Transferability: It must be possible for the originator to transfer the receivables to the buyer without excessive expense or formality. Similarly, in the case of bulk receivables, transferability must be possible without the consent of the debtors. This is due to the inertia of communication in that often the debtors are disparate and varied and needing to require consent from them all would almost paralyse the transaction.

True sale: The sale must always be treated as a complete and final transfer of the receivables from the originator to the purchaser so that the receivables are no longer the assets of the originator and, consequently, the funding loan is not the liability of the originator.

It must also be possible to set up the securitised transaction without other burdensome restrictions or expenses that may attach to it, for example, restrictions and expenses under tax laws and securities regulation.

7.4 The benefits of securitisations[19]

Capital adequacy: Capital adequacy requirements require banks to retain a specific amount of funds with the bank for amounts lent according to the risk weighting of the loans or credit extended. This may also mean that banks and other financial institutions (e.g. home loan firms, the originator) may be required to raise extra capital in order to support new loans. The cost of retaining or raising funds to support loans made is avoided if assets are sold because the sale brings in cash and creates space on the balance sheet for the banks or institutions to lend more money. The sale also reduces regulatory reserve requirements, which are essentially a portion of deposits that a bank must pay to its central bank on the deposits funding the asset.

Better returns on capital: If accounting rules permit, the originator can raise money without the loan appearing on its balance sheet or being a liability of the originator and still keep the residual profits from the sold receivables. The cash price can then be used to pay back the originator's liabilities, leaving the originator with less liabilities and hence more borrowing space. Its financial ratios (debt to equity) may consequently be improved, for instance, if a bank has assets of 500 and debt of 300 (ratio 5 : 3) and then sells 100 worth of its assets in order to pay off 100 worth of its debt, then it has assets of 400 and debt of 200 which is a much better debt to equity ratio of 1 : 2. Return on capital is thus improved because the originator has removed the asset and liability from its balance sheet but still retains the profit.

Quicker fund raising: The originator raises funds faster through securitising the securities rather than having to wait for the receivables to be repaid.

Liquidity: The originator is able to raise more money at a cheaper cost through securitisation (especially if in bulk) hence granting him greater liquidity through the sale of otherwise illiquid assets by marketing them as securities to investors. It is a cheaper means of raising money because:

- The finance is essentially 'secured' so it is cheaper and more long-term than unsecured finance.
- The strength of the investors capital is improved by the fact that the SPV enjoys credit enhancement and is insulated from the insolvency of the originator (by virtue of the sale and because the SPV is a separate legal entity).

Diversification: The originator can diversify its funding sources, especially if the securities can be sold internationally as in global and cross border securitisations. This makes securitisation particularly attractive to developed economies that have turned to emerging or Islamic economies that possess vast amounts of dormant wealth (that can be tapped into through securitisation) to raise funds. Similarly, it has enabled emerging and Islamic economies capable of attaining the requisite global financial standards to diversify their fund raising portfolio and tap into new sources of capital.

Avoids restrictions: Securitisation is essentially similar to a secured loan. Its structure, however, allows it to escape many of the restrictions that may otherwise attach to a secured loan. For example, a securitisation will normally avoid the originator's negative pledges, borrowing restrictions and cross-defaults (assuming the purchaser or SPV is outside the originator's group) because the transaction is a sale. The funding loan is made to the SPV and the actual security over the receivables is granted by the SPV. Securitisations is often the only way banks can raise 'secured' money because it is otherwise inappropriate for them to grant security over their assets (a regulatory prohibition to protect depositors).

Cost effective: For emerging and Islamic economies, the structure of securitisation presents a more cost-effective method of financing within the framework of interest-bearing loan financing being prohibited. This is because securitisation structures remain relatively cheap and straightforward compared to other financial structures.

Facilitates future growth: Securitisation facilitates growth of the specific industry in which it is used, and of the financial market and economy as a whole. This may be explained by the structures as well as the standards that must be attained by the financial sector and the economy as a whole, that is, the accounting standards, the global rating standards, a listed stock

exchange, efficient and effective dispute settlement mechanisms, etc. so as to ensure the viability of the transaction and attracting investors. In Muslim-nation economies, securitisations create a precedent that may lead to better structured securitisations and in turn facilitates progress and future development of the market.[20]

Risk: The originator has the advantage of transferring the risk of non-recovery of the receivables to the issuer (and lenders of the funding loan), whilst retaining its right to profits.

Avoids lending limits: A securitisation being a sale and not a secured loan transaction enables the bank to avoid lending limits and restrictions placed on banks with regards to both how much they can lend to any one single obligor and the lack of diversification.

7.5 The drawbacks of securitisations and issues in application

Originators often transfer their best receivables so that the originator's credit may be weakened.

- It may be expensive due to the complicated structure a securitisation may acquire and the need to ensure compliance with legal and regulatory requirements.
- It can be very technical in nature owing to the regulatory and audit insistence that the originator must not be morally obliged to support the SPV. The transfer may thus tend to be more manufactured than real.
- The debtors liable on the receivables may object to the change of creditor/s from their originator to an SPV controlled in substance by unknown bondholders and often located in a tax haven country.

Moreover, jurisdictional requirements (legal or regulatory) and the structure of a securitisation raise issues that may lead to difficulties in application.[21] The more pertinent among them are:

1 *Notice to debtors*: In the case of bulk receivables, notice of transfer of the receivables to the issuer (and subsequent purchasers) will not normally be given to the debtors because of:

    - The inconvenience and expense – by virtue of requiring change of mandate from the originator's bank to the SPV bank
    - The originator's (usual) desire to maintain its relationship with its customers and debtors and, hence, continue collecting the receivables due.

In England, unlike other jurisdictions,[22] giving notice is not mandatory and does not affect the validity of the transaction. However, failure to give notice may affect the securitisation transaction in the following manner:[23]

- The SPV might lose priority if the originator resells or charges the receivables to a third party.
- The secured investors might also lose priority if the SPV resells or recharges. This, however, is prohibited by the documentation, and investors and rating agencies are usually content to rely on the originator and SPV complying with these prohibitions.
- Debtors may continue to pay the originator as opposed to the SPV. This, however, is not usually an objection as the originator wishes to continue collecting the receivables from its debtors/customers. The issue at hand is the effect it may have on bankruptcy remoteness of the SPV from the originator because though the originator must in essence hold the receivables collected in trust for the SPV, the originator's creditors not having been given notice may demand a stake in the SPV upon the originator's bankruptcy.
- Debtors without notice can continue to acquire new set offs and defences e.g. if goods supplied are defective, or the debtors have deposit accounts with the bank originator.
- In the absence of notice, the debtors and originator can vary the terms of receivables; again one relies on contract compliance by the originator.

The rating agencies are, however, prepared to assume that the originators will comply with the securitisation documentation so as not to bring about the above referred to scenarios or act fraudulently and negligently.

2 *The true sale requirement*: The 'true sale' component of securitisation is pivotal with regards to many of the issues one faces in securitisation including sources of credit enhancement, capital adequacy, balance sheet and accounting rules, re-characterisation of security interests, etc. [24] It is also considered as determinant of the sharia compatibility of a securitisation. This is because of the existing conceptual hurdle that denies receivables proprietary status, as discussed in chapter 6. Should this misconception be dissolved, less emphasis need be placed on the legal requirement of 'true sale' with greater emphasis being placed on economic substance and the equitable effect of the transaction.

The main conceptual features of a true sale include:[25]

- The seller (originator) has no liability for the asset once sold except normal warranties for defects.
- The seller does not guarantee recoverability of the asset, or have a duty to repurchase, or to provide additional cash (for purposes of credit enhancement, for example, through loans) or additional assets either directly or under a swap, and has no commercial non-legal 'moral' duty in practice to compensate for shortfalls. If the seller has a liability, then clearly this must be recognised and indicated in the balance sheet and the regulated seller must have capital against it.
- The buyer must have exclusive control and dominion over the assets. This means that the buyer (SPV) can sell it, exchange it, pledge it, does not have to resell it to the seller (except perhaps for a clean up of the final small amounts) and can itself manage and collect the receivables. It does, however, have the prerogative to delegate this duty to the seller which it normally does for practical reasons.
- The buyer must also take all the profit made from the assets after the sale without having to remit any part of it to the seller. If the seller continues to have a certain degree of control or dominion after the sale, the assets may still be seen as belonging to the seller and consequently be available to the seller's creditors upon its insolvency.
- The sale should not be revocable on the bankruptcy of the buyer, either because it was a preferential transfer or because the buyer is really part of the seller, or because the sale was not published and must not be reachable by the creditors of the buyer – if it were, then in substance the seller still has the asset.
- The asset sold must be isolated and insulated from the creditors of the originator. In other words, the assets must be bankruptcy remote from the bankruptcy of the originator. Clearly, this non-revocability is essential for the purpose of a true sale and securitisation in general.

The two main issues arising under the true sale component of securitisations are:

- Re-characterisation of a 'sale' as a security interest;
- Bankruptcy remoteness.

7.6 True sale: the re-characterisation of a 'sale' as security interest[26]

In essence, a securitisation must involve the (genuine) sale of receivables by the originator to the SPV and, therefore, not be re-characterised as a security interest for the purpose of security and bankruptcy laws. This is because if it were to be characterised as such the results would be disastrous.

1 The assets would remain on the balance sheet of the originator and the funding loan becomes a direct liability of the originator. It would thus be subject to the originator's other loan agreements, financial covenants, cross defaults and other restrictions.[27]
2 The security may require registration or perfection by filing if it is not to be void on the insolvency of the originator, infringe negative pledges of the originator, and be subject to restrictive mortgage enforcement procedures, for example, have its enforcement frozen on the insolvency of the originator, and be subject to the enforcement laws of the originator's jurisdiction as opposed to that of the SPV.[28]

Therefore, through re-characterisation, the investors lose their insulation from the originator's credit so that a default by the originator would force the investors to realise their security prematurely.

Many legal systems seek to ensure that transactions which are like security interests are subject to the legal rules relating to security interests.[29] The main characteristic of a security interest is that the debtor has the right to get back the charged collateral if the debtor repays the secured debt. It also has the right to receive the surplus proceeds if the creditor enforces and sells the collateral. Hence, the chief factors in considering whether to re-characterise a securitisation transaction as security interest include:

- The originator's rights to repurchase the receivables become in substance the mortgagor's right to get back the mortgaged property on repayment of the loan.
- The extraction of profit by the originator (e.g. by deferred purchase price or a subordinated loan) amounts to a lender accounting to the borrower for the excess of the mortgaged property over the loan. In a true sale, the purchaser keeps the residual value (profits) of the purchased property, but in a mortgage, the borrower receives back the residual value on the repayment of the loan.
- The transaction resembles a sham whereby the parties carry out the transaction in a different way than that contemplated by the documents,

for example, where the records make reference to a loan and interest as opposed to a sale.
- The continued collection of the receivables by the originator negates a true sale. In a true sale, the buyer usually manages the asset because it belongs to the buyer.

Re-characterisation is discussed more specifically in chapter 8, section 8.2.

7.7 True sale: bankruptcy remoteness

A securitisation must also be isolated and insulated from the insolvency of the originator in order to satisfy all interested parties: investors, rating agencies, accountants and regulators. The main requirements are:

- The SPV must not be consolidated, fused or merged with the originator on the originator's bankruptcy so that all its assets and liabilities are merged with those of the originator. If that happened, then the funding lenders would have to enforce their security over the receivables prematurely on the insolvency of the originator and would be subject to the bankruptcy laws applicable to the originator, for instance, freezing orders upon a bankruptcy judgement. This is because the merger or fusion would result in the asset becoming assets of the originator and the funding loan a liability of the originator.
- The documents and their implementation must ensure separateness of the SPV, for example, separate officers, no commingling of assets, separate records, observance of corporate formalities, disclosure in financial statements and the like. Bankruptcy consolidation is rare and tends to happen only if there is extreme commingling ignoring the separate legal identities of the two or if the SPV is just an agent of the originator managing the property of the originator. The originator's management of the property of the SPV, however, does not entail such consolidation and is not usually a serious risk.
- Transfers or payments by the originator to the SPV must not be capable of being set aside as a preference or transaction at an undervalue on the bankruptcy of the originator. If set aside, the creditors of the originator have a claim on the receivables – which cease to be insulated or remote. This affects mainly the sale itself and any substitutions by the originator, that is, they must not be undervalued.
- There should be no material loss of or delay in the recovery of funds collected by the originator as servicing agent, if the originator becomes

insolvent. The document usually requires frequent turnovers to the SPV, for example, every two or three days, or payments go direct to the SPV account.

Conclusion

In concluding, it is important to note that there are other issues apart from those addressed in this chapter that may arise with regards to a securitisation transaction. This is because different jurisdictions may have different formalities of form or manner of execution relating to the instrument of transfer or indeed the notice. There may also be prohibitions on the type of assets that can be transferred; some jurisdictions, for example, prohibit the transfer of obligations owned by public authorities. The receivables themselves may contain prohibitions on assignment in their terms, although such prohibitions are not enforceable in all cases. In some jurisdictions, only receivables due and owing at the time of the transfer can be validly assigned, others contemplate the sale of future receivables which are transferred as they arise. Jurisdictions also vary with regards to the amount of detail that is required to identify the receivables which are the subject of a sale. In this light, the next chapter compares a securitisation structure in Islamic finance with a common law securitisation and considers the issues that arise in structuring a securitisation deal to be compatible with both Islamic law and the common law.

8

STRUCTURING A SECURITISATION TO BE COMPATIBLE WITH BOTH THE SHARIA AND COMMON LAW

Having reviewed the basic structure and theory of securitisations, this chapter considers how, and at which stages a basic securitisation structure is affected, specifically, by the vitiating concepts of *gharar* and *riba* and *bay al dayn* or sale of debt and, generally, by other factors involved. The purpose of the structural comparison undertaken in this chapter is to demonstrate the importance of the issues discussed in chapters 3, 4, 5, and 6 and how they are practically engaged. The comparison not only points out the distinctions between the structures but also how the proposals in the above named chapters render them no longer an impediment to structuring sharia compliant securitisations.

Initially, however, let us consider why dual compatibility of sharia compliant securitisation should even be sought. Why bother? Why not simply have Islamic finance products in consonance with the sharia made available to Muslim consumers or those who choose such financial services and products? The answer, very simply, is as we mentioned in chapter 2. Securitisation is a conventional law invention and sharia compliant securitisations would mostly be structured either in the financial centres of the world or by financial institutions governed by the rules and regulation of the global financial centres. This is so as to increase their rating, profile and marketability to institutional and other investors who seek assurance from the knowledge that Islamic finance products are at par with conventional products as far as legal and regulatory standards are concerned. As such, it is obvious that they must comply with the laws and regulations of the financial jurisdiction in which they are structured, they intend to

draw investors from and the sharia. This external jurisdictional law to be complied with tends to be the common law – be it Singapore, Hong Kong, Malaysia, London, Dublin or New York. Even those structured in Doha or Dubai tend to comply with the common laws and regulations governing contractual and financial transactions for purposes of marketability. This is also, partly, because the laws of England and New York are the most developed and predictable systems of law in the world thus less risky and amenable to flexible financial structures that better suit risk averse investors. Dual compatibility is thus hardly an option for Islamic financiers; it is simply a matter of commercial survival if not common sense.[1] Therefore, the need for dual compatibility in Islamic finance structures is also fuelled by the issue of enforcement and the requisite legal certainty, as we shall discuss below.

Further, we have indicated that the distinction between 'Islamic finance' and common law or other conventional modes of finance is, currently, more a matter of form or arbitrage that the industry is cashing in on.[2] Islamic finance jurisdictions and the industry as a whole, has promulgated the theory, with the exception of few vocal academics and practitioners, that the sharia frowns upon the payment of any increased returns on loans, any contractual uncertainty and any future or intangible asset sales. Islamic finance securitisations, therefore, are camouflaged in 'sharia compliant' transactions as a matter of form so as to secure the advantages of a conventional securitisation whilst appearing to avoid interest, uncertainty (*gharar*) or the sale of receivables. In essence, they are both the same and the purpose of this chapter, therefore, is to clarify the misconceptions of the current Islamic finance theory and to reconcile it with conventional finance wherever possible.

8.1 Issues involving *gharar*, *riba* and *bay al dayn*

Securitisation in its classic form involves the sale by an originator of its income-generating assets (receivables) to a special purpose vehicle (SPV) that finances the acquisition of those assets by issuing debt securities to one or more investors. The income generated by the assets is then used by the SPV to service its obligations to the holders of the securities. The SPV will normally be a company or other legal entity which has no (or only minimum) outside creditors, and whose sole functions are to acquire and hold the assets and to issue the securities.

Therefore, at the most basic level, a securitisation structure involves the Originator, the Seller, the Trust SPV, and the Note holders as, for instance, in the following sketch.

Originators → Stage I → Seller (Oxford Mortgages) → Stage II → Trust SPV → Stage III → Note holders.

Stage I entails the sale of mortgages by the originator to Oxford Mortgages. This is a primary market transaction of sale of assets (mortgage receivables).

Stage II involves the sale of receivables by Oxford Mortgages (OM) to Trust SPV (SPV). This is a secondary market sale of debt obligations since the originator and mortgagee are the original contracting parties. Once the receivables are sold to the SPV they become the property of the SPV. In principle, the true sale requirement means that the receivables are no longer the property of OM.

At *Stage III*, SPV creates and issues (sells) notes to investors so as to raise or borrow money to pay for the purchased receivables. This transaction is, again, a primary market transaction as the SPV is the originator of the notes (created and issued for the first time).

Issues: How, and at which stages specifically, is this basic securitisation structure affected by the vitiating concepts of *gharar*, *riba* and *bay al dayn* (sale of debt)? The responses that is made here to each issue is based on current Islamic finance theory and application, much of which would not be an issue if applied within the suggested framework of this book, that is, a focus on economic substance in compliance with the principles of contractual fairness and permissibility rather than a focus on legal substance based on compliance with rules formulated in ancient context.

1 Both Stage I and II must be characterised as true sales for Islamic finance purposes. This is mainly a concern at stage I despite the fact that the economic effect of stage II is a loan attained via sale of securities to investors. The importance of characterisation pertains to the theory that a loan or mortgage transaction triggers the rules of *riba* that, currently, prohibit any increase (or decrease) on money lent or borrowed. Thus, if stage I is characterised as a loan to be repaid upon sale of notes to investors, no interest/premium or discount (over original receivables value) can be received by OM from SPV. The above concerns are dealt with in detail in chapter 5 on *riba* and the issue of increased return should not, according to the discussion therein, threaten to vitiate a securitisation structure except on the ground of being inequitable to the parties involved.
2 The sale of receivables at stage I is a sale of debt rights or obligations. The validity of such sale, given debts' (current) derivative proprietary nature, depends on the assets 'backing' the mortgage receivables being deemed

sharia compliant (i.e. not bear debts, interest-bearing loans, night club, casino, cinema complex, etc.). Under current Islamic legal theory debt, unlike lease, has no independent proprietary status. Again, this is dealt with at length in chapter 6, section 6.5.

3 The sale of debt issue at stage I also engages the *riba* rules, again, since debt is currently erroneously equated to money and, therefore, the mortgage receivables can only be sold at par, for spot payment, that is, 'equal for equal, hand to hand'. Herein lies the importance of demonstrating the distinction between debt and money (dealt with in section 6.3), otherwise, any sale of receivable or securitisation is limited by this characterisation.

4 The *gharar* objection creeps into stage II through the issue of sale of debt obligations to third parties because it is said to create a risk of repayment given that the SPV is not the originator of the receivables (i.e. the contractual link between mortgagor and mortgagee has been severed and the originator of the securities (notes) has no contractual link to the mortgagee/s). However, should stage I be well documented (perhaps also indicating the consent of the mortgagees to such sale and their agreement to pay SPV instead of OM) and repayment is guaranteed or insured, then *gharar* is eliminated from the outset. Further, assuming the evidential nature of *gharar*, the concept would allow the curing of such risk if it arises. It is, therefore, also important that the degree of *gharar* be considered – only excessive/exorbitant *gharar* renders a contract defective. Minor *gharar* has always been deemed tolerable.

5 As long as the stage II transaction is well documented so as to ensure certainty of terms of contract (parties, time of periodic payments and maturity, price, etc.) then no *gharar* arises. Otherwise, any uncertainty as to the contractual terms would trigger *gharar*. Again, the vitiating effect depends on the degree of *gharar* and, if defective, the evidential nature of the concept would allow curing *ex post factum*.

6 The sale of notes to investors at stage II may be regarded as an invalid *sale of debt* since what 'backs' them is the receivables (not the mortgaged property giving rise to the stream of receivables). This goes back to the derivative proprietary nature of debt recognised only in the more progressive jurisdictions like Malaysia. Hence, the importance of establishing debt as independent proprietary rights that can be dealt in freely as is the cases with lease rights or company shares (discussed in sections 6.5 and 6.6).

7 Again, even if the sale of debt transaction is valid, it is caught by the characterisation of debt as money that triggers the *riba* rules (spot exchange and sale at par value). See 3 above.

8.2 General issues arising from dual compatibility structuring

Using the 2003 Qatar Sovereign *ijara sukuk* (outlined below), I undertake a more elaborate comparison of the facets of a lease securitisation:

- The government of Qatar sells land parcels valued at US$700 million.
- The issuer (SPV) purchases the land parcels at a deferred payment basis.
- The SPV undertakes to resell the property to the government at certain agreed terms or subject to certain redemption conditions.
- SPV issues *sukuk* instruments which the Investors (both Islamic and conventional) purchase.
- The gross proceeds received by the issuer from the issuance and sale of the certificates are used to pay the purchase price (pursuant to the purchase agreement) to the government of Qatar.
- The SPV then leases out the land parcels under a Master *Ijara* Agreement to the government of Qatar, effectively a ground lease. The lease is for seven years after which ownership reverts back to the government.
- The returns to the certificate holders are variables. The government of Qatar pays semi-annual lease rentals under the Master *Ijara* Agreement which are calculated by reference to (i) London Inter-Bank Offer Rate (LIBOR) plus a margin of 0.4 per cent per annum, (ii) the Amortisation Payment[3] (beginning in April 2006). The two amounts equal the Periodic Distribution Amounts payable on the Periodic Distribution Date coinciding with the Rental Payment Date for such rentals.[4]
- The SPV disburses semi-annual distribution payments (equal to the government's rental payments) to the certificate holders, that is, the rental payments are the return on investments.
- The investors enjoy the irrevocable undertaking by the Qatar government to buy the parcel of land.

In comparison, a conventional lease receivables securitisation structure is as follows:[5]

- The leasing company leases assets to lessees under lease agreements.
- As a result of the lease agreements, rents (receivables) are paid by lessees to the leasing company.
- The SPV advances to the leasing company the current cash value of an aggregate number of leases in exchange for a securitisation agreement (of the leases).
- The leasing company forwards repayments from the lessees to the SPV.

- The SPV issues to investors the interest bearing notes in exchange for cash to cover the securitisation agreement.
- Investors receive interest and principal payments over the life of the notes.

Before proceeding to consider the actual or potential issues that arise in structuring the above sharia complaint structure to be dual compatible, note that a fundamental difference between the two structures is that in the conventional structure, the securitisation is not 'asset backed' in the sense currently required by Islamic law and, hence, is deemed non-sharia compliant.[6] The other main difference is that, in the conventional structure, the SPV *borrows* money through the notes issue in order to purchase the leasehold estates instead of *selling* or leasing the property or assets in question as Islamic finance would require. In the Qatar structure, on the other hand, the issuer *bought* the asset on deferred payment basis, securitised it and *sold* undivided shares of it so as to raise funds to pay the purchase price then *leased* it to repay the investors.[7] The real difference, however, lies in the form or structure of the transaction such that the conventional structure is a securitisation for the purpose of funding the *purchase* of an asset as opposed to a (sharia compliant) securitisation to finance payment of an already purchased property. The distinction is subtle but obviously deemed significant. In substance, the fact that no money is borrowed does not preclude the existence of credit transactions structured as sales or leases or the fact that the asset backing is specifically manufactured as a formality to attain the same financial objective.[8] Moreover, the 'asset-backed' requirement is not necessary as discussed in chapter 6 since debt qualifies, even under Islamic law principles, as (personal) property in its own right and may be freely dealt with as one does with the share/s of a company without insisting that it be 'asset backed'.

That said, structuring the Qatar securitisation to be dual compatible raised the following issues.

8.2.1 True sale and the risk of re-characterisation

A major issue under sharia-compatible securitisation has been structuring one that embodies the ownership characteristic of an equity instrument as well as the priority status and the fixed income characteristics of a bond instrument. A concern within the issue is that upon winding up of the originator, there was a possibility of re-characterisation (by the courts)[9] of the transfer of interests from the originator to the SPV as a loan as opposed to a true sale.[10] The theoretical effects of such re-characterisation

is outlined in section 7.6 and issue of substance verses form is elaborated in chapter 1.

For sharia compliance, as the theory stands, a re-characterisation of the securitisation as a financing transaction, throws up the issues of increased periodic returns to investors as *riba*, the sale of debt (debt being non-proprietary) with possible vitiating effect, and/or vitiation of the transaction for uncertainty as a *gharar*-tainted transaction. Re-characterisation is a concern that arises from the fact that most Islamic finance transactions are governed by English common law. The case of *Orion Finance Ltd v Crown Financial Management Ltd*[11] demonstrates the effect re-characterisation can have on an otherwise structured transaction being deemed a security transaction.

In *Orion*, Vinelott J's considered whether the assignment was by way of charge. He concluded that it was in fact an outright assignment of book debts by way of charge and thus was void for lack of registration.[12]

In the Qatar Global *Sukuk* securitisation, for instance, it was difficult to reconcile the investment banks' requirement that the risk of the securitisation be linked to the Government of Qatar as clearly as possible with the requirement of the sharia that a true commercial transaction (sale) take place. Sharia compliance required that the fee simple title or discernable ownership move into the SPV. The leasehold payments then attach to it and the certificates represent an undivided beneficial right to the land for a seven-year term. Unlike notes in a conventional asset backed securitisation which are due whether or not the underlying lessee pays, the investors in the Qatar issue were theoretically at full property risk (though substantially mitigated by other features of the transaction).

Accordingly, it has been noted[13] that for any sharia securitisation *s*tructure to work, it is critical that the issuing vehicle have good title to the asset being securitised and, if the funding is to comply with the issuance the sharia StandardNo.17[14] on Investment *sukuk*, the *sukuk* holders must have effective title over the assets. It is vital, therefore, that the true sale requirement in *sukuk* structures be complied with over and beyond the mere balance sheet accounting and capital adequacy purposes, that is, it must be a true sale of economic, rather than legal, substance. As discussed in chapter 5, as long as the economic substance is equitable, the issue of *riba* should no longer arise as all such structured transactions are commercial in nature.

A likely solution to the concerns pertaining to the risk of re-characterising a sharia compliant securitisation as an interest earning loan structure is the use of the common law concept of 'trust'. A trust may be defined as an agreement under which one person transfers title to specific property to another (trustee) who agrees to hold or manage it for the benefit of a third

person (beneficiary). The beneficiary on whose behalf the trustee holds the asset/s on trust for is the beneficial owner of the asset. The relationship between the trustee and the beneficiary is evidenced by a trust deed executed (often unilaterally) by the settler or the trustee himself.[15] These characteristics of the trust instrument squarely meet the requirements of sharia.[16] The risk of re-characterisation is thus avoided altogether when a trust or trustee element is incorporated into the structure because the trustee is deemed to hold the property on trust for the beneficial owners of the assets (*sukuk* or security holders) whilst the financier, leasor or seller maintains legal title.

8.2.2 Bankruptcy remoteness

Bankruptcy remoteness, generally, is satisfied through the true sale requirement or the trust structure and requires that, so far as is legally possible, the potential for bankruptcy or other insolvency proceeding being brought against the SPV is remote. This means that the transaction is to be structured so that the SPV is unlikely to be bankrupted which normally entail restricting the SPV purpose exclusively to its role in the transaction (often through orphan vehicles) and confirming that non-petition[17] clauses and provisions for limited recourse[18] will be legally binding in the relevant jurisdiction/s. It usually also means that the transaction is structured as such that the bankruptcy of the originator does not affect the SPV which is achieved by using the trust structure as explained in 8.2.1. The principle purpose of this requirement is therefore to make the initiation of bankruptcy or insolvency proceedings unlikely in any and all relevant jurisdictions.

8.2.3 Security interest

Security interest is the right acquired by a creditor or lender, on the property held by him as security for the amount due to him, to use the right on the property to recover the amount due to him. In a securitisation, the security interests purported to be created over the collateral constitute first priority security interests perfected in accordance with the applicable law and procedures. The concept of security interest, however, is not recognised by sharia law in a manner consistent with the common law understanding as a consequence of the prohibition on the sale of debts and interest based transactions as discussed in chapters 5 and 6. Securitisations under Islamic finance are (as we have seen) ideally structured on the basis of the investors' shared ownership in the trust asset whilst conventional securitisations take the form of a loan backed by collateral (asset) the increased returns on which are deemed interest (*riba*) and thus non-amenable to Islamic finance. The

nature of the security interests, if at all created, under the *sukuk* structure therefore needs to be clarified.[19]

One way of approaching the issue of security interest in sharia securitisations is that the land parcel/s or assets sold or leased under Islamic finance are the security interests and the periodic returns are the principle plus interest. This approach attains the same ends by different means and under different labels. Alternatively, the security interest created by the SPV over the receivables, which it has purchased, could be granted in favour of a trustee who would hold it on trust for the investors (holding undivided ownership in the asset). The interposition of a security trust in this type of transaction provides a means whereby a group of assets can be retained by its current owner and yet made available as security to investors thus ensuring sharia compatibility. This is achieved by providing a proprietary link between investors and the underlying receivables through the shared/divided ownership of the trust concept (which is comparable to the *sharikat al mulk* (shared-ownership) concept in Islam). The above approach also enables the securities or *sukuk* to be rated based on the assets without taking into account the credit risk of the originator.

8.2.4 Tax

The SPV should generally be structured so as to minimise, or ideally eliminate, any liability to tax. Tax issues are particularly important in deciding where to domicile an investment vehicle whether sharia compliant or not. Tax advice is also required to understand the taxation treatment of both the establishment and operation of an investment vehicle and in order to confirm the favourable tax treatment of a particular jurisdiction to all aspects of the business and the operation of the investment vehicle.[20] In structuring a sharia-compliant dual compatible securitisation it is vital (for purposes of legal certainty) that all tax obligations are predictable and that no withholding tax or other taxes are payable by the SPV.[21] However, since the use of SPV for financing transactions is relatively new to sharia jurisdictions, tax classifications and absolute tax obligations of an SPV remain uncertain. It is therefore important that sharia jurisdictions minimise unfavourable tax treatment for foreign investors or commercial entities generally and create certainty as to the tax treatment of both the originator and SPV.

Since tax stability is required for securitisation to flourish and to attract investors confidence. It has been suggested that the issue be addressed by a tax directive from the appropriate authority, or an opinion by reputable tax consultants.[22] In Malaysia, for example, through recent tax changes such as the elimination of real property tax on certain types of lending, transactions

have removed obstacles that held back investors.[23] The Asset Securitisation Consultative Committee (ASCC),[24] in its report,[25] noted that there was no specific tax legislation that dealt with asset securitisation and thus each transaction was to be examined based on its own facts and circumstances by reference to existing tax legislation[26] and practices.[27] The report noted further that in the absence of tax incentives for the asset securitisation, the importance of tax neutrality cannot be overemphasised.[28] The report noted that where an SPV (in Malaysia) exists in the form of a limited company, its tax status remains unclear in terms of whether it should be considered an investment dealing/trading company or an investment holding company.[29] Finally, the report proposes that in order to clarify the tax treatment applicable to the SPV, the following options should be considered:

- exempt the SPV from corporate income tax;
- accord the SPV a trading status to treat it as a company involved in the purchase of discounted securities; and
- tax the SPV on a cash basis.

The absence of specific tax legislation, tax impediments can erode the economic advantages of securitisation transactions. For instance, in a two tier structure where the 'owner SPV' has to route funds to an offshore 'issuer SPV', such funds may be subject to withholding tax. Such a charge may be avoided by entering into tax treaties or establishing SPV in tax friendly countries.[30] Where tax legislation does exist, complications may, nonetheless, arise when such legislation is amended by the government[31] or is subject to other legislative/tax requirements in a way that negates the benefits of the tax legislations.[32] Such alteration may further render payment to investors unworkable leading to a default in the structure and the undesirable consequences that follow a default.

8.2.5 Uncertainty regarding choice of law and enforcements of judgements

The form of uncertainty referred to here is distinct from that of *gharar* in chapter 5 and pertains to the law governing a dispute that arises and the enforcement of judgement. The issue is pressing for the very fact that most Islamic finance jurisdictions are relatively young in their laws, or at least some aspects of their laws, which have been imported and adapted to meet local requirements whilst ensuring they do not contravene the principles of the sharia. The issue also includes the subjective nature of the courts and/or other adjudicative authorities.[33]

Therefore, whilst the sharia explicitly recognises the concept of a contract, in the event of a dispute the sharia courts are more likely to place emphasis on the actual performance of the parties under the contract and the fulfilment of the contractual obligations as opposed to the underlying intentions of a contracting party.

Sharia courts are also unlikely to consider previously decided cases as precedent applicable in the case before them. They would turn to the sources of the sharia (primary, then secondary) so as to arrive at a decision. The judges would consider national laws but their overriding mandate remains to adjudicate the dispute according to the sharia. Remedies for breach of contract are also at the discretion of the sharia court and compensation will normally be limited to the amount of any direct loss, with little or no allowance made for punitive or expectation loss.

There are at least four schools of Islamic jurisprudence each of which may interpret the precepts of the sharia differently, yet equally, in value. Hence, though a jurisdiction would normally adhere to one school of jurisprudence, it is possible for the courts to apply the precepts of another school if deemed appropriate. Malaysia, for instance, adheres to the Shafi'i school yet permits the sale of debt (permitted by the Hanafi school and prohibited by the Shafi'i school). It is also possible for different views to exist on particular issues within the same school.[34]

More importantly, Islamic finance transactions, whether structured as securitisations or otherwise, are increasingly drawn up as agreements governed by, and to be construed in accordance with English law. In certain instances, the agreement also provides that the courts of England shall have exclusive jurisdiction to hear and determine any suit, action, or proceeding, and for such purposes, the parties irrevocably submit to the jurisdiction of such courts.[35] The legal uncertainty caused by the above factors creates unease among foreign investors and renders sharia investment structures comparatively less attractive than their common law counterparts.[36]

In the case of *Shamil Bank of Bahrain v Beximco Pharmaceuticals Ltd*, [37] for instance, the English High Court held that English law would take precedence notwithstanding a choice of law provision in the contract that, 'subject to the principles of the glorious sharia, this agreement shall be governed by and construed in accordance with English law'.[38] The Court of Appeal thus affirmed the decision of Morison J and held that the judge had been correct in holding that English law was the governing law of the contracts.[39] Morison J concluded that, on the proper construction of the applicable law clause, he was not at all concerned with the principles of sharia law; the agreements were enforceable in accordance with English law

despite the fact that they amounted to agreements interest and would thus be unlawful in sharia law.

If a securitisation deal is to be rated by a rating agency, for example, Fitch Ratings, it is expected that if the parties choose the laws of a given jurisdiction to govern aspects of the transaction, its choice would be recognised and upheld by: (i) the courts or adjudicative authorities of the chosen jurisdiction; (ii) the jurisdiction of the incorporation of the parties; (iii) the jurisdiction in which the assets are located.[40]

Choice of law concerns and the consequent uncertainty is not limited to sharia jurisdictions and may arise under the common law as demonstrated by the abovementioned case of *Shamil Bank* where the English courts were invited to decide whether 'sharia' as a body of jurisprudence could be incorporated into and govern agreements made under English law through the operation of a choice of law clause. The court held that provisions of the sharia were too indeterminate to be validly incorporated into a contract as the governing law. The Court of Appeal affirmed Morison J's decision[41] that:

> The doctrine of incorporation could only sensibly operate where the parties had by the terms of their contract sufficiently identified specific 'black letter' provisions of a foreign law or an international code or set of rules apt to be incorporated as terms of the relevant contract, such as a particular article or articles of the French Civil Code or the Hague Rules. By that method, English law was applied as the governing law to a contract into which the foreign rules had been incorporated. The general reference to sharia in the instant case afforded no reference to, or identification of, those aspects of sharia law which were intended to be incorporated into the contract, let alone the terms in which they were framed. The words were intended simply to reflect the Islamic principles according to which the bank held itself out as doing business, rather than a system of law intended to 'trump' the application of English law as the law to be applied in ascertaining the liability of the parties under the terms of the agreement.

Similarly, in the case of *Symphony Gems*,[42] despite the court hearing evidence from two expert witnesses on the nature of a *Murabaha* agreement, the applicable principles of Islamic law, and accepting the conclusion of one of the expert witnesses, Dr. Samaan, that the agreement did not have the essential characteristics of a *Murabaha* contract, Tomlinson J stressed that it was critical to note that the contract with which he was concerned (in the

case) was governed by English law, not sharia law. He went on to decide the case according to English law. This leads to the conclusion, that even if the Tomlinson J had found that the contract was in accordance with the characteristics of a *Murabaha* agreement, English law was still the governing law and the fact that the contract charged interest would not have invalidated the financing agreement between the parties. To understand Tomlinson J's reasoning and conclusion it is helpful to set out relevant extracts of his opinion:

> It will be noted that cl 25, which I have just set out, provides that the agreement and each purchase agreement made pursuant thereto shall be governed by and shall be construed in accordance with English law, and cl 26.1 contains an irrevocable submission to the jurisdiction of this court by the purchaser, who is of course the first Defendant.
>
> There has been placed before the court some evidence concerning the nature of a Murabaha agreement. Thus I have the benefit of an expert report from Dr Yahya Al-Samaan … and I also have an expert opinion of a Dr Martin Lau … I do not need to go into the minutiae of the matters with which they deal. However, it is interesting to note that Dr Samaan describes the legal nature of a Murabaha contract and the prerequisite conditions for such a contract.
>
> For a contract of Murabaha to be valid, two separate procedural requirements have to be satisfied by the prospective Purchaser (the client) and the Seller (the bank). The first requirement involves mutual promises by the two parties, namely a promise by the bank to acquire and sell goods to its client, and a corresponding promise by the bank's client to purchase the goods.
>
> Dr Lau points out that two principles central to Islamic law, namely the prohibition on interest and the prohibition on uncertainty in the object of a contract, limit the scope of commercial activity in Islamic law. The Murabaha contract is intended in Islamic law to be a contract which complies strictly with the requirements of the sharia.
>
> However, it is important to note – indeed, in my judgement, it is absolutely critical to note – that the contract with which I am concerned is governed not by sharia law but by English law. Indeed, it is equally critical to note that Dr Samaan, after examining the nature and terms of the contract with which I am concerned, comes to this conclusion:
>
> 'I have therefore come to the conclusion that the Agreement in issue does not have the essential characteristics of a Murabaha contract'.

In the later case of *Shamil Bank v Beximco Pharmaceuticals*[43], the defendants on appeal, readily conceded that there could not be two governing laws in respect of the financing (*Murabaha*) agreements, and the governing law was English law, not sharia law. Charging interest is an acceptable part of financing arrangements under English law and the court, having accepted the evidence of the Bank's expert witness of Dr Martin Lau, former director of the Centre of Islamic and Middle Eastern Law at the School of Oriental and African Studies at the University of London,[44] that the concern whether the agreements were in compliance with the Murabaha agreements was of no relevance to whether the Murabaha agreements complied with Islamic law.

Further, the Court of Appeal held, having considered the case of *Symphony Gems*, observed that as far as the principles of the sharia are concerned, these were not settled principles but rather an area of considerable controversy and difficulty arising from their ancient moral and religious nature and the need to pay heed to the opinions of the various schools of jurisprudence. On this basis, the principles of the sharia would only have been successfully incorporated into the agreement so as to vitiate the contract on its interest paying character if the parties had sufficiently set out the specific principles applicable. In this case, therefore, mere reference to the principles of the sharia was insufficient, and the validity of the contract and the defendant's obligation thus fell to be decided according to English law.[45] Paragraphs 52 and 55 of the judgement are useful to set out:

> 52. The general reference to principles of sharia in this case affords no reference to, or identification of, those aspects of sharia law which are intended to be incorporated into the contract, let alone the terms in which they are framed. It is plainly insufficient for the defendants to contend that the basic rules of the sharia applicable in this case are not controversial. Such 'basic rules' are neither referred to nor identified. Thus the reference to the 'principles of … sharia' stands unqualified as a reference to the body of sharia law generally. As such, they are inevitably repugnant to the choice of English law as the law of the contract and render the clause self-contradictory and therefore meaningless.
>
> 55. Finally, so far as the 'principles of … sharia' are concerned, it was the evidence of both experts that there are indeed areas of considerable controversy and difficulty arising not only from the need to translate into propositions of modern law texts which centuries ago were set out as religious and moral codes, but because of the existence of a variety of schools of thought with which the court may have to concern itself

> in any given case before reaching a conclusion upon the principle or rule in dispute. The fact that there may be general consensus upon the proscription of *riba* and the essentials of a valid Murabaha agreement does no more than indicate that, if the sharia law proviso were sufficient to incorporate the principles of sharia law into the parties' agreements, the defendants would have been likely to succeed. However, since I would hold that the proviso is plainly inadequate for that purpose, the validity of the contract and the defendants' obligations thereunder fall to be decided according to English law. It is conceded in this appeal that, if that is so, the first and second defendants are liable to the Bank.

Shamil Bank thus demonstrates that the proscription against *riba* and the essential characteristics of a Murabaha agreement did nothing more than to indicate that had the proviso incorporating the principles of the sharia been sufficient, the defendants would have been successful. In this case it was not and, as the defendants conceded, the first and second defendants were liable to the bank under the Murabaha financing agreements despite its interest paying character.

Prior to the decisions in *Shamil* and *Symphony Gems*, parties to an agreement were able to incorporate specific sharia rules into agreements they made. In the case of *Glencore International AG v Metro Trading Inc*[46] Moore-Bick J's judgement establishes that the principle of '*ghasb*' (misappropriation or usurpation) was validly incorporated into the contract and it was therefore necessary for the court, having heard expert evidence on the relevant jurisprudence, to determine how the principle should be interpreted. Therefore, whilst it appears that the governing position on choice of governing law in securitisation transactions is that expressed in *Shamil*, the issue remains uncertain and in need of clarity.

8.2.6 Asset selection

The underlying asset/s of a securitisation has to be *halal* (lawful) both in and of itself as well as pertaining to its purpose.[47] For instance, enterprises involved in alcohol or gambling, or the use of interest are therefore not deemed sharia compatible. The assets in securitised pools are invariably interest-bearing debt instruments, such as credit card receivables, mortgages, etc. and, as the theory stands, the payment or receipt of interest is prohibited as is the sale or purchase of debt obligations unless they are asset backed, interest-free and sold at par-value. A sharia compliant securitisation will thus require the underlying assets to be securitised based on lease financing, sale

or shared ownership, all of which are conventionally established. However, given the conclusions reached in the chapters on *gharar*, *riba* and the sale of debt obligations, the above concerns with Islamic securitisations and the apparent distinctions between them and those under conventional finance are likely to fade. We discussed and concluded that interest is not the subject of the *riba* prohibition in commercial transactions except where the effect of such transaction is inequity, and that the sale of debt obligations at a discount was envisaged and practiced at the time of the Prophet implying its proprietary nature. Further any uncertainty (*gharar*) arising in the structure pertaining to assets would not vitiate the contract unless it was excessive or a major component of the contract and, based on *gharar*'s evidential nature, would be remediable.

8.2.7 The use of the London inter-bank offered rate (Libor)

A securitisation structure, whether intended for international investors or not, tends to have its rent rates pegged to LIBOR for marketability purposes. These rent returns to *sukuk* (certificate) holders are variable and may be deemed to be interest (*riba*) based. As discussed in earlier chapters this need will no longer be an issue of concern given the transaction is commercial in nature and the rates of return are equitable or market based.

The concern only persists if the current theory and position towards interest is kept. Yet, even then, it need not be cause for concern as the payments are made for the use of the asset parcel (i.e. rent) and not the money. Pricing the rent off the international exchange makes the certificate competitive with and similar to conventional floating-rate notes. This basis has not been explicitly accepted by most sharia scholars, but neither has it been rejected nor has an alternative benchmark been proposed. What has been suggested is that the sooner an alternative benchmark is developed the better it will be for the development of *sukuk* structures. Further, that returns alternatively be calculated in relation to the profitability of the projects being financed by the *sukuk* as opposed to being priced off the international exchange rates.[48]

8.2.8 Late payment and penalty charges

Under the Master agreement of the Qatar global *sukuk* issue, the consequence for late payments of rentals was the government's irrevocable undertaking to donate a late payment amount to be paid directly to a charity of the issuer's choice in respect of the period from and including the due date for payment to the date payment was made but excluding the date of full payment. It is possible for such payments to be considered interest payments parallel to

riba. The arrangement has, however, been acquiesced to by a large number of sharia scholars since the beneficiary of such penalty is not the party to whom the rentals is owed and incentivises the borrower (through added transaction costs) to make timely payments. In this regard, attention must be drawn to the emphasis Islamic law places on timely payment of contractual obligations. A saying of the prophet Muhammad encourages one to pay workers their wages before their 'sweat dries'. By analogy, this translates to the emphasis to make timely payments for any other commercial obligation owed. Similarly, such payments could not be classified as *riba*, as per our earlier analysis, as banking and finance are commercial activities on which increased returns may be made as long as the effect of the payment is equitable. Alternatively, the *riba* characterisation of the late payment charge fails because the rationale behind the prohibition of *riba* as explained earlier is to avoid inequity, for instance, the exploitation of others' need of cash/finance. To impose a penalty for late payment as an inducement for timely payments is clearly not an exploitative measure.

8.2.9 The creation of a trust within a civil law framework

In chapter 1 we noted the similarities between the common law and Islamic law – the availability and use of the concept of 'trusts' being one such similarity. Recent historical studies have traced the roots of the common law system of trusts to the Islamic concept of *waqf*.[49] This similarity of legal reasoning and concepts has been taken as explanation of the relative success of Islamic finance in countries with a common law heritage for instance those within the Gulf Co-operation Council and Malaysia.[50] It is thus an issue of major concern pertaining to the structuring of a sharia compatible securitisation that many sharia jurisdictions do not recognise the trust (because they are civil law jurisdictions) yet the trust as noted above resolves several difficulties that arise with regards to the true sale or re-characterisation issues.[51] In the Islamic securitisation structure illustrated at the beginning of this chapter for instance, the fact that Qatar has no trust law and posed severe restrictions on foreign ownership of real property, meant that structuring the Qatar Global *sukuk ijara* transaction required creativity. The apparent difficulty was, therefore, resolved through the issuer being incorporated as an SPV under Art 68 of Qatar's Commercial Company Law which created an exemption from the general application of Qatar's company law in respect of companies whose shares are owned by the government. This exemption was helpful in the creation of a 'golden share' transaction whereby the issuer's ordinary shares were owned by the government, while the bank held the golden shares as agent for the *sukuk* holders pursuant to a share

agency declaration. Accordingly, notwithstanding Qatar's majority ownership of the issuer,[52] the share agency declaration (using the trust concept) and the golden share regime, served to protect the interest of the *sukuk* holders.[53] The added benefit of the structure lay also in that foreign investors were able to participate in the *sukuk* structure despite the foreign ownership restrictions due to the fact that the golden shares were held by the bank (on the investors' behalf).

The issuer, in the Qatar structure, thus acted in a trustee capacity for and on behalf of the *sukuk* holders. Since Qatari law does not recognise trusts, the trust relationship between the *sukuk* holders and the issuer was created under an English law trust instrument. Any choice of law and enforcement difficulties arising therefrom was overcome principally by the abovementioned Qatari law creating: (i) an agency relationship between the issuer and *sukuk* holders that gave the issuer a recognised Qatari legal relationship to *sukuk* holders in any local enforcement proceedings against the Government therefore ensuring that the interest of the *sukuk* holders in any such proceedings would be recognised by the Qatari courts;[54] and (ii) an exemption from the application of Qatari law with regards to the *sukuk* structure.

An issue that arises from the above transaction is whether an exemption from the application of a jurisdiction's law, as was in the case of Qatar, is necessary in order for the trust to be applicable. The laws of any Muslim nation – whether civil, common or other law – remain subject to the sharia as a body of law. The concept of trust (*amanah*) and agency (*wakalah*) has always existed and applied in contractual and financial transactions throughout the history of Islam. The concept of trust, in fact, finds application in Islam in different forms, that is, *waqf* (charitable trusts), *amanah* (trusteeship) and *sharikat al mulk* (shared ownership/partnership). The main reason why the use of trust structures remains a problem within Middle Eastern countries is because many of them belong to the civil law legal family that does not recognise the trust. This 'disconnection' between the legal system and compliance with the sharia is thus proving unnecessarily detrimental and serves only to complicate matters. This book proposes that the trust concept be freely applicable as a sharia concept as opposed to a borrowed concept from common law. The contract of *mudharaba* (trust financing) clearly demonstrates the compatibility and application of the trust in Islamic finance. Under a *mudharaba*, the financier entrusts his assets or funds to an asset or fund manager in an agreed profit sharing arrangement. Further, Malaysia's application of the trust concept in *sukuk* structures, albeit through the common law, demonstrates in reality the compatibility of the trust with the sharia.

8.2.10 Interpretation of commercial laws and contracts in sharia jurisdictions

The uncertainty over the interpretation of the commercial laws and contracts drafted and signed under those commercial laws in sharia jurisdictions is another concern pertaining to dual compatibility of sharia compliant securitisations. The nascent sharia compliant securitisation market is especially hampered by the fact that not only do judicial decisions often differ from scholars' decisions but also by the fact that each jurisdiction seems to sport its own scholarly decisions on any given issue pertaining to Islamic finance transactions and structures.

The importance of addressing this issue cannot be stressed enough due to the fundamental impact it has on securitisations. To mention but a few, on the part of investors, the prevalent disagreement and disparity in opinions and judicial decisions undermines investor confidence because it negates certainty of outcome in the event of default and could possibly jeopardise investors' rights. On the part of the capital market and Islamic finance economies, it shakes the foundation of structuring a securitisation because it could possibly deny the securitisation being rated by the rating agencies. Major rating agencies, such as Fitch Ratings or Moody's, are only concerned with the credit aspects of the financial structure. They will not rate such structures merely based on their sharia compliance or otherwise.

In summary, among the main reasons why such uncertainty over interpretation and effect of contractual and commercial laws arises is that:

- Various aspects of the national legislation have been imported and adapted to meet local requirements with particular care that these laws do not contravene the principles of the sharia.
- The sharia judges presiding over a dispute consider national laws but are more concerned about ensuring that a dispute is resolved by reference to sharia law; the Courts of England are likely to ignore sharia concepts and rules where the parties have agreed to be governed by the laws of England and Wales, as discussed in section 8.2.5.
- Sharia courts are unlikely to consider previous judgements (precedents) and remedies to breaches of contract are at the discretion of the court.

It is thus important both for rating purposes and for investor confidence, which will in turn lead to growth in demand for Islamic investments, that transactional and legal certainty be enhanced.

8.2.11 The role of the sharia committee

The sharia committee occupies a very important position in Islamic financial institutions and in Islamic finance generally. An Islamic bank will not participate in a transaction unless the sharia committee approves the transaction as being sharia compliant and the transaction offering documentation includes a copy of their fatwa.

The actual role of a sharia committee varies from transaction to transaction and in addition to their transaction approval role, other roles include:[55]

- studying the offering memorandum, constitutional documents and major agreements controlling the relationship between the functionaries of the structure;
- giving general advice to the manager or advisor with regards to compliance with the sharia principles;
- advising on the use of instruments and techniques for efficient cash management and their compliance with the principles of the sharia;
- advising on the separation of non-sharia compliant profit of the transaction and suggesting the charitable activities to which they may be directed;
- preparing annual sharia audit and reviews concerning the securitisation activities and the issue of a report to the investors.

Sharia committees thus have the important role of not only determining what is acceptable and what is not, but also to seek to: reconcile, as far as possible, Islamic finance with conventional finance; harmonise the practice of Islamic finance as practiced in different jurisdictions: and, generally, guide the market as it progresses and develops. The scholars, who are experts in the sharia law as it relates to financial products, have admittedly adapted to a market place that has grown in sophistication and complexity. With the emphasis on adapting conventional financial structures to meet the requirements of the sharia, there has been pressure on the sharia scholars expert in the field to build a similar level of proficiency in understanding today's complex conventional structures so that they can assist in developing similarly efficient sharia-compliant alternatives. They have risen to the challenge and though there still does not exist a codification of previous opinions into one formalised set of guidelines adopted as standard practice, there is a considerable body of expertise available for consultation.

A sharia committee can, however, play an even larger role by adopting a more open and progressive attitude towards Islamic finance and commercial transactions within today's global financial markets and the need for

Muslims to develop financial products that are both sharia compliant and competitive at the global market level.[56] Sharia committees have the ability to foster greater legal certainty in the industry (with regards to compatibility and enforcement of judgements in sharia jurisdictions) through their availability for consultation on the different aspects of a deal. The scholars on the committee, being well versed with the sharia rules and jurisprudential opinions, are well placed to give general and authoritative opinions (and even advise the rating agencies), for example, on the acceptability of an outcome or ruling in that jurisdiction should a dispute arise and, hence, whether the judgement would be enforced locally. Consideration should also be given to the formation of a single sharia committee in any given Islamic finance jurisdiction (preferably established and run independent of the government) and through it, a single coherent body of rules, laws and principles applicable not only to securitisations but the industry as a whole can begin to take shape.[57]

The effect of the above would no doubt create greater certainty and clarity in the application and effect of the sharia rules in at least three ways:

- with supervision from and consultation with the sharia committee , legal judgements are less likely to be unpredictable;
- there is less likely to be more than one prevalent view or two or more conflicting views on the acceptable rules and practices in the industry; and
- through the opinions and fatwas of the sharia council, greater clarity among the sharia judges as to the effect of contractual clauses and obligations within the overall sharia framework will be fostered for the benefit of the industry, regulatory bodies and rating agencies.

The resulting certainty and cohesion will mark an important step in the development and eventual harmonisation of practices and rules for Islamic finance both at the industry level and collectively, at the global level.

Conclusion

In closing, this chapter has examined the difficulties faced in structuring a securitisation structure compatible with both the sharia and common law. Wherever possible, suggestions have been made as to how these (potential or actual) difficulties may be avoided or overcome. It is significant to note that this chapter examines the theory and practice as it now stands and, thus, may be at variance with the conclusions drawn in chapters 4, 5 and 6 that would render the distinction between 'Islamic finance' and conventional finance a non-issue except as far as the objective of the finance is concerned.

9

ISLAMIC FINANCE IN MALAYSIA

A MODEL TO EMULATE

9.1 Genesis and growth of Islamic finance in Malaysia

Malaysia embarked on a pioneering effort to develop a comprehensive Islamic Finance (IF) system more than 30 years ago and was among the earliest to recognise the potential to create a financial system compatible with Islamic principles that provides an alternative to the conventional system. The process began with the first Islamic financial institution, Lembaga Tabung Haji[1] (the Pilgrim Fund Board aka Tabung Haji), established in 1969. Tabung Haji's objective was (and remains) to mobilise savings of Muslims intending to perform the hajj (pilgrimage) with the pool of savings being invested in sharia-permissible instruments. Malaysia was not alone in her experiments with Islamic finance at the time; Egypt had their own pilot scheme that was called Mit Ghamr by its founder. However, unlike the Mit Ghamr[2] scheme that was created and sustained by an individual without political affiliations (and subsequently extinguished at the behest of the political fabric in Egypt), Tabung Haji was inspired and supported by the leadership in Malaysia for the benefit of the populace. The tangibility of its benefit to society ensured fervent support for and popularity of Islamic banking. It is thus no surprise that the Tabung Haji model has been hailed as exemplary by Muslim majority nations. More importantly, the institutionalisation of Tabung Haji as a sharia-compliant organisation paved the way for the development of a better-structured institutional framework of Islamic banking and finance in Malaysia. The Islamic Banking Act 1983 was introduced and Malaysia's first full-fledged Islamic bank was established

followed by the enactment of the Takaful Act 1984 for purposes of Islamic Insurance. The system was further complemented with the inception of the Islamic inter-bank money market in 1994 followed by the availability of short- and long-term financial instruments.[3] These sharia-compliant investments and instruments have been providing Islamic banking institutions with funding and liquidity requirements, fully supported by the state-of-the-art technology and services including settlement and custodian systems, funds transfer and scripless Islamic securities and commercial papers.[4]

In the area of regulatory development, the Islamic Financial Services Board (IFSB) was established in Kuala Lumpur in the year 2002 to develop international prudential regulatory standards globally to enhance soundness and stability of Islamic financial system. Bank Negara Malaysia, Malaysia's national bank, is a founding member of IFSB together with 15 other full members that comprises central banks, monetary and supervisory authorities. Thus far, two standards have been issued: Standards for Capital Adequacy and Guiding Principles for Risk Management for Islamic financial institutions. Bank Negara Malaysia has implemented these IFSB standards for adoption by Malaysian Islamic banking institutions since 2007[5]. The regulatory development effort was further strengthened through the establishment of the International Islamic Financial Market (IIFM) in 2005. The IIFM provides the market mechanism to facilitate capital mobilisation, stimulate the creation and trading of Islamic financial instruments, enhance investment opportunities and facilitate efficient liquidity management by Islamic financial institutions. Similarly, for the orderly development of an Islamic Capital Market (ICM), the Securities Commission has initiated various measures over the past decade. Consequently, Malaysia's ICM has witnessed a proliferation of products and services ranging from equities, unit trust funds, structured products, derivatives, index, fund management and stock broking services. At present, there are 89 Islamic unit trusts, about 85 per cent of the listed stocks are sharia-compliant and 46 per cent of the corporate bond market comprises Islamic bonds. It is, thus, fair to say that Malaysia has the most comprehensive Islamic capital market in the world. Further, Malaysia possesses social, political and economic stability in a mostly democratic setting. Malaysia's stable and consistent monetary and fiscal policies coupled by the requisite experience (evinced by the country's handling of the Asian crisis in 1998) do much to promote the country's status as a leader of Islamic finance. Political and economic stability enables the government to promote the orderly development of the market especially in preparing domestic players for the challenges posed by a more liberalised market. However, beyond mere stability, it is Malaysia's willingness to

embrace innovation and develop alongside conventional banking practices that has and will continue to serve the country in future developments. Malaysia's key asset, both as an Islamic finance jurisdiction and as a global leader, is the grassroots support that the country's Islamic banking enjoys due to the tangible benefits with which Islamic banking and finance continue to provide the Malaysian population.

The Malaysian Government plays an effective ongoing role as a catalyst for the development of Islamic finance. It recognises that though the role of the public sector is to provide an environment conducive to the flourishing of the private sector, it is generally the private sector that carries the baton into further development. It therefore provided a foundational structure for Islamic finance, which is now open for the private sector to capitalise and continue to build upon it so that a free market evolves from it. It is also encouraging that while the Malaysian Islamic financial market offers a comprehensive range of product and services in banking, insurance, and investments, its institutions are themselves turning into originators of a wide range of Islamic products and services. This is a marked development from when the financial institutions took on the business model of adapting conventional structures as templates for 'off-the-shelf' Islamic products largely for the retail market. It is, however, not certain whether this development also means a shift from 'form-based' Islamic finance to a more substance-based approach. Nonetheless, having built up their knowledge of the underpinning sharia principles and in line with the growth of demand in Islamic banking products, private institutions now realise the potential of sharia-compliant products as a viable driver of profitability, market differentiation and enhancer of shareholder value. The industry simply needs to continue moving up the value chain, injecting effort into the development of increasingly sophisticated structured products applicable to the needs of increasingly demanding domestic and international markets. From being a policy driven initiative, Islamic finance in Malaysia is slowly developing into a market-driven one. It is, thus, encouraging that the Malaysian government recently acknowledged that the fast-growing Islamic financial sector needs strong regulation to ensure it never faces the damage caused by the financial crisis. Malaysia's prime minister, Najib Razak, is reported to have said that it was 'imperative for the industry to draw upon the lessons learnt to ensure that we avoid any such financial instability in the future'. Malaysia's government is also reported to oversee one of the world's largest and most comprehensive Islamic financial sectors as this chapter details.[6]

An area of initiative that could be undertaken by Malaysia towards the development of Islamic finance globally is the treatment of income derived

from various Islamic finance jurisdictions. Currently, individual countries rely on local conventional-based tax legislation to govern the treatment of income from Islamic finance activities. In most cases, such legislation is inadequate to deal with the intricacies of Islamic financing. This results in the possibility of Islamic finance profits being taxed differently depending on the individual country's tax legislation and how these profits are categorised. The inadequacy of local tax legislation in most countries, in dealing with such issues, causes tax-cost inefficiencies for Islamic investors. Similarly, the resulting uncertainties and inconsistencies represent a significant obstacle to the cross border movement of Islamic capital. However, this inadequacy also presents an opportunity for innovation. Labuan Offshore Financial Service Authority (LOFSA) can take the lead on studying the development of an Islamic Model Tax Convention (IMTC), similar to the Double Taxation Agreement (DTA) of the Organisation for Economic Co-operation and Development (OECD). The objective of an IMTC would be to provide a framework of clear and transparent rules for the uniform taxation of such income in the signatory countries. The framework will facilitate the flow of Islamic funds across international borders, making it possible for market players to package and price Islamic products with greater liquidity and certainty. LOFSA's experience gained from the many years of networking abroad and with its working knowledge in regards to the issues of international taxation will place it in good stead to undertake this study and more importantly, it will pave way for further development of Islamic finance through enhancing product efficacy alongside cost efficiency.

It is Malaysia's declared mission to develop a vibrant, innovative and competitive international Islamic financial services industry that is supported by high calibre human capital, world-class infrastructure and best international standards and practices. So far, Malaysia has proved its commitment to extend all that is necessary to ensure that this is accomplished. Whether the country remains so, and more importantly, whether it attains this goal is largely dependent on whether Malaysia continues to focus on the efficiency and equitable nature of the Islamic finance industry it develops at home – it is these two factors that will grant Malaysia industry leadership and continued global presence.

9.2 Malaysia's distinct structural and institutional advantages over other Islamic finance participants

In discussing the four outlined components of Malaysia's structural and institutional framework it is intended that the appraisal will serve as an example from which other Islamic finance jurisdictions, including the UK,

may draw from for their better performance in the Islamic Capital Market (ICM). These are:

- a common law jurisdiction;
- a dual banking system;
- a multifaceted approach to Islamic banking; and
- the Labuan International Offshore Financial Centre (IOFC).

9.2.1 A common law jurisdiction

International trade and finance, because of its global nature, is necessarily affected by many factors that may give rise to uncertainty as to the application of contractual terms under which certain trade and financing arrangements are made. These factors range from political to environmental and global economic stability to specific laws governing the agreement. As a common law jurisdiction, therefore, Malaysia enjoys the advantage of a mature legal system that is well equipped to deal with lacunae in the law or legal structure in an established manner and provides the requisite level of certainty for purposes of equity. Therefore, whilst other Islamic finance jurisdictions have patched together bits and pieces of various legal systems according to what the political fabric preferred and/or was most aligned with their concept of Islam, Malaysia simply embraced the common law framework, replacing only those aspects of the common law that are explicitly provided for or prohibited by the primary texts of Islam. This augurs very well with the contractual and commercial principle of Islam that permits anything unless explicitly prohibited by the primary sources. Among the pertinent benefits of inheriting the common law system is, thus, the mechanism it provides for filling any lacunae in the law, that is, through precedent, judicial law making, rules of equity, customs and trade practices in addition to legislating new laws. Common law jurisdictions can also rely on, as persuasive authority, decisions of other common law jurisdictions in determining how to address a novel or unforeseen outcome or situation. Though these mechanisms find direct parallel with concepts under Islamic law – i.e. *ijtihad* (independent legal reasoning), *qiyas* (drawing analogy from past cases), *maslaha* (equity) and *urf* (customs and practices) – the distinct advantage Malaysia's common law system possesses over other Islamic finance jurisdictions is the certainty and reassurance it provides foreign investors and regulators (through the application of common law concepts and principles) whilst retaining an Islamic law framework that facilitates Islamic banking. Two clear examples of how certainty is fostered through the common law in Malaysia are: (i)

the concept of binding precedent that allows Malaysia to build up a repository of judicial guidance on Islamic finance issues, and (ii) the possession of a judicial system and arbitration framework that recognises and enforces foreign judgements. Both these factors are either missing or patchy in Middle Eastern countries due to, firstly, the codified civil law system that is not underpinned by the principle of judicial precedent and, secondly, due to the fact that sharia courts in the Middle East are unlikely to enforce any foreign judgement without enquiring into the merits of the case (which it may then agree or disagree with). Therefore, although Islamic law provides a mechanism to address any lacunae in the law, the conservatism with which the law is applied, the heightened unpredictability of decisions as a consequence of individual judge's religious views or jurisdictional preferences (as is illustrated by the disparity between the fatwas issued), an absence of the concept of binding judicial precedent and the alien nature of the Islamic legal system to foreigners, have all served to spread a veneer of uncertainty in its financial products. For these reasons other Islamic finance jurisdictions tend to limit the application of Islamic law only to the certification of 'sharia compliant' – which generally means no predetermined rate of interest payable on loans, an acceptable level of risk, and assets that are *halal* (lawful) in Islam. Beyond such certification, foreign laws (mainly the common law) are adopted to structure 'global Islamic deals' so as to provide the requisite level of certainty that make the investments attractive to foreign investors. Alternatively, as witnessed in the Qatar global securitisation in 2004, the 'sharia compliant' structures may be altogether exempted from the application of local laws through royal decree/s so as to provide the requisite legal and regulatory certainty.

Another advantage of Malaysia's common law system is its principles and law of equity. Among equity's greatest inventions is the concept of *trust*. Before creation of the trust, the settlor had both legal and equitable title. After invention of the trust, legal title was vested in the trustee (or trustees), and equitable title in the beneficiary (or beneficiaries). A trust, therefore, inevitably involves the separation of legal and equitable title. The significance and importance of the law of trust to sharia compliant securitisations is that it allows for the replication of conventional financial structures in Islamic finance and facilitates the passing of beneficial title in the securitised assets or receivables of the underlying assets to the note holders whilst legal title is retained by the SPV.[7] Using the trust structure further ensures that greater credibility attaches to the sharia compliance certification since the implausible disguise of a financial transaction behind a sale à la *Exfinco*[8] becomes unnecessary. Malaysia has thus enjoyed the advantage of the ability

to attain the requisite form for purposes of sharia compliance by transferring the assets in a securitisation to a trustee SPV as opposed to non-common law jurisdictions[9] that must contend themselves with 'selling' the assets to the SPV so as to attain remoteness of risk in the structures. Ironically, property laws in most Middle Eastern Islamic finance jurisdictions restrict or prohibit the foreign ownership of property which either negates the viability of the 'sale' structure or otherwise reinforces the effect of the sale as merely a matter of formality. The use of trust structures would thus simplify and facilitate securitisation deals in other Islamic finance jurisdictions both practically and for purposes of sharia compliance. And, while it is the principle of equity that balances the scales of risk and profit, the trust structure allows for flexibility and innovation in creating new financial structures to serve both individual and societal needs. In this regard, it may also be noted that, though Malaysia inherited the concept of trust as a common law concept, the trust is an established concept in Islamic law (*amanah*) that is implemented in the social sphere through *waqf* (charitable trusts) that allows for the divisibility of property that may be held under different ownership and by different legal persons.

9.2.2 Dual banking system

Unlike any other Islamic finance jurisdictions, Malaysia has seamlessly integrated its Islamic banking system within its pre-existing conventional banking fabric without denigration of or separation from the latter. The dual banking system is thus complementary and supplementary in nature rather than exclusionary. Islamic banks and financial institutions draw upon the expertise and technical acumen of conventional banks in setting up parallel services and products. The main difference between conventional and Islamic banking products being qualitative, with a greater emphasis on fairness and socio-economics in Islam, by ensuring the majority of the population has access to the direct benefits of their products. It is thus hardly surprising that Malaysia is a leader in the Islamic finance jurisdiction.

The fact that Malaysia chose to develop Islamic finance in tandem with the already existing conventional banking structure, as opposed to determinately wanting to differentiate one from the other, has enabled the country to draw from the conventional banking experience and framework. Islamic banking's only potential distinction from conventional banking, as has been discussed throughout this book, is nothing more than attainment of the dual objectives of equitable outcomes and efficiency of structure. Therefore, it is not *what* transaction but rather *how* the transaction is executed that legitimately distinguishes sharia compliant transactions from other transactions.

It follows that if conventional finance structures and transactions are equitable and efficient, they too qualify as 'sharia-compliant'.

9.2.3 Multifaceted approach to Islamic banking

Section 9.1 outlines Malaysia's Islamic banking industry from inception as a local selfhelp pilgrimage fund to what it has become today by detailing the institutions' services Malaysia has in place so as to put the country on the global scene of Islamic finance. The result is a comprehensive Islamic banking sector. Malaysia has an effective regulatory body in the Malaysian Securities Commission which, in overseeing the regulatory compliance of the Islamic Capital Market (ICM), supports and compliments the regulatory role of Malaysia's central bank. Bank Islam, founded in 1983 as the first Malaysian financial institution to operate on sharia-compliant principles, continues to develop innovative banking products to benefit the population. The bank's vision of being 'the global leader in Islamic banking' has caused the formation of both local and international partnerships, for instance, its partnership with the Tabung Haji scheme to continue financing prospective pilgrims for the hajj on the one hand and the Dubai Investment Group's acquisition of a 40 per cent stake in Bank Islam late in 2006 for approximately US$240 million, on the other. These strategic alliances do not stop with Islamic banks but extend to conventional banks which operate Islamic finance windows and from which Bank Islam draws valuable experience. Malaysia also possesses a thriving home-grown *takaful* (Islamic insurance) sector to provide insurance for her Islamic finance structures. Further, as section 9.2.4 will detail, the Labuan offshore centre provides an attractive alternative to the worlds existing tax-free havens that attract foreign investors and where global deals may be structured with ease. Malaysia has developed its Islamic banking industry using a kaleidoscope of institutions and perspectives catering for both the nations and foreign investors' financial needs and foreseeable eventuality, yet retaining a commitment to serving the individual and collective need of society through her spread of sharia compliant products. Similarly, Malaysia exports her own Islamic finance products through attracting foreign investor subscription to her Islamic finance structures as well as attracting foreign investors to structure deals in Labuan.

In contrast to Malaysia, other Islamic finance jurisdictions are largely dependent on foreign institutions for regulation, foreign legal provisions for the offshore structuring of transactions and legal enforcement and, at times, even for purposes of taxation. With no grassroots germination, à la Tabung Haji, no equivalents to the Securities Commission, Labuan international

offshore financial centre or the comprehensive legal framework the common law provides: the main advantage these other jurisdictions retain globally is a perception of religious superiority and a surplus of funds to cushion inefficient structures – both being non-durable advantages. Certainty cannot be secured by money, nor can religious form replace substance. It has taken Malaysia more than half a century to attain what she has today and it is likely to take most other Islamic finance jurisdictions the same. No quick fix solution will suffice because, just as icing on a mud pie doesn't make a cake, foreign substitutions in place of a lacking national framework will eventually be an impediment to Islamic finance's development. The sooner effort is channelled into the development of a comprehensive legal, regulatory and financial framework, the better the prospects of growth and development will be.

9.2.4 Labuan international offshore financial centre

Malaysia has its own international offshore financial centre (IOFC) known as the Labuan IOFC which plays a central role in the development of the Islamic financial services sector in Malaysia.[10] It is of significance, therefore, that Labuan IOFC was the jurisdiction for the issuance of the world's first global sovereign *sukuk*: the US$600 million Malaysian Government *sukuk*. The issuance of the global sovereign *sukuk* signified a new era in international Islamic finance. Numerous institutions including those from Asia, Middle East, Europe, North America and the Indian sub-continent subscribed to the groundbreaking issue. It was the catalyst and precursor to the development of the international *sukuk* market and, as a sovereign issue that was twice oversubscribed, it placed Labuan IOFC in the annals of international Islamic finance history.

Labuan IOFC is now an integrated offshore financial centre that offers the full range of offshore financial services including banking, insurance, trust business, fund management, investment holding companies, investment management and management services activities. Labuan IOFC has become increasingly popular for advising and structuring Islamic financing. The better-known centres for setting up funds have always been traditional tax haven jurisdictions, such as the British Virgin Islands, the Cayman Islands, Luxembourg and Dublin. However, these locations may not be best suited for fund investments in the Asia region, particularly in developing economies such as China and India. Labuan provides an alternative to these traditional jurisdictions.[11] Labuan is also fast becoming a popular tax haven for Middle Eastern funds and, though a new player among the international offshore centres, it provides readily available infrastructure, facilities and

expertise. The full potential of the fund management industry has yet to be realised but, so far, fund managers from Malaysia, British Virgin Islands, Canada, Hong Kong, Singapore and Switzerland have established funds in Labuan IOFC. Its key attraction lies in its strict laws and regulations that protect investors' interests, its effective privacy laws and the fact that it is constantly reviewed to meet global offshore market demands.[12] The legislation governs and facilitates the smooth establishment and operation of funds. Among other things, the legislation and rules provide that private and public funds are required to appoint trustees to maintain records and ensure investors are protected. Further, to protect the interests of investors and to comply with the Labuan offshore requirements, at least one of the administrator, custodian, or trustee and manager functions must be carried out within Labuan IOFC. With respect to fund managers, there is no licensing restriction. However, when a public fund is set up, the fund manager must be licensed in a recognised jurisdiction and Labuan Offshore Financial Service Authority (LOFSA) must approve their appointment to the fund.[13]

Among the laws and regulations that protect investors are the requirements of ongoing reporting to LOFSA. Companies and partnerships must file annual returns as well as annual audited accounts. A public fund carrying on business under the supervision of another authority must file a certificate of compliance from the governing authority with LOFSA annually. Properly structured, activities of the fund could fall within the definition of an offshore business activity and specifically as an offshore trading activity. When carrying on an offshore trading activity, the fund benefits from a low tax regime of 3 per cent or a lump sum payment of $5,300 a year. The proceeds from redemption of units (in a unit trust fund), preference shares (of fund companies) or payment of any dividends from fund companies are also exempted from withholding tax as income derived from an offshore business activity or out of exempt income; this is also the case with interest paid by a Labuan offshore company (LOC) to a non-resident person, a resident person or another offshore company. Technical or management fees paid by an LOC to a non-resident person or another offshore company are also not subject to tax and an LOC is able to access some of Malaysia's double taxation agreements with over 47 countries to minimise withholding and capital gains tax. The operational cost of a fund in Malaysia is thus lower, from an Asian perspective, than that of other offshore financial centres in the Asia Pacific region. The operational cost is estimated to be 40 per cent less than the cost in Hong Kong and Singapore. It is also undoubtedly lower than tax havens in the US and Europe. Likewise, Labuan boasts over 50

international banks through which fund administrators have the flexibility to hold multi-currency accounts as well as access to the cost-effective and fast transmission of funds.

The roles required for a typical fund set-up are set out in the diagram below. Although not legally necessary, each of the different roles can be carried out from Labuan IOFC by licensed trust companies, investment banks and fund managers. Moreover, the Labuan International Offshore Financial Exchange (LFX) also provides a venue for listing and trading funds.

9.3 Making a difference through Islamic finance

Perhaps the most important lesson learnt from the Asian financial crisis was the interdependence of financial markets. Even the most developed economies were not spared the effects of the financial turmoil, which began as a

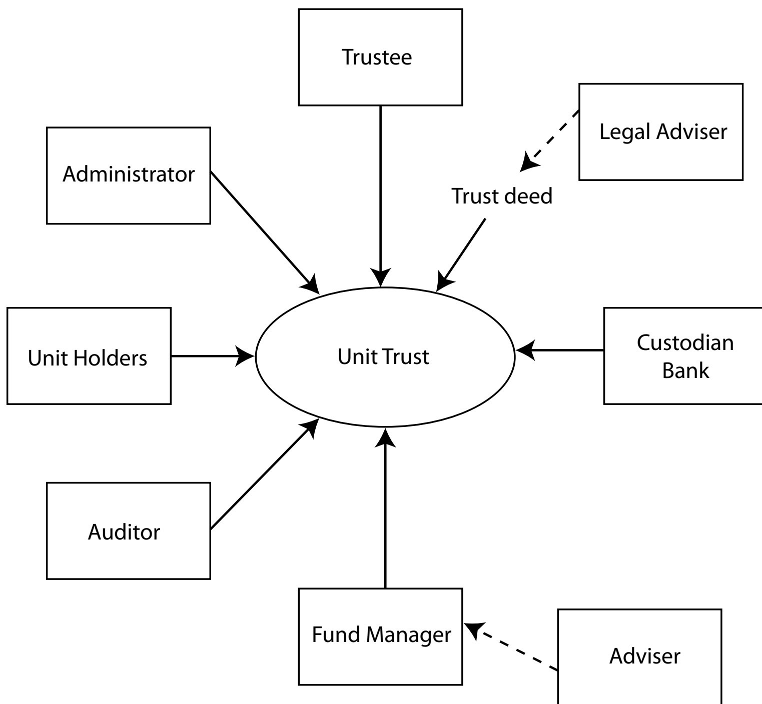

Figure 9.1 A typical unit trust set-up

result of Thailand's default on its Eurobond issue in February 1997. By May 1997, the Malaysian Ringgit (RM) was under severe pressure from currency speculators and interest rates had risen from 7 per cent to 9 per cent. It was reported that Bank Negara expended approximately RM1.2 billion of its foreign exchange reserves towards trying to stave off the attack of currency speculators.

Therefore, while a success story on the Islamic finance scene, lessons from the Asian financial crisis suggest three factors that will make a difference to Malaysia's Islamic finance industry and its socio-economic fabric in the current tumultuous global economic climate:

1 A focus on the substance of the structured transactions as a criteria of sharia compliance because, whilst in buoyant economic conditions people may subscribe to any structure labelled 'Islamic', only investments and transactions that provide equitable returns will continue to attract the growing number of disillusioned customers and subscribers disappointed by the arbitrage witnessed in the Islamic finance industry. Equitable transactions, not necessarily garbed in Arabic jargon or strictly modelled after traditional structures, are more likely to serve Malaysia's population and hence be more attractive and profitable. The intention must be: *Emulate*, not imitate.
2 A focus on the development of efficient structures so as to facilitate equitable outcomes in sharia compliant financing. Ultimately, the essence of Islamic traditional commercial structures is the attainment of equitable and efficient outcomes – efficiency being part of the concept of equity. Equitable effect ought to be Islamic finance products' main focus and distinguishing factor if it is to continue insisting on a distinction between it and conventional financing. Again, while the Islamic capital market may appear cushioned by customers willing to pay a premium for 'Islamic' products, as the industry grows and in current tumultuous economic times, attracting customers will depend greatly on whether the products are perceived to offer equitable returns and are attained through cost-efficient transactions.
3 The continued drawing of local support for its Islamic finance industry. This can only effectively be achieved through the populations' continued enjoyment of the tangible benefits of the industry – as they did initially from the Tabung Haji scheme of finance. Malaysia rose to its current status on the Islamic finance scene partly because of its home-grown support and it would be foolhardy to neglect the Malaysian peoples' credit and financial needs in its aim for attaining global eminence. There

are numerous instances of other Islamic finance jurisdictions that began their experimentations with sharia compliant structures only to fail miserably because in their fervent efforts to compete with and discredit conventional banking, they forgot to bring the benefits of their endeavours home to the local population. In Jordan, for example, even those who supported the industry, initially, are now discrediting it for its corrupt, inefficient and exploitative nature. Those who purchase Islamic banking products do so solely because of the inculcated perception that conventional banking is sinful and wrong. If it is sinful and wrong, however, why does the Islamic finance industry put so much effort into imitating conventional finance structures and products? Egypt, the first jurisdiction in the world to experiment with Islamic banking in the mid-twentieth century through the successful Mit Ghamr scheme, is floundering on its banking and finance front not because it retains a mostly conventional banking system with a veneer of sharia-compliance but because when the government eventually took up Islamic banking, it was corrupt, inefficient and inequitable and, thus, succeeded in alienating the majority of the population who are poor and do not benefit tangibly from the industry. With the Sheikh of Al-Azhar himself calling all Islamic bankers a band of thieves, it is little wonder its potential is not fulfilled.

One may question however why Dubai, Qatar and, to a lesser extent, Saudi Arabia continue to do well in Islamic finance. The answer is twofold:

- These jurisdictions are populated with religiously orthodox yet wealthy individuals. The industry, therefore, continues to exploit the religious overtones and forms of the Islamic transactions they structure, for either local consumption (mainly government departments) or foreign investors attracted by the less risk prone investments, offering high fixed returns.
- The surplus of funds and liquidity available to the government plays a role in both the structuring and subscription of the products and cushions the inefficient and costly nature of the products through their willingness to pay a premium for 'Islamic' products.

The apparent success of Dubai and the rest of the region has been upset by the recent near default of Dubai World and the controversy surrounding the Al-Nakheel group in Dubai. These events precipitated a drop in value and capital market activity throughout the Middle East. The illusion of success created and cushioned by surplus funds and good economic times is now being tested.[14]

Conclusion

In current economic times when surplus funds no longer provides a cushion, when the scope for growth and expansion calls for subscription beyond government agencies, and when religious form loses its intrigue and appeal through the apparent lack of substance or distinction from conventional banking, it is only well-functioning legal and regulatory national institutions plus a focus on the three factors suggested above that will ensure enduring success. Without a well-functioning legal and regulatory system encompassing the requisite institutions, the structures that now exist will crumble for lack of a strong foundation. In illustration, contrast Thailand, Indonesia and the Philippines with Malaysia during the 1998 South-East Asia financial crisis. Malaysia successfully survived the 1997/8 Asian speculative capital-market crisis because of her well-regulated financial system and the efficacy of Bank Negara Malaysia (Malaysian Central Bank). Hence, Malaysia's prime minister's recent call for tighter regulation of Islamic finance in current market conditions is apt and timely. Malaysia is a leading Islamic banking jurisdiction mainly due to the continued advantages it enjoys as a result of its well-functioning legal and regulatory structure and the consequent certainty it provides investors both locally and globally.

10

THE WAY FORWARD

With Adam Smith's words, prudence is 'of all virtues that which is most useful to the individual',[1] I am reminded of the following story, the moral behind which fuelled my writing with the intention of contributing to the development and long-term sustainability of Islamic finance. The story is that of a friendly, flightless, happy-go-lucky bird – the dodo. In brief, the dodo was left behind by evolution. With no natural predators, on the Island of Mauritius, it had no need to adapt to its environment and eventually found itself defenceless against the settlers that hunted it. Eventually, it became extinct in 1681. To date, a foolish person is referred to as a 'dodo' and the story is a pragmatic example of how failure to change impedes evolution, leaves one vulnerable and leads to extinction. The same is applicable to any person, practice or sphere of life. It is applicable to the theory and practice of Islamic commerce and finance. The concept of social evolution accompanied by evolving solutions is not novel or peculiar to any civilisation, religion or community. Neither is its relevance time specific. Indeed, even as we assess the causes and outcomes of the current financial crisis, the debate of what is socially useful is acknowledged to be subject to time and context. As Lord Turner puts it, '[t]he basic proposition of securitisation is not daft. The problem was that it became over complicated'.[2] The 'complication' lies partly in the 'bogus assets' that were securitised and sold on to the market for purposes of passing on risk. This, we now know, is part of the cause of the financial crisis we now face and the reason why the regulatory arm of European Commission has gone to length to tighten regulations of securitisation transactions.

Until recently, international finance literature was rife with statistics and claims of the booming market and scope for expansion that exists for *sukuk* (Islamic bonds) and all other Islamic finance structures. Having only taken off in the past couple of decades, it is hardly surprising that the future of

Islamic finance appeared bright: novelty, of both the products and mode of investment for Muslims and non-Muslims alike, strong state support resulting in lower risk of investments and the undoubted need for liquidity and development finance in Muslim-populated jurisdictions created an appetite for Islamic finance products. The story is less glamorous today in the wake of the 2008/9 global financial crisis that has seen scores of investors leaving cities like Dubai and Doha and the Islamic finance industry slowing down considerably.[3]

Available literature and publications do not provide much detail on what Islamic finance really is beyond the hype, jargon and statistics. What makes it *substantially* different from conventional modes of finance? What is currently missing – generally or in certain jurisdictions – the presence of which would ensure the sustainability of its development both in product array and market confidence? Therein lies the key to the development of Islamic finance structures and products and this book has put forward answers, albeit non-conclusive, to these questions.

For purposes of focus and direction, this book chose a particular finance transaction that has not yet been successfully structured within the Islamic finance industry: securitisation. The intention was, thus, to facilitate the structuring of a sharia compliant securitisation by clarifying current key concepts and misconceptions within Islamic legal theory and practice. Within that framework, several pertinent issues were discussed revolving around the current meaning, application and effect of *gharar*, *riba* and *bay al dayn* on contractual and financial transactions as well as suggested alternatives that may be adopted towards facilitating the expression of the spirit and principles of the *Quran* and traditions of Muhammad. Further, the issues of dual compatibility structures, subjective interpretations, selective application of rules and the claim to moral superiority and religious legitimacy were discussed (and where appropriate, discredited).

The book touches briefly upon the possibility of developing a secondary Islamic capital market in chapter 6, having clarified the proprietary status of debt and intangible assets, as the next step towards growth and widening accessibility of investments in the global market. Emphasis, nonetheless, was laid on the fact that there was no necessity for an exclusive Islamic capital market, for we have seen that much of the current distinctions drawn between 'Islamic' finance and the conventional finance it closely copies, are superficial. However, should the industry insist on drawing distinctions, the only appropriate distinction, as perceived by the author, is that between finance generally and equitable finance. The label 'Islamic' finance is susceptible to confusion and preconceived notions – equity, on the other hand,

is more readily discernable from inequity. In this case, a separate capital market may be cultivated to cater to those interested in equitable investments but it need not be labelled 'Islamic' and neither need it be displayed as an 'exclusive' mode of conducting finance. Principles of equitable dealings and justice belong to all cultures and civilisation – the comparability of Islamic law with common law has made this amply clear. As for the when and how it will be developed, the only sustainable means of growth and proliferation of equitable modes of finance is by commencing at the grassroots much like the Tabung Haji and Mit Ghamr schemes did in Malaysia and Egypt, respectively, or the Grameen bank project in Bangladesh. Under this model, Islamic finance products and structures as currently marketed would be free to choose and use conventional capital markets should they qualify. Unfortunately, to date, the form-driven quest for sharia arbitrage in financial investment, at the cost of economic substance, has sabotaged any such effect.

Given the fast declining scope for further growth as a result of current financial market conditions, tighter regulatory controls resulting from increased awareness about sharia arbitrage practices and the diminishing difference between conventional banking and Islamic finance, an enquiry into change in mode and scope of Islamic finance has been triggered. Inefficiencies arising from an industry built on arbitrage that resulted in an increase in transaction costs and a rise in legal and juristic fees have now been exposed by a financial crisis of global scale that has called for tighter regulatory control and monitoring. The effect of the recent global market conditions has also created an interest in synthesising conventional financial products in line with the sharia. The Islamic finance industry calls this 'innovation', the very innovation that was initially depicted as 'prohibited'.

Whilst agreeing with the shift towards harmonisation, this book emphasises that what must now be the essence of Islamic finance, if it is to be sustainable and win the hearts of the currently disenfranchised and disillusioned Muslims, is equitable outcomes through efficient processes. Further, Islamic finance cannot continue to make the profits it has enjoyed without making a meaningful difference to the financial and developmental needs of Muslims. It needs a new identity and the label 'Islamic', if it is to be retained, must be earned through the economic substance it creates. While principles of Islamic economics are entirely compatible with making profit and creating wealth, Islam stresses the requirements of equitable dealings, social justice and efficiency of outcome. How then might Islamic finance go about achieving these objectives? The most logical and simplest place to commence is what chapter 1 stresses: an emphasis on substance with the

complementary use of form, for purposes of attaining such substance, in all structures and transactions.

We noted that the principles of contract and commerce in Islam, and the emphasis on substance and social justice, are neither peculiar to Islam nor distinct from the principles of conventional finance. The wake of the 2008/9 financial crisis revealed the existence of the same 'Islamic' principles within Western capitalism, as put forward by its fathers, Smith, Schumpeter and Keynes, amongst others.[4] In Edmund Phelp's words (winner of the 2006 Nobel prize in economics): 'Capitalist systems function less well without state protection of investors, lenders and companies against monopoly, deception and fraud'.[5] The shedding of a prohibition-driven and form-based Islamic finance industry may, thus, cultivate cross-jurisdictional compatibility and shed the false differences between Islamic and conventional finance. Throughout chapters 1, 4, 5, 6, 8 and 9 we have demonstrated that the common law shares much with Islamic law on all the issues considered and that the formalistic distinction drawn by Islamic finance ought to be dropped to enhance the equity and efficiency of its products. Should this be done, a long-due steer in the right direction for Islamic commercial practice will be at hand.

NOTES

1 Islamic Law and the Role of Interpretation

1 M.T. Mansuri, *Islamic law of Contracts and Business Transactions* (Adam Publishers, New Delhi, 2006), 3–4, 14–15. See also M. Hashim Kamali, *The Dignity of Man: An Islamic Perspective* (Ilmiah Publishers, Selangor, Malaysia, 2002).
2 M. Hashim Kamali, *Freedom, Equality and Justice in Islam* (Ilmiah Publishers, Selangor, Malaysia, 2002), 7.
3 H. Beale (ed.), *Chitty on Contracts*, 30th edn (Sweet & Maxwell, London, 2008), vol. I, 10.
4 Abdullah Yusuf Ali (tr.), *The Holy Quran* (King Fahd Holy *Quran* Printing Complex, Madina, by Royal Decree 12412, 1405 AH), herein after simply referred to as the *Quran*, *al-Hajj*: 78, 'It is the religion of your father Abraham who has called you *Muslim* from before and in this [revelation]'.
5 *Quran*, *al-Baqara*: 260; *al-An'am*: 74–9; *Maryam*: 41–8 and *al-Anbiyaa*: 51–8.
6 *Quran*, *al-Baqara*: 127–32 (n. 4).
7 *Quran*, *al-Baqara*: 135–41 (n. 4).
8 *Quran*, *Fussilat*: 43 (n. 1), 'Nothing is said to you (O Muhammad) except what was said to the Messengers before you'; also, *Quran*, *al-A'la*: 18–19 'Verily! This is in the former scriptures. The scriptures of Abraham and Moses'.
9 Karen Armstrong, *Islam: A short History* (Phoenix Press, London, 2001), 14–15. This Muhammad did by adopting forms of worship from the Christians and Jews living amongst the pagan Arabs at the time. The *Quran* gives examples of fasting with the Jews and on specified days (*Ashura*), praying in, initially, the same manner (including late night vigils), and in the same direction (*Qibla*) as the Jews (facing Jerusalem)
10 Karen Armstrong 4–5 (n. 4).
11 M. Hashim Kamali, *Freedom, Equality and Justice in Islam* (Ilmiah Publishers, Selangor, Malaysia, 2002), 47
12 M. Hashim Kamali, *Freedom, Equality and Justice in Islam*, xi.
13 Oditah, *Legal Aspects of Receivables Financing* (Sweet & Maxwell, London, 1991), 46, 'Common law did not, and still does not, as a general rule recognise a preset transfer of future property'. Oditah cites *Lunn v Thornton* (1845) 1 C.B. 379.
14 See chapter 4 for a detailed discussion of *gharar*.

15 El-Gamal, *Islamic Finance: Law, Economics and Practice* (Cambridge University Press, New York, 2006), 81–2. See chapter 5 and 6 for a detailed discussion.
16 El-Gamal, ibid.
17 See Oditah, Legal Aspects of Receivables Financing, 46 (n. 13).
18 Mansuri, *Islamic Law of Contracts and Business Transactions*, 205–6.
19 See sections 4.1, 4.2 and 5.1 and 5.2.
20 See conclusion to chapter 5.
21 El-Gamal, 103 (n 15).
22 M. Furmston, *Cheshire, Fifoot & Furmston's Law of Contract*, 15th edn (OUP, Oxford, 2007), 1–5. The English law of contract it has been seen, was evolved and developed within the framework of *assumpsit* as a remedy for the breach of informal agreements reached by word of mouth , and, so long as that framework endured, it was not necessary to pursue too fervently the search for principle. An *assumpsit* was an undertaking. Thus, in the case of *Skyrne v Butolf* (1367) YB 2 Ric 2 (Ames Series) 223, the plaintiff sued a doctor to whom he had come to seek a cure for the ringworm. He alleged that the doctor, undertook (*assumpsit*) in London in return for a certain sum of money previously paid into his hand, competently to cure the [plaintiff] of a certain infirmity.
23 [1929] All ER Rep 679.
24 [2007] UKHL 40, per Lord Hoffman at paras 1–12.
25 [1929] All ER Rep 679 at 683.
26 [1929] All ER Rep 679 at 683.
27 Furmston, *Cheshire, Fifoot & Furmston's Law of Contract*, 404.
28 [1892] 2 QB 484 at 490–1.
29 *Ellesmere v Wallace* [1929] 2 Ch 1 at 24, 36, 48–9.
30 Furmston, *Cheshire, Fifoot & Furmston's Law of Contract* 406.
31 Carlill v Carbolic Smoke Ball Co. [1892] 2 QB 484.
32 Ibid.at 491–2.
33 Examples include the sale of next year's apple crop, the sale of the next haul of a fisherman's net, and the sale of an undeclared dividend. See *Thacker v Hardy* (1878) 4 QBD 685, CA; *Marten v Gibbon* (1875) 33 LT 561, CA.
34 [1992] BCLC 148 at 160.
35 Roy Goode, *Commercial Law* (3rd edn, Lexis Nexis Butterworths, London, 2004), 605–8
36 Ibid.
37 [2002] EWCA Civ1138.
38 [2006] EWCA Civ 694.
39 *Re Watson* (1890) 25 QBD 27; *Polsky v S & A Services* [1951] 1 All ER 185, affirmed in [1951] All ER 106n.
40 Roy Goode, *Commercial Law*, 605–6 in reference to, and drawing from, the *Exfinco case*.
41 [2009] EWCH 340 (Ch) para 51.

2 Scope, Methodology and Objective

1 See chapter 7 on Securitisation.
2 Currently interpreted and applied as a prohibition of interest on loans.
3 Vogel and Hayes, *Islamic Law and Finance: Religion, Risk and Return* (Brill-Leiden, Boston, 2006), 68.

4 Only excessive *gharar*, as opposed to merely an imputation of *gharar*, renders a contract void. See chapter 4 at 4.2 for greater detail.
5 With the exception of Malaysia as a progressive Islamic finance jurisdiction that allows the sale of debts/future obligations to the limited extent that it is backed by real assets. A full discussion follows in chapter 6.
6 *Quran*, *al-Baqara*: 215 (n 1); see also Karen Armstrong, *Muhammad: A Biography of the Prophet* (Phoenix Press, London, 2001), 92.
7 El-Gamal, *Islamic Finance: Law, Economics and Practice* (Cambridge University Press, New York, 2006), 15–16.
8 El-Gamal, *Islamic Finance*, 16–17.
9 See Financial Services Authority (FSA) Report, 'Islamic Finance in the UK: Regulation and Challenges', 28 November 2007 at www.fsa.gov.uk, last accessed on 2 December 2009.
10 See chapter 4, section 4.2–4.3.
11 Karen Armstrong, *Islam: A Short History* (Phoenix Press, London, 2001), 85. It was during the Mongol reign (fifteenth century ad) that 'world hegemony' was sought, that it was agreed that the *ulama* (scholars) could no longer use their independent reasoning and thus resulted in the metaphorical 'closing of the gates of *ijtihad*'. This essentially denied people their right to apply their minds to the scriptures and/or what the scholars interpreted them as. Henceforth, all interpretations of the primary sources had to be taken and applied on the basis of past authorities to be applied without introspection or question. The scholars and political rulers of the day were concerned with the possibility of the sharia being a potentially subversive source by giving rise to multiple interpretations of Islam that had proliferated from the ninth century ad. It was claimed that the intention was to stop the abuse of *ijtihad* (independent reasoning) by people who were not theologically or legally qualified.
12 El-Gamal, *Islamic Finance*, xiii.
13 *Quran* Al-Nisa: 59 (n.1).
14 Armstrong, *Islam: A Short History*, 79.
15 El-Gamal, *Islamic Finance*, 15–17.
16 John Makdisi, Makdisi, John, 'The Islamic Origins of the Common Law', *North Carolina Law Review* 1999, 77 (5); cited in El-Gamal, *Islamic Finance*, 16 (n. 22). See also, Landes, David, *The Wealth and Poverty of Nations* (Abucus Publishing, London, 2000), 54. Landes states that Islam was Europe's teacher through contact made in Spain and, otherwise, through translated books.

3 Islamic Finance: An Introduction

1 Monzer Kahf, 'Islamic Banks: The rise of a New Power Alliance of Wealth and Sharia Scholarship', in C. Henry and R. Wilson (eds), *The Politics of Islamic Finance* (Edinburgh University Press, Edinburgh, 2004), 18–22. The Islamic Development Bank was founded in 1973 and the Dubai Islamic Bank in 1974. Note, however, that two micro-economic schemes pioneered Islamic finance long before the Islamic banks came onto the scene: the Mit Ghamr banking scheme established in Egypt in 1963 by Ahmad al-Najjar and the Tabung Haji finance scheme established in Kuala Lumpur by the Malaysian government in 1956.