New York Law Journal
GC New York
WWW.NYLJ.COM
An ALM Publication
VOLUME 248—NO. 8
THURSDAY, JULY 12, 2012

FINANCE

Islamic Finance and Investment In U.S. Expected to Grow

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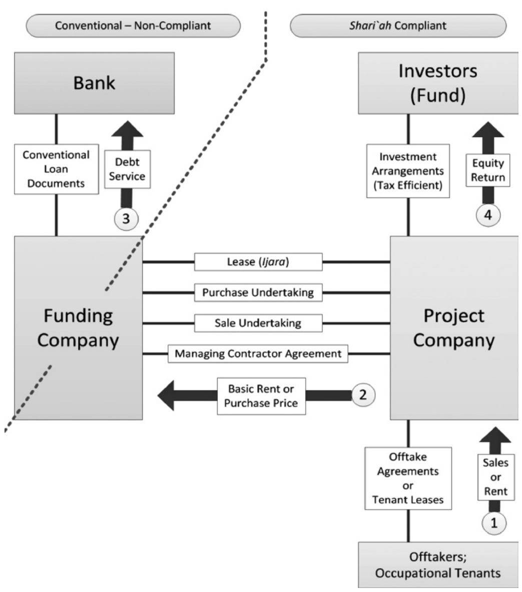
The United States has been, and is now, one of the largest markets in the world for Islamic finance and investment transactions, which are transactions conducted in accordance with those principles of the Shariáh that are applicable to commerce and finance.[1] A wide range of U.S. and international practitioners have participated in Islamic finance and investment transactions, and it is likely that even more will participate as the global financial markets rebound and investment activity in the United States increases again. This article anticipates those increases in transactional volume in the U.S. and presents summaries of some of the main financing structures that U.S. and international practitioners will encounter in the Islamic finance and investment transactions.

Most U.S. Islamic finance and investment transactions involve investments by foreign investors in U.S. real estate, equipment and private equity assets and businesses throughout the country. Many of these transactions involve prominent U.S. real estate projects (such as sale and leaseback arrangements involving corporate headquarters buildings) and prominent U.S. corporate entities (including warehouse chains, nursing home chains, coffee companies, and clothing companies). It is estimated that more than 150 U.S. banks have provided financing for these transactions, usually by way of a conventional interest-based loan that is integrated into a Shariáh-compliant transaction.

It is anticipated that there will be a further increase in Shariáh-compliant transactions driven by strong accumulations of investable cash in the Middle East, decreased interest in European investments as a result of the current European woes, decreased enthusiasm for short-to-medium term prospects in BRIC (Brazil, Russia, India and China) countries, and the large number of bullet financings of outstanding Shariáh-compliant debt that will come to refinancing in 2012-2014.[2]

The unfamiliarity factor is falling away as thousands of transactions have been completed in non-Muslim jurisdictions, including North America and Europe, many involving conventional interest-based banks. There is recognition that (i) Islamic finance and investment is not a mysterious process, (ii) it is an ethically oriented structured finance, (iii) customary risks are addressed in ways that are familiar and do not disrupt existing underwriting, credit, legal, regulatory and tax assumptions and practices, and (iv) there are no significant unanticipated risks as a result of using these financing and investment techniques.

FIGURE 1: GENERIC LEASE (*IJARA*) FINANCE STRUCTURE



Factors Affecting Growth

Islamic finance and investment transactions are conducted in accordance with those principles of the Shariáh that are applicable to commerce and finance. The Shariáh is a body of ethical, religious, moral, legal and ritualistic principles and practices; it is the 'path' by which a Muslim leads his or her life, in all aspects of life. Islamic finance and investment involve primarily the legal principles, which are comprehensive in respect of commerce and finance. The best known principle is that a compliant participant cannot pay or receive interest. However, the Shariáh has evolved as a body of law for more than 1,400 years, and lawyers, with time, tend to increase the complexity of the system in which they operate (if only to achieve greater precision, definition and certainty): 1,400 years is a long time. Thus, there are principles applicable to sales, leasing, agency, financing, guarantees, mortgages, pledges, and virtually every concept addressed by any other legal system. Mastery, even familiarity, takes a bit of effort, particularly in light of the absence of written compilations of the principles (knowledge transmission has been oral) and the absence of rigorous contemporary books and articles on the topic.

Before considering some illustrative modern contractual arrangements, consider five factors that have had the greatest impact on the development of the industry.

First, there has been a move toward consensus (ijma) in respect of transactional structures. Divergences as between the four orthodox schools of Sunni Islamic jurisprudence continue to exist, but there has been a focused effort to develop structures that work under all four schools. The consequent reduction in transaction costs is apparent.

Second, until recently transactions could make use of only one "nominate contract," which are long-approved, but quite rigidly defined, contractual forms. In the mid-1990s Shariáh scholars determined that a transaction could use more than one such contract. This allowed for significant advances in the sophistication of transactional structuring.

Third, the fatwa (opinion of Shariáh scholars) issued in 1998 to Dow Jones Islamic Indexes in respect of equity indices and equity investing (i) institutionalized a degree of permissible impurity or permissible variance from absolute adherence to principles, (ii) institutionalized purification or cleansing concepts, and (iii) institutionalized principles for determining permissible business activities in situations where a business has multiple lines of business.

Prior to 1998 a devout Muslim could acquire virtually no stock because essentially all companies either pay or receive interest (for financings or from investments). The fatwa set forth tests that allow investment if the amount of interest is not too great, and then required that the investment be purified or cleansed by donation of the impermissible interest income to charity. Impermissible business activities are relatively well known (pork or alcohol for human consumption, interest-based banking, non-compliant insurance, pornography, prostitution and others). But questions remained as to the permissibility

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of investment in companies that have multiple businesses, some of which are not permissible. Until 1998, an investment in an automobile, aircraft or turbine manufacturing company might well be precluded because the corporate group included an interest-based credit company. The fatwa established the principle that (with some exceptions) the determinative analysis is the core business of the group.

Fourth, the development of sukuk opened the financing side of the capital markets. And that area is now the fastest growing area of the industry.

Fifth, bifurcated structures were developed that allow the use of conventional financing in Shariáh-compliant transactions, as discussed below. This brought the Western banks and financial institutions into the industry and allowed Islamic finance and investment to be used in Western markets.

Transactional Models

By way of introduction, consider three contractual arrangements that are at the core of modern Islamic finance and investment: (a) the murabaha, or cost-plus sale;[3] (b) the ijara (lease); and (c) the diminishing musharaka or diminishing partnership.[4] There are many others, but these three are predominant and illustrative.

The murabaha is the most frequently used, and the most frequently abused, structure. It is an ancient contract for commodities purchase and sale transactions. A client needing financing for the purchase of a commodity approaches a bank. These two parties execute a murabaha agreement pursuant to which the bank purchases the commodity from a third-party seller at a negotiated price (cost) pursuant to a purchase agreement that was negotiated by the client with that seller.

The bank then sells that commodity to the client at cost plus a mark-up (which may be determined at a fixed or a variable rate) with deferred payment terms. A debt is generated. There are various rules regarding a) disclosure of cost and profit, b) the bank taking actual ownership risks, c) the fixing of the price at inception of the transaction (any subsequent change in that price is prohibited), and d) the prohibition of discounts for early payment and interest for late payment.

That murabaha structure is well and good, and frequently used, where it involves a commodity desired by the parties. But in some transactional variants the commodity is only a vector and the parties' focus is really on generating the debt obligation. These vector murabaha transactions are commonplace, such as for term or revolving loan equivalents and short-term deposit accounts. Here, the commodity is a metal (usually platinum) or another permissible commodity (e.g., palm oil). It is purchased by the bank from a third-party seller at spot, sold to the client on deferred payment terms, and then sold by the client to a third-party purchaser at spot, all in the course of an hour or so.

The bank is out the spot payment amount; the client receives the spot payment amount and has a deferred payment obligation to the bank. This is compliant in form, but of questionable substance. The metal is used because all Shariáh requisites can be easily satisfied and there is no real ownership risk to the bank or associated costs (insurance or transportation). The structure is as an expedient, but is disfavored.

The ijara (lease) is long-accepted and the most frequently used contractual form in sophisticated financings throughout the world. In various forms (it is highly flexible) it is used in financing real estate, private equity, project, infrastructure, equipment, aircraft, vessels, services and many other assets.

An ijara is a sale of a usufruct (right to use) under the Shariáh. The principles are quite similar to Western leasing principles, although there are some variances. The similarities render the structure easily accessible and comprehensible in the West. A generic transaction is illustrated in Figure 1. Notably, it is quite similar to a leveraged lease (albeit one that fails on the tax ownership side, such that the project company is the tax owner, but does not hold title).

A special purpose vehicle, the funding company, acquires (or constructs) the asset using a conventional interest-bearing loan from the bank plus an equity contribution from the fund via the project company to the funding company. The funding company then leases the asset to the project company, who may sublease it (or sell product to an offtaker).

Basic rent payable by the project company to the funding company on the lease from time to time is exactly equal to the debt service payable by the funding company to the bank at such time.

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A purchase undertaking incorporates mirror images of all mandatory prepayment provisions from the bank loan documents, allowing the bank, through the funding company, to pass all mandatory prepayment obligations to the project company. The payments may be a portion of the outstanding principal amount of the bank financing (for example, a partial prepayment on a debt service coverage ratio violation), or the entire outstanding principal balance (as in a default acceleration).

The sale undertaking incorporates mirror images of all voluntary prepayment provisions from the loan documents, thereby allowing the project company to prepay the financing in whole or in party or acquire the asset (such as for sale to a third party). The managing contractor agreement removes the funding company from all decision-making in the overall transaction. The funding company is a disregard entity for tax purposes.

The diminishing musharaka, like the ijara, is frequently used for home purchase financings and project and infrastructure financings.

In a construction financing for an electricity project, the project company (electric company) contributes capital to the musharaka (partnership) and receives partnership interests (hissas). The bank contributes cash, on a monthly basis in conformity with monthly construction certifications, to the musharaka to pay for construction, and receives hissas for each contribution. The interest of the bank is leased to the project company to allow the project company to construct and operate the project.

Repayment of the financing is effected on an agreed amortization schedule (identical to a conventional schedule). The project company purchases hissas from the bank until the project company owns all the hissas (and the partnership is dissolved into the project company). The bank is the financial partner, controlling all financial matters, and the project company is the technical partner, responsible for construction and operation.[5]

Conclusion

Islamic finance and investment transactions are now commonplace throughout the world, including the United States. Most U.S. transactions are governed by and enforceable under New York law. Most international transactions are governed by and enforceable under English law. Normally no mention is made of the Shariáh in the transactional documents and customary enforceability opinions are rendered. Both international and U.S. finance practitioners are likely to be involved in an Islamic finance and investment transaction. It will become apparent that these are structured financings that are more similar to conventional financings than not, although there will be a need to seek guidance in addressing the (relatively small) portion of the transaction that is divergent from the conventional.

1. Michael J.T. McMillen, Islamic Capital Markets: Market Developments and Conceptual Evolution in the First Thirteen Years, available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1781112, summarizes developments in the Islamic finance and investment industry since the mid-1990s.

2. The factors favoring an increase in US activity are enhanced by related global developments. For example, Middle Eastern and Southeast Asian governments are actively promoting Islamic finance and investment, particularly in the infrastructure sector. As another example, there are significant increases in the volume of sukuk issuances (sukuk are Islamic asset and whole-business securitizations that are commonly, but inaccurately, described as "Islamic bonds"), in the first quarter of 2012 (volume was US$43.5 billion, an increase of 55 percent over 2011, and the best year on record). Notably, in 2011, for the first time in history, sukuk issuance volume in the Gulf Cooperation Council exceeded conventional bond issuances in those countries.

3. Michael J.T. McMillen, Trends in Islamic Project and Infrastructure Finance in the Middle East: Re-Emergence of the Murabaha, available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1753252.

4. Regarding the ijara and diminishing musharaka, see Michael J.T. McMillen, Islamic Shariáh-Compliant Project Finance: Collateral Security and Financing Case Studies, 24 FORDHAM INTERNATIONAL LAW JOURNAL 1184 (2001).

5. In a home purchase financing, there is one bank payment at the time of house acquisition.