Common Islamic Finance Structures

December 1, 2017

Finance

Introduction

What is the purpose of this note?

This note is intended for clients who are largely unfamiliar with Islamic (Shari'ah compliant) finance products and interested to understand:

- the basic principles underpinning Islamic finance structures;
- how those structures differ from the conventional (non-Shari'ah-compliant) financing structures that they may already be familiar with; and
- what some of the most common Islamic finance structures look like in concept.

As a general note, in line with other law firms involved in the documentation of Islamic finance structures, we do not, and are not competent to, express any opinion on Shari'ah generally or more specifically as to whether any document, or the transactions contemplated therein, comply (or otherwise) with the teachings of Islam or Shari'ah.

What is Shari'ah?

Shari'ah is derived from a number of sources, including the Quran, and is a non-codified body of law underpinning Islam generally and Islamic finance as a product. Because it is not a codified body of law, it is capable of development and subjective interpretation. In order to be considered Shari'ah-compliant an Islamic finance structure typically receives an opinion (*fatwa*) from a religious scholar (*mufti*) or recognised Shari'ah adviser.

The capacity for subjective interpretation of Shari'ah means that the opinions of the specialist scholars and advisors on issues may vary, not least depending on which of the five Islamic schools of law (*madhabs*) that they belong to.

What is Islamic finance?

The term "Islamic finance" refers to the network of financial institutions and commercial financing activities that conform to Shari'ah.

The following are the key prohibitions under Shari'ah that are the key principles guiding Islamic finance structures:

- prohibition on usury or changing of interest (*riba*), with returns required to be based on sharing profit and loss;
- prohibition on uncertainty (*gharar*);
- prohibition on speculation (*maisir*); and

- prohibition on the use of or dealing with impermissible (*harem*) activities or commodities (such as alcohol).

How does an Islamic (Shari'ah-compliant) financing product differ from a conventional (non-Shari'ah-compliant) financing product?

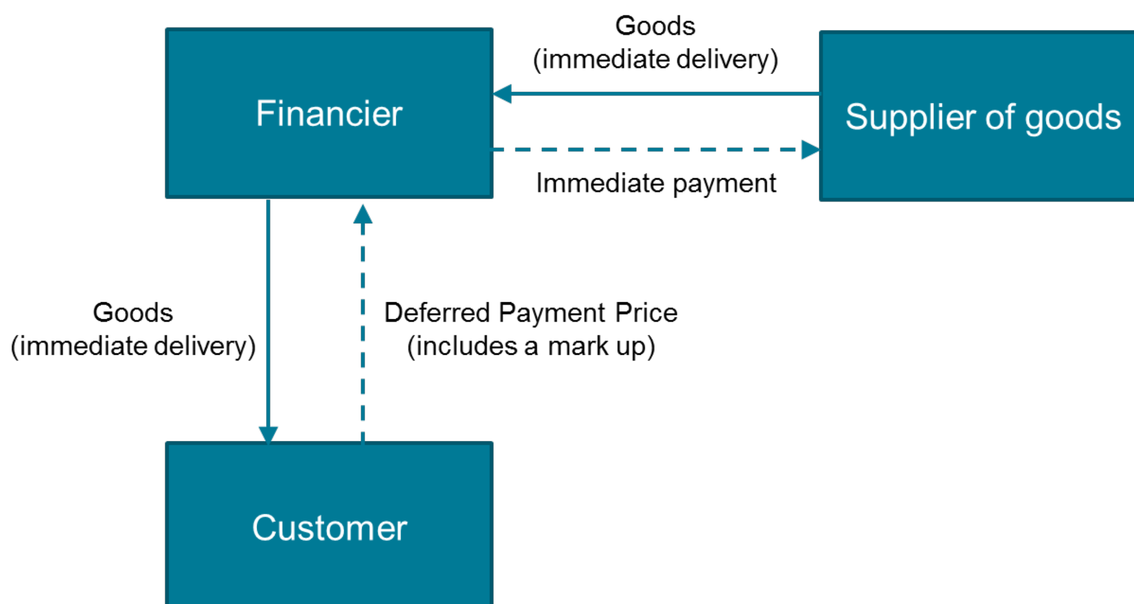
In terms of translating the key principles referred to above into a financing structure, the following table illustrates some key required deviations from a conventional (non-Shari'ah - compliant) floating rate loan structure:

Provision	Conventional Financing Product	Islamic Financing Product
Return on principal payment	Conventional financing typically levies interest on any principal advanced.	The charging of interest is regarded as *harem* and any return on principal invested must be structured as a share of profit or a payment for a service provided. This is the fundamental driver for most Islamic finance structures as they cannot involve a simple advance of principal with a return on such principal calculated simply by reference to the amount of such principal outstanding (in essence, an Islamic finance structure cannot simply allow for the Financier to earn money on money).
Floating rate return on principal	Most conventional commercial loans require payment of a floating rate of interest, calculated in arrears based on application of a base rate (i.e., LIBOR) for the number of days for which the principal is outstanding over a certain period (i.e., three or six months) and applicable only to the amount of principal outstanding at any point in time.	While return on principal invested is commonly structured in Islamic finance structures using a floating base rate (i.e., LIBOR) and is often payable in arrears at the end of set periods (i.e., three or six months), the prohibition on uncertainty means that the amount of return payable at the end of the set period must be structured so that it is known upfront at the beginning of the period. This requirement for certainty can lead to complexities, particularly where principal is returned mid-period or additional costs are incurred by the

		financier mid-period which it is looking to pass through.
Hedging floating rate interest or exchange rate exposures	Many conventional commercial floating rate loans require the debtor to hedge its floating rate exposure and/or (where there is a currency mismatch between the borrower's revenue and debt payment obligations), its foreign exchange rate exposure. This is typically done separately from the principal debt documentation, under an ISDA based agreement.	The prohibition on speculation (interest rate or foreign exchange rate hedging being, in essence, speculating on the direction of the respective markets) means that Islamic finance structures are not hedged.
Underlying asset financed	Subject to any issues arising under applicable law and the risk appetite of a financier, there is typically no restriction on what can be financed using a conventional product, such as a loan.	Islamic financing products cannot be used to finance any underlying asset or activity that would be consider *harem*. Obvious examples would be the acquisition or operation of a brewery or distillery. However, this can lead to complexity when one looks to finance a "mixed use" asset or business, such as a hotel or aircraft (which likely serves alcohol) or a shopping mall (where certain outlets may be considered harem, such as a non-halal butcher, a shop selling alcohol or, in certain cultures, a cinema).

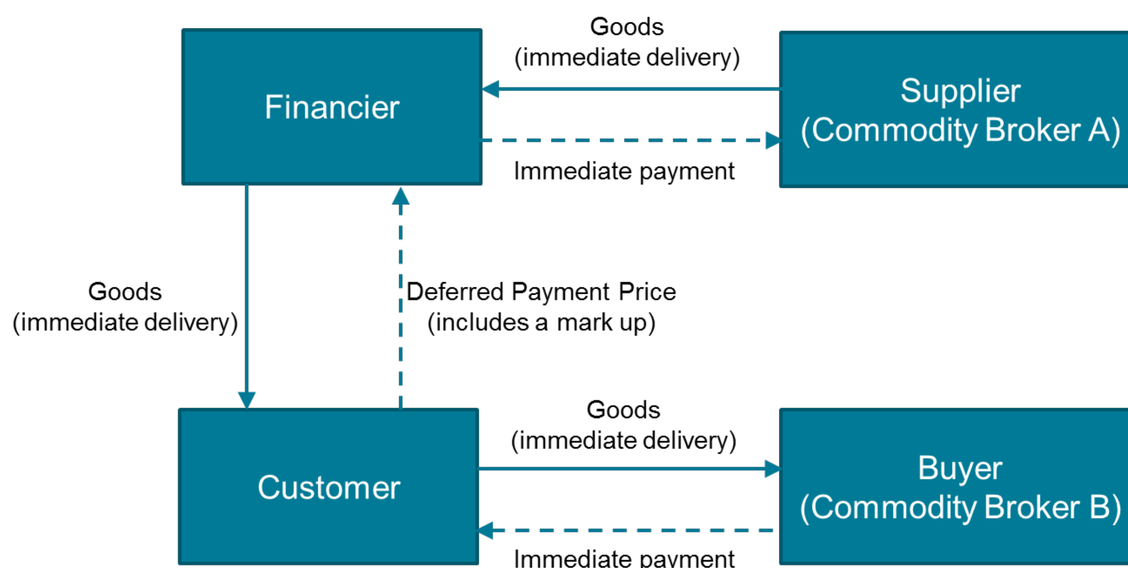
With these principles in mind, the rest of this note seeks to summarise some of the more common structures currently in use in the Islamic finance market.

Traditional *Murabaha*



- A traditional *murabaha* structure is ideal for a trade finance situation, where a Customer has to pay for goods, but cannot immediately pay the full amount of the purchase price for the goods.
- A worked example looks like this:
  - a Financier steps in and buys the goods and pays the Supplier the full amount of the purchase price, on delivery;
  - on receipt of the goods, the Financier sells them on to the Customer (usually on an 'as-is-basis' and usually the Financier directs the Supplier to deliver to a location nominated by the Customer, so the on-sale occurs immediately); and
  - the Financier and Customer's payment terms are such that the Customer pays the Financier within a set time period (e.g., one year) either as a single payment or in staged payments on a pre-agreed schedule, together with a pre-agreed profit margin (typically calculated as an ascertainable floating base rate (i.e., LIBOR) + a fixed percentage) charged to reflect the Financier's risk of facilitating the purchase.
- The structure is less suitable for transactions with payment terms linked to a floating benchmark such as LIBOR if the underlying payment period goes beyond one LIBOR period.

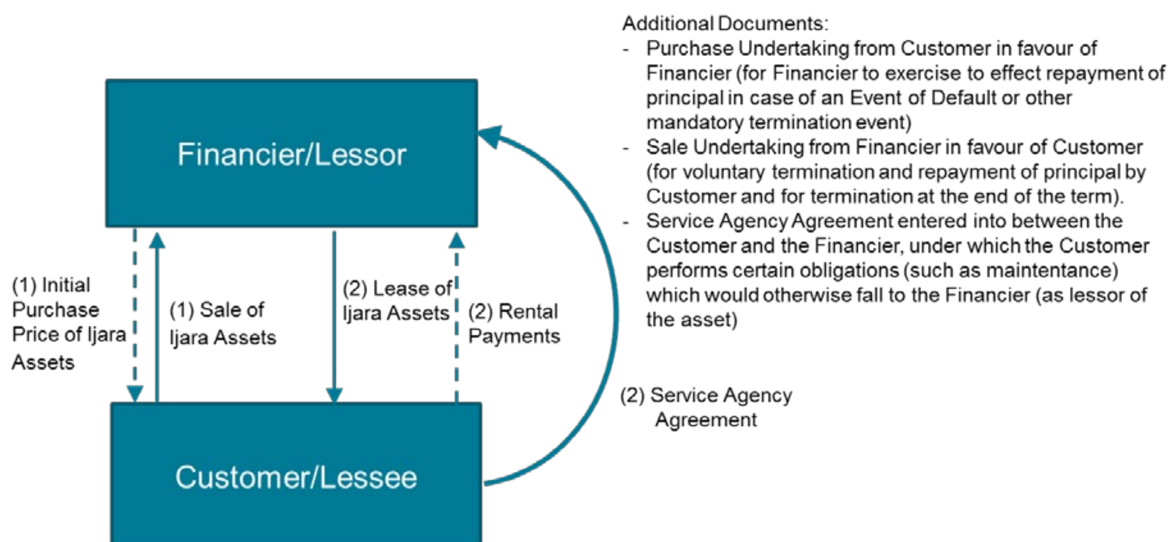
Commodity *Murabaha*



- A commodity *murabaha* is generally considered to be the Islamic finance structure that is closest (in terms of practical effect) to a conventional loan and typically the most straight-forward to effect (in a large part as it requires the Customer to neither want to acquire a tangible asset or be in possession of an underlying tangible asset which can be used in the financing structure). In light of this perceived similarity to a conventional financing, not all Shari'ah scholars and advisers are willing to issue a fatwa on a financing structured in this manner. Nevertheless, a commodity *murabaha* is arguably the most commonly used form of Islamic financing product.
- A commodity *murabaha* works similarly to a traditional *murabaha*, only that on receipt the Customer immediately sells the goods back into the market. Unlike a traditional *murabaha* (where the financing is to facilitate acquisition of a commodity that the Customer actually wants), a commodity *murabaha* structure can be used to facilitate funds flow to an entity, even where the entity does not want the underlying commodity. The commodities are usually something traded in over-the-counter certificates in a liquid market (to ensure all ownership transfers can be effected immediately and the Customer can sell the commodity swiftly back within a few seconds of instructing the Financier to buy the assets in the first place). The only additional requirement being that the commodity is not *harem*. Typical underlying commodities used are warrants on the London Metal Exchange.
- A worked example looks like this:
  - the Financier buys USDXm of steel from Commodity Broker A at market price.
  - on the same day the Financier sells the steel to the Customer with payment due from the Customer within a set time period (e.g., one year), the price is agreed as USDXm + a pre-agreed profit margin (typically calculated as an ascertainable floating base rate (i.e., LIBOR) + a fixed percentage) charged to reflect the Financier's risk of facilitating the commodity sale; and
  - the Customer sells the steel back into the market (to Commodity Broker B) at the same market price (i.e., USDXm) and on immediate payment terms.

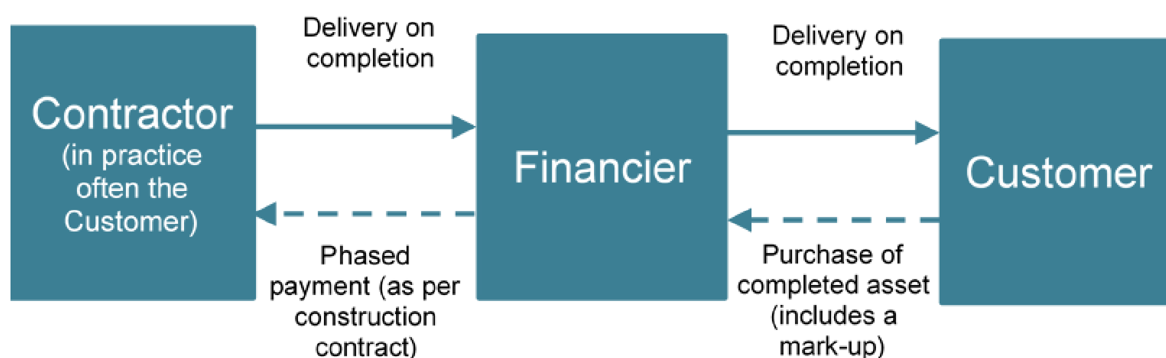
- The practical effect of the structure is:
  - given that the market price on that day was USDXm, the Customer now has USDXm in cash, but an obligation to pay to the Financier USDXm, plus its profit margin; and
  - often Commodity Broker A, Commodity Broker B and the Financier co-ordinate, so that all book entries are made nearly simultaneously and money in practice often flows directly from the Financier to the Customer with other transfers being netted-off.
- It should be noted that the deferred purchase price (together with profit margin) is payable in full at the expiry of each *murabaha* contract (which, in order to facilitate the payment of the LIBOR-based profit margin, will be at the end of what in conventional loan terminology would be the end of an interest period). While a typical commodity *murabaha* structure will include mechanics envisioning the parties entry into a new *murabaha* contract on the same terms on the expiry of the previous contract, the structure does, in effect create something akin to a conventional revolving credit facility (even if the Customer is actually looking to receive funds on a basis equivalent to a conventional term loan facility). The principal issue that this gives rise to is the danger of a drawstop being triggered, requiring payment of the deferred purchase price in full without the ability to roll into a new *murabaha* contract.
- Subsequent *murabaha* contracts can be entered into for quantities of commodities with a reduced market value, if the intention is to replicate a conventional amortising term loan approach to return of principal.

Ijara



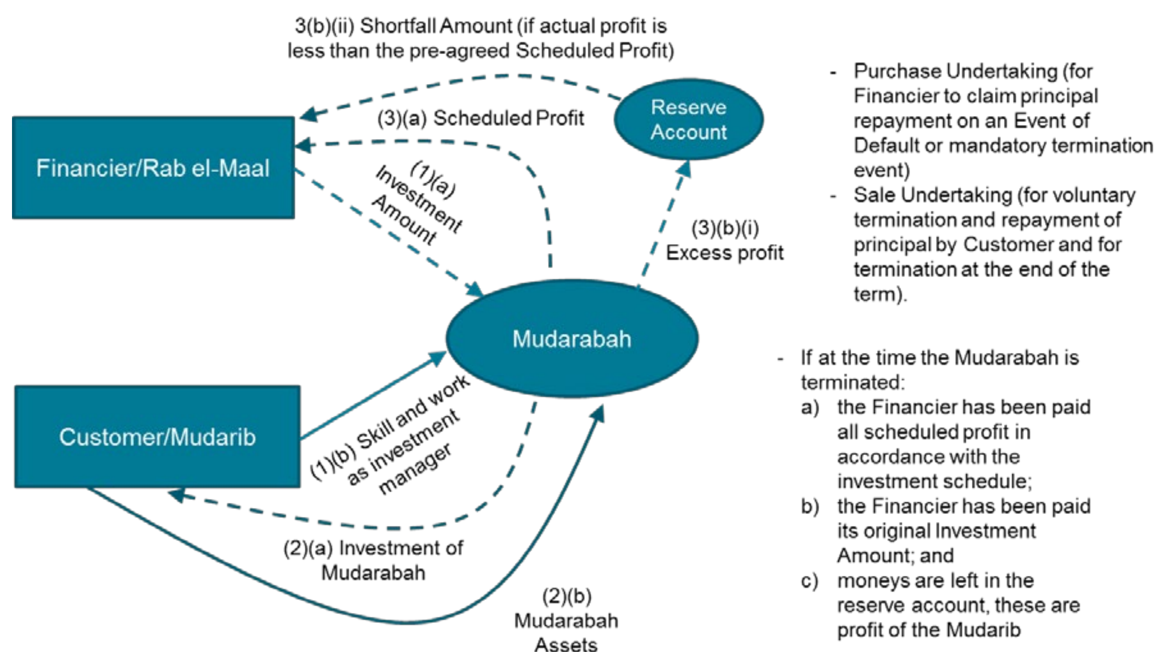
- An *ijara* structure is the Islamic finance equivalent of a conventional finance lease. It is often used for real estate or asset financings, because it requires the availability of an underlying tangible asset.
- An *ijara* is arguably the second most commonly used form of Islamic financing product, after a commodity *murabaha*.
- A worked example looks like this:
  - the Financier purchases title to a tangible asset owned by the Customer, or the Customer acquires a new tangible asset on behalf of the Financier (using the Financier's funds);
  - the Financier then leases the purchased asset (back) to the Customer at a pre-agreed rent (typically calculated as an ascertainable floating base rate (i.e., LIBOR) + a fixed percentage) charged to reflect the Customer's use of the asset; and
  - at the end of the *ijara* contract or earlier default, the Financier sells the asset (back) to the Customer (under a Sale Undertaking), or the Customer is required to (re)purchase the asset from the Financier (under a Purchase Undertaking), in either case, for an amount equal to the original purchase price plus accrued and unpaid rent.
- Sometimes the underlying asset can be split up (actually or theoretically on a percentage basis) to allow for a sculpted reduction in the purchase price payable or to allow for partial (voluntary or involuntary) payments of the purchase price during the terms of the *ijara* contract (to mirror amortisation or early repayment under a conventional term loan).
- Some Shari'ah scholars and advisers dislike structures where the purchase price payable by the Customer is set by reference to the Financier's original purchase price and require it to reflect market value at the point of (re)purchase of the asset by the Customer.

Istisna'a



- An *istisna'a* structure involves one party undertaking to procure for the other party the manufacture or construction of an asset, in line with an agreed specification, for delivery at an agreed time, for an agreed price.
- A worked example looks like this:
  - the Contractor (very often the same entity as the Customer) undertakes to manufacture or construct an asset on behalf of the Financier, in return for phased payments from the Financier;
  - the Contractor manufactures or constructs the agreed asset and, on completion, delivers it to the Financier; and
  - the Financier sells the completed asset to the Customer for an amount equivalent to the aggregate of all phased payments made plus a profit margin (typically calculated as an ascertainable floating base rate (i.e., LIBOR) + a fixed percentage) charged to reflect the Financier's risk of facilitating the manufacture or construction of the asset.
- An *istisna'a* structure is often used in project or real estate development financings to facilitate the advance of monies during the construction phase. In such circumstances, to facilitate a long-term financing arrangement, it is very often paired with an *ijara*. In such circumstances, on completion of the underlying asset, the *istisna'a* will be replaced by an *ijara* over the completed asset.
- When used in project or real estate development financings, where the Customer is the Contractor and a single purpose company, in parallel with entering into the *istisna'a*, the Contractor will enter into a construction contract with a third party, passing through the obligations that it has undertaken pursuant to the *istisna'a*.
- Some Shari'ah scholars and advisors permit the use of a forward *ijara* arrangement in parallel with the *istisna'a*, to facilitate advance rental payments by the Customer to the Financier (to allow the Financier to receive a return prior to completion of the asset, reflecting the equivalent of the payment of interest during construction, under a conventional term loan).

Mudarabah



- A *mudarabah* structure is a shared investment venture, under which a Financier agrees to cooperate with a Customer as follows:
  - the Financier invests money; and
  - the Customer invests skill and working hours.
- The *Mudarabah* is usually unincorporated but, for capital markets issues or to avoid risk of a partnership arising under English law, a corporation can be formed.
- Money contributed by the Financier is invested by the *Mudarabah* in the Customer's business and is used to acquire "assets" with the intention of generating profits (often the term "assets" for this purposes is interpreted broadly and there is no tangible asset or specific chose in action is acquired and rather the acquired "asset" is the anticipated resulting growth in the Customer's business).
- The *mudarabah* agreement stipulates that the *Mudarabah* will generate profits periodically for set periods at a pre-agreed scheduled rate (typically calculated as an ascertainable floating base rate (i.e., LIBOR) + a fixed percentage).
- The Customer pays all profit generated by the business to the *Mudarabah*.
- The *Mudarabah* then distributes the profit as follows:
  - up to the scheduled profit for the relevant period:
    - 99 percent to the Financier; and
    - 1 percent to the Customer; and
  - amounts in excess of the scheduled profit are then paid into a reserve account (although note that, in practice, the reserve account is often only a ledger account with the sums in practice continuing to be used (and spent) by the Customer).

- If the *Mudarabah* assets do not generate sufficient profit to meet the scheduled profit, the shortfall is covered from the reserve account.
- In the same way as with an *ijara*, a purchase undertaking and a sale undertaking provide the mechanism for the Customer to repay the original investment amount and for the arrangement to be terminated (on expiry, or earlier default).

Meet the Team

If you have any questions concerning the material discussed in this client alert, please contact the following members of our Finance practice:

David Miles
Partner

London
+44 20 7067 2216
dmiles@cov.com

David Miles leads the firm's English law general lending and Islamic finance practice and is based in our London office. Mr. Miles has extensive experience structuring, advising on, and executing complex, high-value financing transactions across both the developed and emerging markets. He advises clients on a broad array of financing matters, including both conventional bank debt and Islamic financing structures. Prior to joining Covington, Mr. Miles was based in the UAE for over eight years and has also worked in Hong Kong, Tokyo, and New York.

Christoph Schulz
Associate

London
+44 20 7067 2380
cschulz@cov.com

Christoph Schulz is based in our London office and advises corporates and financiers on the structuring and delivery of debt finance transactions. Mr. Schulz, an Arabic speaker, has particular experience in the Middle East and emerging markets. Prior to joining Covington, Mr. Schulz was based in the UAE for over five years.

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