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Islamic Finance in the Current Financial Crisis

Isam Salah*

Good morning. It is amazing to see this many people here. If somebody had told me five years ago that you could gather together 100 people early on a Saturday morning to discuss Islamic finance I would not have believed it, but here you are! I would like to thank Khalil and Amy, and the *Berkeley Journal of Middle Eastern and Islamic Law*. It's a pleasure to be here to address your second annual Islamic Finance symposium. The symposium is quite an accomplishment, so congratulations.

I liked the earlier discussion about whether or not a question mark should be added after the conference title of "Islamic Finance: Resilience in a Time of Financial Crisis?" I think maybe I should have had a question mark on my title as well, so that it would read "Islamic finance in the current financial crisis?" Perhaps by the end of the day we will know whether or not the title of my talk should have posed a question rather than make a statement.

I would like to begin by taking a look at how the economic crisis has affected Islamic finance on a macro level, and then take a look at how Shari'ah-compliant products have reacted to the current financial pressures, to see if there is anything unique about their performance.

INTRODUCTION

Let us first understand the nature of these current financial pressures. There are some real economic problems out there. They began

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with sub-prime loan assets; toxic assets on the balance sheets of a number of banks that have uncertain valuations, but clearly do not hold their face value. This uncertainty over the quality of assets held by financial institutions brought about a credit crunch—a lack of liquidity affecting the capital markets. A number of transactions at the end of 2007 and the beginning of 2008 were delayed because of difficulties in obtaining financing. This lack of liquidity led to further deterioration in world economic conditions and produced a continuing deep freeze on credit that persists today despite governmental efforts to free up the credit markets. Stock-market valuations began a corresponding drop, as did property values, while foreclosures, layoffs and unemployment rates began to rise. Consumer confidence in the economy plunged as the economy spiraled downward. This was clearly not a pretty picture.

The questions before us now are whether Islamic finance has been affected, and if it has been affected, how it has been affected, and how has it responded? What issues have presented themselves and what challenges are likely to still be confronted by the Islamic finance industry?

To appreciate the impact of the financial crisis on Islamic finance, we first need to understand the state of the market when economic conditions began to deteriorate. At the beginning of 2008, Islamic finance was a vibrant and growing industry. What began with a single bank in Egypt in the 1960s had blossomed to over 300 institutions in 75 countries by the beginning of 2008. Current estimates of the size of the Islamic finance industry today range from \$500 billion to \$800 billion, up from \$140 billion in 2000. This estimate includes assets held by Islamic financial institutions, assets held in insurance schemes and assets held in Islamic windows of conventional financial institutions. The McKinsey consulting firm estimates that the total Islamic finance market will reach \$1 trillion soon, with some claiming that the industry has already reached that size. I do not think it has, but it may reach that size by the end of 2010.

Moody's has a more aggressive projection. It predicts that the Islamic finance market will grow from \$500 billion today to \$4 trillion in five years.¹ That projection was made in August of 2008, so it may have been revised downward since then.

The growth rate in the Islamic finance market has usually been quoted as being approximately 15% per annum, regardless of whether

1. David Oakley, *Islamic Bank Shrugs off Financial Market Woe*, FIN. TIMES, Sept. 7, 2008.

the size of the market was put at \$300, \$500 or \$800 billion. However, some estimates at the beginning of 2008 put the growth rate at between 25% and 30% per annum, a significant up-tick from the often-cited 15% rate.² It is worth pointing out that to achieve a \$4 trillion market within five years, there would need to be a growth rate higher than 25% to 30% per annum but, again, these are the rates that have most recently been quoted.³

ISLAMIC MUTUAL FUNDS

These estimates of the size of the current Islamic financial market also include amounts held in Islamic mutual funds, that is, funds that invest in equity securities that have undergone a permissibility screen. There are currently between 300 and 500 such funds, and their number is projected to increase to 1,000 by the end of 2010. The assets held by Islamic mutual funds have doubled in the past three years, and last year alone increased from \$23 billion to \$35 billion.

The first screen is an activity screen, which involves screening out companies that are engaged in certain impermissible activities such as pork or alcohol production or distribution, theaters, interest-based financial institutions and weapons manufacturers. The second screen focuses on the financial affairs of a company. This screen rules out companies that have leverage levels exceeding certain accepted norms, usually 30% of assets or total capitalization, and places a limit on the interest income these companies receive.

The companies, which are typically public companies, that satisfy these screens comprise the universe of permissible stocks in which Islamic mutual funds may invest. These qualifying stocks are monitored on an ongoing basis to make sure they remain in compliance with the screening criteria.

SUKUK ISSUANCES

An important element in the growth of the Islamic finance market

2. *Sharia Deals Boost Aviation*, AIRFINANCE J., Sept. 1, 2008, <http://www.airfinancejournal.com/Article/2048807/Search/Results/Sharia-Deals-Boost-Aviation.html>. See also *Islamic Banking 'No Longer Immune to Crisis'*, TRADE ARABIA, Dec. 4, 2008.

3. Moin Siddiqi, *Islamic Banking: Text and Tables*, 394 THE MID. E. 35 (Nov. 2008).

has been the growth in the issuance of Sukuk. Sukuk represent, essentially, an ownership interest in an underlying asset, transaction, project or venture, and the related revenues. Sukuk can have the characteristics of debt or equity depending on the nature of the underlying asset, transaction, project or venture. Sukuk are classified as debt-like if they produce a fixed return with a final payment date, or equity-like if produce a variable return.

Sukuk first appeared in 2002 when Malaysia undertook a sovereign issuance. Most sukuk are issued out of the countries of the Gulf Cooperation Council (GCC) and Malaysia and are issued by both sovereign and, increasingly, corporate issuers.

When issuances of sukuk hit \$25 billion in 2007, this positive trend was projected to continue. Many people first heard about sukuk in connection with the Dubai Ports World acquisition, which used a jumbo sukuk in excess of \$2 billion to finance the deal. With this issuance, people began to appreciate the size of some of these Islamic financial transactions. As sukuk continue to be issued, they become more structured and complex.

GLOBAL CENTERS OF ISLAMIC FINANCE

In early 2008, Islamic finance was increasingly attracting global attention as the industry quickly grew in size, reach and popularity. In the Middle East, Dubai and Bahrain were competing for a leadership role in Islamic finance in the Gulf. London had already announced and staked out its position as a global center of Islamic finance, both on the capital markets side, as well as in licensing Islamic banks, with U.K. regulators having licensed five Islamic banks.

Meanwhile, Hong Kong, Singapore and Kuala Lumpur battled for dominance in Asia. France and South Korea have also shown an interest in attracting Islamic financial institutions. In the U.S., regulators have approved a number of Islamic financial products and shown an openness to looking issues that may arise when that first application to establish an Islamic bank is submitted.

Finally, a new Islamic bank that was recently established in Kenya, proclaimed that Nairobi was going to be the industry hub for East Africa. So everyone is getting into the act.

THE FIRST SIGNS OF TURMOIL

At what point did we begin to see the first cracks in Islamic finance as the economic crisis affecting the United States spread through the world economy? As I noted earlier, sub-prime problems in the United States snowballed into a credit crunch and then deteriorated into a further lack of liquidity in the credit markets. These developments impacted the market for sukuk as well.

It is important to note that most sukuk are U.S.-dollar denominated, and interestingly, about 60% of the buyers are Western institutions, with the remaining 40% percent being GCC buyers or others. This linkage between U.S. credit markets and sukuk issuances makes it easy to understand how the market for the issuance of sukuk would be affected by the conditions affecting Western capital markets.

The Dubai Ports World sukuk, for example, was set up to comply with Regulation S and Rule 144A so that it would be acceptable to U.S. buyers. As a result, 56% of the Dubai Ports World sukuk issuance was purchased by U.S. and European buyers, with 8% of the buyers coming from Asia, and the remaining 36% coming from GCC countries.

The issuance of \$25 billion in sukuk in 2007 dropped to \$16 billion in 2008. Southeast Asia had a drop off in excess of 70% - down to about \$6.5 billion in sukuk issuances in 2008, and there was a roughly 50% drop off in the GCC - down to sukuk issuances of a little over \$9 billion in 2008. So the market went from \$25 billion down to about \$16 billion and continues to decline.

The fourth quarter of 2008 saw the lowest issuance of sukuk since the fourth quarter of 2002. Bear in mind that Malaysia issued the first sovereign sukuk in 2002, so the market basically fell back to its beginning levels with sukuk issuances equivalent to approximately \$580 million in the last quarter of 2008 and no U.S. dollar issuances.

SHARI'AH CONSIDERATIONS

Sukuk issuances were clearly affected by the credit crunch. However, another factor besides the credit crunch affected the issuance of sukuk in 2008. At the beginning of 2008, Justice Taqi Usmani, one of the industry's most respected Shari'ah scholars, issued an opinion stating that approximately 80% of the sukuk in circulation were not Shari'ah com-

pliant.⁴

As mentioned earlier, sukuk can take the form of instruments that resemble debt obligations with determinable returns or, depending on the type of underlying transaction, they resemble an equity investment with a variable return. Typically, sukuk resembling debt obligations are based on an underlying asset leasing transaction. Sukuk that resemble equity-like instruments are typically based on an underlying partnership or venture, or on an investment agency. These types of sukuk produce uncertain returns.

What was happening was that both buyers and issuers were looking for debt-type sukuk, which would require the use of a leasing structure, which in turn would require an issuer to have leasable assets. If a prospective issuer doesn't have suitable assets that can be leased, its remaining option is to issue a sukuk that is based on an underlying transaction that represents an equity investment, which would necessarily produce uncertain returns.

This is not what issuers and investors were seeking, so some engineering took place. A variety of features were added to what originally started off as equity-like sukuk in order to produce returns that would be comparable to debt-like sukuk. The issuer undertook a buyback obligation at a future date that was similar to the repayment of principal. The sponsors stepped in and provided that, in case of a shortfall in the revenues generated by the underlying transaction, they would make interest-free loans to the project to support the payment of returns at the projected level of return. Conversely, if revenues exceeded the project return—the return that was expected by the buyers and expected to be paid by the issuers—the sponsors applied an incentive fee eliminating that excess by paying it to the sponsors as an incentive fee.

The net effect of these features was to turn something that originally began, and should have remained, as an equity-type of sukuk instrument into something that more closely resembled a debt instrument. It was this change in features as well as other objections that brought Taqi Usmani to take the position that many of these sukuk were no longer Shari'ah-compliant.

There was also the view earlier on, when sukuk were first coming to market, that Shari'ah scholars were willing to be more lenient and allow some of these features because the Islamic finance market was in its in-

4. *Most Sukuk 'Not Islamic,' Body Claims*, ARABIAN BUSINESS.COM, Nov. 22, 2007, <http://www.arabianbusiness.com/504577-most-sukuk-not-islamic-say-scholars>.

fancy. However, the Shari'ah scholars also expected that issuers and buyers would eventually move away from these types of modified sukuk structures.

So when we look at the drop off in Sukuk issuances in 2008 from 2007 levels, there are two factors in play: the credit market crunch clearly had an impact, but there was also a decline attributable to questions raised about some of the structures being used. This demonstrates, at least in the sukuk market, an absence of immunity from the broader economic problems. Even if we were able to isolate the affects of the Shari'ah issues affecting the sukuk market, the lack of liquidity in the capital markets was also clearly at play. As the conventional capital markets dried up, so too did sukuk capital markets.

RISE AND FALL OF SYNDICATED MURABAHA FACILITIES

What was the response of the Islamic finance industry? If your company needed to finance its activities on a Shari'ah-compliant basis and the Islamic capital markets are shut down, where do you go for financing? Many companies looking for Shari'ah-compliant financing called on their established banking relationships seeking syndicated and bilateral financing facilities. Typically, these arrangements were structured as back-to-back commodity murabaha transactions.

What are back-to-back murabaha transactions? A murabaha transaction is a transaction in which a company purchases goods or commodities from a finance provider at the cost paid by the finance provider plus an agreed mark-up. Payment is made by the company at the time of purchase or at a future point in time, as agreed to by the company and the finance provider.

A murabaha purchasing arrangement is a very common method of financing the purchase of assets and equipment on a Shari'ah-compliant basis. If your company needs to import goods (for example, grain, oil or equipment) and you approach an Islamic bank for financing, it would be quite typical for the Islamic bank to provide murabaha financing. The bank will buy the goods and resell them to you at cost plus an agreed profit, with payment to be made by your company at a future date. Payment can be made in installments; the payment arrangements are as agreed to by purchaser and seller, subject to a couple of limitations.

This type murabaha financing structure has been used as a way of providing cash to a company that needs financing but does not necessarily need to purchase goods or commodities. It has expenses it must pay,

such as salaries and rent, and it needs cash to pay those expenses. Early on, members of the London Metals Exchange (LME) recognized that they could facilitate these financing transactions by making available their supplies of metals for use in murabaha transactions. Ownership of these supplies of metals is represented by warrants that are easily purchased, sold and transferred.

The finance provider will buy metals—copper, for example—on a spot basis from an LME broker and sell those metals to the operating company at cost plus agreed profit, payable at an agreed future date or in installments. The operating company has no use for the metals it has just purchased, so it immediately resells the metals for the cash it needs.

For example, if the operating company needs \$1,000,000, it asks the finance provider to buy agreed-upon metals having a purchase price of \$1,000,000. The operating company and the finance provider will agree on the profit component assuming payment of cost plus the profit in six months—assume the profit is \$100,000. The finance provider purchases the metals for \$1,000,000 from an LME broker and then resells the metals to the operating company at \$1,100,000 with payment to be made in six months. The operating company immediately resells the metals to another LME broker for \$1,000,000. At the end of these back-to-back transactions, the operating company has the \$1,000,000 in cash it needs to finance its operations and is obligated to pay a purchase price of \$1,100,000.

This basic structure has been used in syndicated financing facilities for Shari'ah-compliant companies on a regular basis, but this financing arrangement has become more prominent as the sukuk capital markets contracted. Shari'ah-compliant companies turned to their relationship banks to provide this kind of bilateral and syndicated financing. As evidence of this trend, the market for syndicated and bi-lateral murabaha transactions grew from just under \$19 billion in 2007, to just over \$27 billion in 2008—a 32% growth rate. Eventually, however, these murabaha facilities were also impacted by the spreading credit freeze, and in the last quarter of 2008, almost no syndicated facilities were booked.

ISLAMIC MUTUAL FUNDS AVOID A MELTDOWN

What was the impact of the crisis on Islamic mutual funds, which I described as funds that invest in equities that have been subject to activity and financial screens? As noted earlier, during the three-year period between 2005 and 2008, the number of Islamic funds increased from 300 to 500, and assets held by the funds increased from \$23 billion to \$35

billion.

In prior years, the performance of these funds had been consistent with that of conventional equity funds. This consistency continued into the beginning of 2008, as both Islamic mutual funds and conventional funds suffered consistent and significant declines in their returns. As the economic crisis took hold through 2008, these declines continued, but the Islamic mutual funds began to perform slightly better than their conventional counterparts, in the sense that the declines they were experiencing were not as steep. For example, Standard & Poor's in 2008 observed that in the MENA region, those funds that had Islamic mandates outperformed conventional funds because their performance did not decline as rapidly as the performance of conventional funds. S&P computed a 29% drop for Shari'ah-compliant mutual funds, versus a 34% drop in the S&P 500 index. There was also a significant drop in assets under management, with both Shari'ah-compliant and conventional funds focused on the MENA region suffering a 46% drop in assets.

In the U.S., Saturna Capital, the investment advisor for the Amana fund, one of the few Islamic mutual funds based in the U.S., observed that the superior performance of Islamic funds late in 2008 was primarily attributable to the avoidance of stocks of financial firms, which were the companies that suffered the most and had the greatest drops in value over the past year. So if you were invested in a fund that was not exposed to bank and other financial-institution stocks, you're probably a little happier than if you had invested in a fund that had such exposure.

In addition to avoiding financial stocks, Islamic mutual funds also benefited from avoiding investments in companies that were highly leveraged. As the credit markets were tightening up and companies needed to refinance, those companies that had lower levels of financing were not as badly affected.

So those two factors—an absence of investment in conventional interest-based financial institutions, as well as restrictions on investments in companies that were leveraged beyond accepted levels—helped the performance of Islamic mutual funds in comparison with the performance of conventional mutual funds.

Interestingly, Saturna has observed that the Amana funds had a significant inflow of capital during 2007 and 2008. Based only on their unscientific review of the names of the new investors, they concluded that two-thirds of the new money may have come from non-Muslims. Although it is not possible to confirm the accuracy of this observation, Saturna's observation is significant nevertheless because it indicates a wide

appeal to investors beyond the Muslim community for funds that were avoiding financial stocks and heavily leveraged companies. A growing segment of the investing public appears to have seen this as the right direction for their investments, and it evidences some success with one of Islamic finance's long-term objectives, which is to have products that appeal not only to Shari'ah-compliant investors, but to the general population.

IMPACT ON ISLAMIC FINANCIAL INSTITUTIONS

How did Islamic financial institutions respond to the financial crisis and persevere during the downturn? They initially escaped some of the effects of the downturn because they were not loaded up with sub-prime debt and other toxic assets. They were not as affected as conventional financial institutions during 2007 and into early 2008. At about that time Moody's came out with a statement that Islamic financial institutions were resilient but were not immune, and some Islamic institutions in the Gulf have been subjected to ratings downgrades. Moody's also projected that the Islamic sector's annual growth rate of 25% to 30% would likely drop to 10% to 15% in 2009. So Islamic financial institutions did feel the impact of the global financial crisis, but that impact was a little delayed.

As problems escalated, however, Islamic financial institutions began to feel the effects more quickly and directly. When we consider the impact on Islamic financial institutions, we need to look at them in two ways: (1) as financiers providing finance to third parties, and (2), as equity investors, because Islamic financial institutions were often sponsors of equity investments in various transactions.

As financiers, most Islamic financial institutions have a significant exposure to real estate, more so than conventional financial institutions because of the limitations on the types of investments Islamic institutions are permitted to finance. As the real estate markets began to be impacted by sub prime problems and the evolving credit problems in the United States as well as globally, and as those problems spread to real estate markets in the GCC, especially Dubai, Islamic financial institutions that were actively involved in providing Shari'ah-compliant finance for home purchases and other real estate investments began to be affected as well.

As equity investors, or as sponsors of equity investments, Islamic financial institutions would pool equity money from their clients, and also invest some of their own funds, for the purpose of making equity investments in the United States, Europe, the Middle East and Asia. Most of

these investments were leveraged using Shari'ah-compliant financing structures.

What has been observed is that as real estate markets suffered a downturn, the investments sponsored by Islamic financial institutions also suffered, and the fact that they were Shari'ah-compliant in tenant composition or in financing structure made no difference.

There were other impacts on Islamic financial institutions that resulted from the financial crisis. Just as funds began to flow into Islamic mutual funds because of the safety perceived by investors in the avoidance of stocks of financial institutions and companies that were highly leveraged, funds in the nature of deposits also began to flow into Islamic financial institutions because it was thought that these institutions would not be holding toxic assets like conventional banks and were thus more secure. There was also the perception that these institutions were more conservative in their financing transactions. As a result of these perceptions, we saw a flow of deposits into Islamic financial institutions in the Gulf late last year and early into this year.

The same appears to be true in England, where the Islamic Bank of Britain, based in Birmingham, also reported a significant increase in deposits, most likely for similar reasons. I'm sure many of us, to the extent we had funds on deposit with banks, were thinking very carefully about the strength of those banks, and whether our deposits should remain there. I think the same thoughts were occurring in the Gulf and elsewhere as deposits flowed into institutions perceived as a safer bet, and some of those perceived safer institutions were Islamic banks.

Although this increase in deposits was a favorable development, there continued to be a mismatch between financial assets, which tend to be long term, and liabilities, which are typically short term deposits. This mismatch has been frequently commented on as one of the weaknesses of Islamic financial institutions. Conventional financial institutions obtain approximately 23% of their funding through long-term liabilities, while Islamic financial institutions are able to obtain only about 10% of their funding on a long-term basis. These funding limitations can create some risks and pressure for Islamic financial institutions.

Could an Islamic financial institution fail? Islamic financial institutions are not immune to the possibility of failure and people have speculated on when an Islamic financial institution might eventually fail. I am not aware of the outright failure of an Islamic financial institution, but that hasn't stopped discussion of the issues that could be raised as a result of such an event.

A number of the issues relate to the corporate and legal structure of the institution. Islamic financial institutions have shareholders that are like the shareholders of any other company. However, unlike conventional banks which have depositors, Islamic financial institutions don't accept deposits, the return of which is guaranteed, and they don't provide a fixed return on their deposits. Instead, Islamic financial institutions have investment accounts that pay a return to the account holder that is a function of the profitability of that institution.

If the institution makes money, the holder of an investment account will get a return on the investment. If the institution loses money, the holder will probably not receive a return on the investment, and may also suffer a loss of a portion of the original investment. So in some respects, an Islamic financial institution has two groups of stakeholders—shareholders and investment account holders—that both share the risk in the performance of the Islamic financial institution.

It is not entirely clear how the respective rights of these two groups of stakeholders would be sorted out, as both groups would be impacted by losses. It is a question of ongoing discussion—how to sort out the relative rights of the parties that have an interest in an Islamic financial institution. Answers to these questions will depend on the contracts that affect those rights, as well as the jurisdiction in which a bankruptcy takes place. So we should expect to have some interesting issues if and when an Islamic financial institution fails.

Many financial institutions have recently been the beneficiaries of governmental support or “bailout” schemes. Although there hasn't been a bailout program in the GCC that has been directed exclusively toward Islamic financial institutions, some of these institutions have benefitted from governmental support programs. In September and October of 2008, the UAE government made DH120 billion available to UAE banks, including Islamic financial institutions. The next month the UAE set up a bank to bail out Amlak and Tamweel, two large Shari'ah-compliant home mortgage financiers.

Additionally, the U.A.E.—really Abu Dhabi—came to the support of Dubai with the purchase of a \$10 billion bond to help Dubai satisfy its own debt obligations. Sovereign wealth funds in Kuwait and Qatar have helped financial institutions in both those countries. In addition, sovereign wealth funds of various GCC countries have been very active in supporting some of the financial institutions in the West.

Some of these sovereign wealth funds have suffered considerable losses arising from their recent investments in conventional Western fi-

financial institutions. With that background, one thing we might see in the coming months is whether the sovereign wealth funds are criticized for their support of conventional financial institutions and are pushed to support domestic financial institutions, including Islamic financial institutions should they should suffer problems.

There are five Islamic banks in England. Because they are of relatively recent vintage and are just now making their investments, they don't hold the historical assets now running into difficulty, and as a result they have performed fairly well. These banks are primarily funded by shareholders and depositors. They are not dependent on wholesale deposits, which have a tendency to evaporate quickly at the first sign of trouble. This has contributed to their stability.

So we see now that the sukuk market has been affected by the current financial crisis, mutual funds have been affected, and Islamic financial institutions have also been affected to an extent. Some effects have been positive, such the inflow of deposits into Islamic financial institutions, and some effects have been negative, such as the poor performance of some of the assets that have been financed by Islamic banks or in which Islamic banks have made equity investments. Despite these negative effects, the Islamic finance industry is expected to continue to grow at a rate of a 10% to 15% during 2009.

A SOURCE OF STABILITY?

Some government officials and commentators have espoused the view that Islamic finance is a force for stability. These officials and commentators claim that the spread of Islamic finance, which is asset-based and avoids speculative activity, can be a force for stability in markets and in economies. In their view, having Islamic financial institutions in the global economy can produce a positive impact and can be a mitigating force when we have a financial crisis of the type we are now experiencing.⁵

Some commentators have even seemed to be quite excited about the fact that the world's economy is in turmoil. One commentator holds the view that the sub prime crisis is the greatest gift one could have made to the Islamic banking sector: in his opinion, the crumbling of the U.S. fi-

5. Faisal Baatout, *Credit Crunch May Spur Islamic Financial System*, AGENCE FRANCE-PRESSE, <http://news.theage.com.au/business/credit-crunch-may-spur-islamic-finance-20081028-5ab3.html> (see specific comments by Yusuf al-Qaradawi).

nancial sector only points out the benefits of Islamic finance, which in his view is a basic, safe, simple and sturdy alternative. Another commentator believes that the current turmoil is not just an economic crisis and instead represents the collapse of capitalism based on usury and paper, and not on the trading of goods on the market. The collapse is proof that capitalism is in a crisis, and the contrast shows the Islamic economic philosophy is holding up. "We have all the wealth, the Islamic nation has all or nearly all of the oil, and an economic philosophy that no one else has."

Other commentators have taken a more cautious view. In their opinion, the Islamic economic system, in theory, offers a complete and solid system. In practice, however, they recognize that the Islamic banking experience is not yet mature, and as a result there exists a dependence on structures that, by their nature, are artificial, like murabaha.⁶

CURRENT CHALLENGES

What are some of the challenges that the Islamic finance industry currently faces? First of all, regulators contend that the industry needs a more proactive regulatory framework with the input of scholars, practitioners and government officials to help design and fill out the regulatory framework within which Islamic financial institutions operate. There is also a critical need for the continued development of human resources capable of effectively managing the business of Islamic financial institutions.

It is important as well to educate the consumer. Current problems in the United States demonstrate what happens when consumers do not understand or appreciate the risks involved in investment and financing transactions in which they are being encouraged to participate. Islamic structures can sometimes be complicated and may not be fully understood by the consumer. In these situations, consumers may have a tendency to rely on the Shari'ah advisor's approval and, while that is a start, it is not a substitute for having a clear understanding of the nature of a proposed transaction or investment, and the potential risks and benefits. The importance of a better understanding of Islamic financial products and investments cannot be emphasized enough.

Regulators have pointed out the need for Islamic financial institu-

6. Duncan Marvin, *Battle Begins to be the Asian Hub of Islamic Finance*, FIN. POST, Feb. 14, 2009 (see statements by Lord Edwin Hitti).

tions to diversify risks. They are generally concerned about a herd mentality among Islamic financial institutions. When one type of product or transaction works out well, there is a tendency among Islamic financial institutions to introduce or invest in the same type of product or transaction. Similarly, there may be a need to diversify away from real estate, which is always a big component of Islamic finance on both the financing and the equity investment side.

There continues to be a need for liquidity management, a need for corporate governance reform and greater transparency, and a need for a greater understanding of how decisions are made internally within an Islamic financial institution.

What is the direction that Islamic finance is taking? Some have wondered whether a convergence of the Islamic finance system with an interest-based system is desirable, or a mistake. Should these systems be heading in the same direction? Should there be an attempt to align these two systems, or should they develop separately and independently without reference to one another?

Does Islamic finance need to be integrated into the global financial system in order to achieve continued growth? Some are of the view that it should be integrated; that it is a force for stability. Others have said there is no need for it to be integrated. It can develop on its own, and it can grow at its own pace.

Overall, there is a need to avoid the development of products that are essentially imitations of conventional financial products. So whenever there is talk about the development of Islamic finance, it is important to remember that we need to continue to move away as much as possible from products that are designed to function exactly like a conventional interest-based product. That tendency is a significant part of what happens today in Islamic finance, but it is important that this tendency diminish as further research leads to the development of products that are more genuine.

What is the outlook of Islamic bankers? A recent survey of 50 Islamic finance professionals found that 83% believe that Islamic financial institutions will survive the crisis, and even benefit from it. This may well be the case. A 71% majority expect to see increased competition from conventional banks in the Islamic finance sector. A minority of 42% think that the Middle East is the natural center of gravity for Islamic finance, while 50% think it will be spread evenly around the world. Interestingly, 55% of the surveyed Islamic bankers think that sovereign wealth funds may soon begin looking at Shari'ah-compliant products.

To date, it is important to recognize that sovereign wealth funds for the most part invest, and finance their investments, on a conventional, interest-based basis. When people from outside the Middle East think about sovereign wealth funds, the first impression they have is that the assets of those funds are being invested on a Shari'ah-compliant basis. This is not the case at all.

DEVELOPMENT OF ISLAMIC TRANSACTION STRUCTURES

We have looked at how the Islamic finance industry and Islamic financial institutions have generally performed in the current difficult environment. I would now like to look now at the types of issues which have arisen when dealing with Shari'ah-compliant transactions that have run into difficulty. Do they behave any differently or in much the same way as conventional transactions?

The legal structures used in Shari'ah-compliant transactions are typically developed by lawyers and are based on the desires and the objectives of clients. It is important to realize that, as lawyers, we tend not to be the ones trying to push the industry forward in the sense of achieving loftier Islamic goals. We come into this with clients saying, "These are our objectives. This is what we are trying to achieve, and here are some of the rules that we have to live by in trying to achieve these objectives."

As lawyers, we take a very secular approach. We have another set of rules and regulations with which we must comply. It is another set of rules that have to be understood. We have to ask questions about the rules and appreciate the nuances of the answers, and we need to structure our transactions in a manner that achieves everyone's objectives.

This may sound self-serving, but it is also important to recognize that lawyers need to be brought into this process early on. Too often we are confronted with clients who have come up with a structure that they like, and at the 11th hour it is presented to the lawyers with a request that we make it Shari'ah-compliant. No prior discussions with the lawyers, no discussions with any Shari'ah scholars, just a request that a magic wand be waived over the structure so that it complies with Shari'ah principles.

That is not the way it should work. It is objected to by lawyers and it is objected to by the Shari'ah scholars who are put in a very awkward position of having to pass on transactions that they have not assisted in developing.

Ideally, when a transaction is undertaken, there should be a good-

faith effort to try to develop a Shari'ah-compliant structure that is genuine, that is robust, and that is authentic. Every effort should be made to stay away from the fallback structures unless a more genuine structure cannot be used.

We have found that when dealing with Shari'ah scholars, they are much more willing to approve a transaction if they can see that there has been a good-faith effort on the part of the parties to the transaction, including the lawyers, to come up with a structure that is more genuine, robust and authentic. If that effort has been made, they may be more willing accept a transaction structure that is a little less genuine, and that is a more open to question. This is why it is important to exercise good faith in designing and bringing these transactions to market.

It is also important, as U.S. lawyers, to recognize that Islamic finance is operating in a sea of conventional finance. There are no Islamic financial institutions in the United States, although there are some conventional financial institutions that provide Shari'ah-compliant products, mostly on a consumer level. This limitation affects the structure of non-consumer Islamic finance and investment transactions taking place in the United State and other Western countries.

When Gulf-based Islamic institutions raise capital to invest in the United States, they are typically seeking to make equity investments rather than provide a source of financing. The equity investments they propose to make will be Shari'ah-compliant, and they will need financing that is in compliance with Shari'ah principles. Structuring these equity investments and Shari'ah-compliant financing for these investments is an important part of the Islamic finance practice that takes place today in the United States. It is a wholesale, inbound, investment practice. The other aspect of Islamic finance in the United States is a consumer-based practice offered by close to 20 institutions that offer Shari'ah-compliant products.

If you are making an investment in the United States, such as a property investment or a corporate investment, the source of finance will be conventional U.S. financial institutions. There are, as mentioned before, no Islamic financial institutions in the United States and the Islamic financial institutions outside the United States have not yet gotten to the point where they are providing finance on a Shari'ah-complaint basis for transactions in the United States.

So the only source of finance is the existing U.S. financial markets, meaning you are dealing with banks or insurance companies that make loans. They don't buy property and sell it to customers at a mark up, they

don't buy companies and sell them to customers, they don't buy properties and lease them to their customers; they make loans. This is a fact that has to be dealt with in structuring any wholesale transaction to be financed on a Shari'ah-compliant basis in the United States.

This limitation results in the need to use intermediary entities so that the transactions are Shari'ah-compliant from the perspective of the client, but are conventionally financed transactions from the lender's perspective. In other words, a circle is drawn around the entity that is required to operate on a Shari'ah-compliant basis, and all the transactions in which that entity is engaged must satisfy Shari'ah requirements.

Looking at the bigger picture, however, there are conventional finance elements at the periphery. It is known that they are there; these features are not hidden. If Shari'ah-compliant financial institutions were in operation in the United States today, we might not have these conventional financing elements at the periphery of the transaction, but until that day, the best we can do is to work with the elements that are currently available to us. That is the state of where we are today.

This reminds me of a joke I heard about "Islamic beer." "What's Islamic beer," you ask? Well, you first approach the Shari'ah scholar and ask "Is it all right if I tie a rope to this door?" The scholar's response is, "Yes. There's no issue there. Go ahead and tie the rope to the door." Next you ask, "Well, is it all right if I lie on the floor?" The scholar responds, "I see no issue with that. You can lie on the floor." The next question to the scholar: "Is it all right if I tie a beer bottle to the end of the rope?" The scholar's response: "I suppose that's all right." With that permission, you tie a beer bottle to the end of the rope, you lie on the floor next to the beer bottle with your mouth open, you wait for somebody to open the door, the bottle is pulled over and the beer pours out into your mouth." That is Islamic beer.

People will look at these structures, and say, "What's the difference? Isn't that what is being done here? You know exactly what is happening and you are manipulating that situation to produce the desired result. You're just lying on the floor, opening up your mouth, and waiting for the beer to pour in." Well, I leave it to you to decide for yourself if this is the case.

The important point here is that the objective is always to try to develop more robust, genuine and authentic structures, and to avoid those structures that are more contrived, are more open to criticism, and frankly just not as good.

FINANCIAL CRISIS IMPACT ON ISLAMIC TRANSACTIONS

We've looked at the impact of the current financial crisis on the Islamic finance market generally, but what has happened on a deal-specific basis? Have Shari'ah compliant transactions responded differently than conventional transactions? Has enforcement been any different? Are there problems or issues that are unique to Shari'ah-compliant transactions in these situations? Most of our work has involved commercial and wholesale transactions rather than consumer transactions, so my remarks have the same focus.

As noted, Shari'ah-compliant transactions taking place in Western jurisdictions will almost always be indirectly funded by conventional, interest-based financing. A conventional lender will make an interest-bearing loan to a borrower (typically a special purpose company that is independently owned and is set up specifically for the transaction), and that borrower will use the proceeds of the loan to enter into the Shari'ah-compliant transaction with the operating company. Many of the substantive terms of the documentation of the Shari'ah-compliant transaction will be consistent with the terms applicable to the conventional loan. As a consequence of this underlying arrangement, most Shari'ah-compliant transactions will be subject to the same pressures as comparable conventionally-funded transactions. Defaults will take place at the same time, and the consequences of those defaults will be similar.

Foreclosure and enforcement of security arrangements will follow much the same process. The driving force in the enforcement of these transactions is the conventional bank that indirectly funded the Shari'ah-compliant structure with a conventional loan. Defaults under the conventional loan documents are almost always tied to defaults of the underlying operating company under the Shari'ah-compliant documents.

If the documents are drafted correctly (from a lender's perspective), the lender should be able to foreclose against its direct borrower (the company that entered into the Shari'ah-compliant transaction with the operating company) and then "stand in the shoes" of that borrower in relation to the Shari'ah-compliant documentation between that borrower and the operating company. We expect that a foreclosure proceeding initiated by the lender would seek to foreclose not only under the conventional documentation against the borrower, but would also seek to conduct a concurrent foreclosure proceeding on behalf of the borrower against the operating company. The feasibility of conducting both foreclosure proceedings concurrently will depend on the documentation and the local foreclosure procedures.

Even if the lender does not have the contractual or legal right to conduct concurrent foreclosure proceedings, it is likely that the operating company (the party to the Shari'ah-compliant transaction with the borrower) will seek to intervene in the foreclosure proceeding brought by the lender against the borrower. The Shari'ah-compliant documents and any lien they create on the property or collateral, will typically be subordinate to the documentation and liens for the conventional transaction, and upon a foreclosure of the conventional financing, the lender will often have the right to terminate the Shari'ah-compliant documentation and liens upon a completion of the conventional foreclosure (to the extent such foreclosure itself did not wipe out those subordinate liens). The investor would seek to intervene in the conventional foreclosure because of the potential impact on the Shari'ah-compliant arrangements. In any event, the worst case scenario from a lender's perspective is that they will have to go through an initial foreclosure on the conventional financing, and then follow that up with a second foreclosure on the Shari'ah-compliant arrangements. From the lender's perspective, the possible additional time and expense are undesirable consequences of the Shari'ah-compliant structure, but do not deprive the lender of the ultimate benefits of its arrangements.

If the lender decides that a work-out and restructuring is preferable to a foreclosure, the back-to-back, conventional and Shari'ah-compliant structure can sometimes complicate matters. Any restructuring will have to be implemented at both the conventional and Shari'ah-compliant levels, so the documentation is likely to be more extensive. Unusual or less common features or rights that are requested by the lenders in the context of a restructuring may not be readily replicated in the Shari'ah-compliant portion of the transaction, so a little creative structuring may be required, and that work will take additional time, increasing transaction expenses.

The restructuring of a transaction that has compliant and non-compliant components can be more complicated than the restructuring of a transaction that has only Shari'ah-compliant components. For example, if the investment is the development of a combined hotel and residential project in which the conventional investor has the entire interest in the hotel component and the Islamic investor's interest is limited to the Shari'ah-compliant residential component, the restructuring of such a project could involve combining the hotel and the residential units into a single entity to improve value. Accomplishing such a restructuring, in a manner that will satisfy the Islamic investor's need to remain uninvolved in the hotel unit and operations, if in fact feasible, could be problematic

and require a good dose of creativity.

Finally, one should expect that the financial institution providing the financing will be less receptive to Shari'ah considerations. The financing will typically have been assigned to the workout unit of the institution providing the financing, which means that the friendly representatives who were so pleased to be involved in structuring and closing of the financing for a Shari'ah-compliant investment will have been replaced by workout bankers whose main objective is to maximize the financial institution's likelihood and amount of recovery. The Islamic investor's Shari'ah considerations will be of little interest to these bankers, and requests to make modifications to the financing structure to accommodate those concerns will generally not receive much consideration. In these circumstances, the Islamic investor will need to be especially creative to develop a structure that satisfies and is consistent with the demands of the financial institution.

CONCLUSION

Islamic finance as an industry has held up well to the pressures of the current financial crisis, but has not been immune to those pressures. Some of the limitations applicable to the Islamic finance industry have stopped Islamic financial institutions from investing in assets that have later turned out to be toxic, and their avoidance of heavily-leveraged companies has been of benefit to them. On a transactional level, Shari'ah-compliant investments have responded in a manner quite comparable to conventional transactions, largely because the financing for those transactions is often indirectly funded with conventional financing. The restrictions applicable to Islamic finance—the requirement that investments and financings be tied to productive assets and the avoidance of speculative investments—will no doubt benefit Islamic finance during the current financial crisis and as the industry develops.

