date, occurred only in Islamic jurisdictions, and only two have been without government or corporate credit backing or guar-

antees: Tamweel (in July 2007) and Sorouh (in September 2008). Due to a combination of difficulties in Islamic jurisdictions including (a) undeveloped and uncertain local structured finance laws and accounting standards; (b) inconsistently applied origination standards; and (c) local investors being unaccustomed to taking risk on a portfolio of assets as opposed to a credit name, many securitization issuances have not been rated and have been directly or indirectly government guaranteed or guaranteed by a big corporate name.

Ironically, a Shariah compliant securitization governed by, for example, English law and sponsored by an originator of English assets, would not face these problems particularly since the passing of the Finance Acts (see above).

Tamweel (a UAE Islamic finance company) provided residential property financing under a typical Ijara: the customer paid rent to Tamweel and upon payment of all amounts due, Tamweel would transfer title to the customer at the end of the term. Tamweel sold the title to the properties and the leases to an SPV formed within the Dubai International Financial Centre. This SPV then passed on the rights to those assets to a Cayman Islands SPV. This SPV then issued the sukuks.

Unlike almost all previous Islamic securitizations, these sukuk holders could look only to the properties and the ijara with the underlying customers to generate the income needed for the return on their investment. Importantly, the interest rate hedging mechanism used involved an adaptation of ISDA master agreement, amended to conform it to Shariah principles (excluding debt exchange, interest payments and indemnities). The hedging arrangement entitled the Cayman Islands SPV to issue a notice of exercise on specific dates during the term of the sukuk, in which it was entitled to require the exchange bank to exchange UAE Dirhams for US\$ at a pre-agreed rate.

**Although not without controversy, hedging is gradually becoming an acceptable means of managing risk in Islamic finance transactions.**

**Hedging**

For a securitization transaction adequately to satisfy investors' needs, it requires incorporation of appropriate hedging. However, a derivative contract risks directly infringing the Shariah principles against speculation and uncertainty. Although not without controversy, hedging is gradually becoming an acceptable means of managing risk in Islamic finance transactions. There is a very strong push amongst ISDA and the

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## **Islamic Finance Market, from page 23**

International Islamic Financial Market ('IIFM') to drive acceptability of Shariah compliant hedging forward. They argue that hedging can be justified as compatible with Shariah provided that the other aspects of the transaction are Shariah

**With some important foundations and clearer guidelines now established as discussed above, in conjunction with a real and meaningful dialogue amongst the scholars, market participants and industry bodies, there is no reason why the time should not soon be ripe for new asset classes to emerge for securitisations.**

compliant and the hedging is used only to the extent required to address real hedging requirements. Progress is evidenced by the agreement in 2006 between the Bank Islam Berhad and Bank Muamalat Malaysia Berhad of a pro-forma derivative master agreement for their Islamic derivative transactions. ISDA and IIFM have formed a working group to develop a standardized Shariah compliant ISDA Master Agreement and are due to

publish their first draft ISDA Master Agreement in February 2009. (For more detail on this see [www.iifm.net](http://www.iifm.net))

## **Credit Enhancement**

Shariah compliant credit enhancement techniques (such as liquidity 'facilities', subordination and over-collateralisation) are technically possible provided the underlying Shariah principles are respected.

## **The Future**

With some important foundations and clearer guidelines now established as discussed above, in conjunction with a real and meaningful dialogue amongst the scholars, market participants and industry bodies, there is no reason why the time should not soon be ripe for new asset classes to emerge for securitisations. For instance, securitization of renewable energy revenue streams should be able to be structured in a Shariah compliant way and, given Shariah law's focus on ethical investment, should be a natural fit in principle. □

*Co-authors Sonya Van de Graaff and Brian P. Gallogly are partners in the Finance Group at Brown Rudnick LLP. They would like to thank Josmar Hart Román, formerly associated with Brown Rudnick, for her substantial contributions to this article. For more information about Islamic Finance, please contact Ms. Van de Graaff at +44.20.7851.6092 / [svandegraaff@brownrudnick.com](mailto:svandegraaff@brownrudnick.com); or Mr. Gallogly at +1.401.276.2656 / [bgallogly@brownrudnick.com](mailto:bgallogly@brownrudnick.com).*

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