Islamic finance and *sukuk* documentation

Rahail Ali
Hogan Lovells

1. Introduction

Islam places supreme importance on the sanctity of, and the value of documenting, a contract for legal certainty. The expectation should therefore be that Islamic finance documentation would by now be highly developed and easily adaptable to fit specific commercial scenarios. The history of Islamic finance documentation and current trends actually tell a different story. The perceived advantages of easily understood and readily accepted documentation forms are well known but too infrequently achieved. Those advantages include reduced transaction costs, avoiding delays, including limited referrals to (often very busy) *Sharia* scholars, and a general increase in confidence through contractual and consequently legal certainty. The conventional loan market has undergone a process of standardising various forms through initiatives by the likes of the Loan Market Association. The reality is that because loans are, in essence, contracts to evidence IOUs coming up with standard loan forms is an achievable aim. That aim is made easier to achieve as the conventional finance industry is premised on debt creation – risks are borne by the borrowers. Can't pay, won't pay considerations aside, loan documentation enables banks to get their principal plus interest and any grossing up of liabilities so that the banks' return on the credit provided is contractually assured.

Islamic finance is not debt-based, but is derived from a sale or investment. While practitioners speak of *murabaha*, *ijara* and so on as being financing forms, they are in essence contracts that can be structured to provide finance. An analysis of contracts in general in Islamic finance is essential. The structures that are used in Islamic financing can largely be split into two general groups, being sale-based methods and partnership-based methods. Sale-based methods include:

- an *ijara*, which is a sale and lease of an asset;
- a *murabaha*, which is a cost plus profit sale arrangement; and
- an *istina*, which is a structure used for the financing of capital assets by selling an asset to be constructed.

There are also a number of partnership-based methods where the principles of profit and risk sharing are strictly adhered to. These include:

- a *mudaraba*, which is a form of partnership between two parties where one party has the expertise to carry out an investment (the bank) and the other party has the money (the investor); and
- a *musharaka*, which is very similar to a joint venture or an unincorporated partnership.

http://www.pbookshop.com

Murabaha, *ijara* and their like may be called forms of financing, but they remain contracts that have been structured to provide finance.

2. Sanctity of contract

Before analysing how these contracts are structured to provide finance, consideration of the general sanctity of contracts in Islamic finance is vital. Sanctity of contract is not just about the parties to the contract keeping their promises; the proposition is deeper. Islam holds that a person's property is inviolable. It forbids the unlawful depletion of other people's property by way of theft, embezzlement, bribery and all other unlawful means of acquiring property and wealth. These prohibitions are in addition to the main prohibitions or *gharar* (uncertainty, risk or hazard), *riba* (interest) and *maisir* (speculation or gambling), which are considered means of usurping or depleting another person's assets.

The extortionate interest rates charged by 'pay day' loan companies in the UK are the easiest contemporary manifestations of what Islam seeks to avoid. A contract must fulfil the *maqasid al-sharia* (objectives or goals of *Sharia*) which will ensure fairness to, and welfare of, all parties. In addition, different transactions will have different requirements that need to conform to the tenets of *Sharia*. Those features that are common to all transactions and which are essential to the validity of all contracts (*'aqd*), whether of sale, lease, pledge, or any other form, are outlined below.

It is well established that the essential elements (*arkan*) that constitute a contract are the form (offer and acceptance), the parties and the subject matter of the contract. These *arkan* have been discussed and examined by *Sharia* scholars to provide proper guidance to the community. The absence of any of these *arkan* renders a contract invalid.

http://www.pbookshop.com

2.1 Subject matter

The object or subject matter of the contract must comply with the following requirements. It must:

- be legal, or *mubah*, and must not be *haram* (forbidden) nor not contain any reference to *riba*, *gharar*, *maisir*, or any other *haram* components;
- be in existence and clearly defined in terms of quantity, quality and value to avoid any issues of *gharar*, *jahal* (ignorance) or uncertainty and speculation;
- be free from any encumbrances such as pledge or fraud;
- fulfil the objective of the contract – perishable goods cannot be the subject of a pledge for example;
- be owned by, and in the possession of, the seller (*milkiyah*). If not, then it must be deliverable at the execution of the contract. It must be something that the buyer may possess (*hiyazah*) during the contract. For example, it is not permissible to sell property that has not yet been acquired.

The exceptions to these rules are the *salam* and *istisna* contracts which are allowed despite the fact that the subject matter of the contract does not exist at the time of the execution of the contract. But even in the case of *salam* and *istisna* the subject matter should be clearly defined in the contract. It is therefore important to

include in a contract a full description of the subject matter together with any issues that might affect the existence or non-existence of the subject matter, including non-possession as discussed above.

2.2 Parties

All transactions, in order to be valid and enforceable, must be based on the free mutual consent of the parties. Consent obtained through coercion, fraud or misrepresentation renders a contract invalid under *Sharia*. The parties must also have appropriate knowledge of the subject matter and terms of the contract and must have legal capacity (*ahliyah*) to enter into contracts, which includes being of sufficient age and having the requisite mental capacity.

2.3 Formation

A contract is valid when it involves an express offer (*ijab*) and acceptance (*qabul*). The offer should be in clear language and unconditional. The offer and acceptance must agree as to the subject matter and the consideration. The formalities surrounding the contract must be completed during the contractual session (*majlis al-aqd*). Offer and acceptance can be relayed by a number of means: by words (written or spoken), by gesture, by indication or by conduct. Any means that conveys the intent of parties with clarity is considered enough for the formation of a contract. However, the validity of implied contracts has long been debated by *Sharia* scholars, with some accepting it and others rejecting it.

2.4 Validity

A valid (*sahih*) contract is one that satisfies all of its conditions (including the requirements mentioned above and the absence of proscribed elements). The validity of a contract is based on this assumption. A contract will therefore be voidable (*fasid*) or void (*batil*) if it does not satisfy all of its conditions or is tainted by *gharar*, *riba* or any of the other elements forbidden by *Sharia*. Contracts that depend on some uncertain events or those which lack some material information, especially in relation to the subject matter, are considered *batil*. The distinction between *fasid* and *batil* is not entirely clear and varies between the *madhaheb* (school of religious legal thought).

2.5 Binding and non-binding contracts

Contracts are referred to as *lazim* (binding) or *ja'iz* (non-binding). *Lazim* contracts are those that can only be terminated by mutual consent, unless a unilateral right to revoke derives from an option (*khyiar al shart*) granted to a party by virtue of which the right to revoke can be exercised. A *khiyar-al-shart* will prevent a contract from being *lazim* until the expiry of the option. A contract is *ja'iz* if one of the parties has the right to revoke it without the consent of the other. Some contracts are inherently non-binding because both parties have the right to revoke it independently, such as contracts of agency (*wakala*), partnership (*shirkah*) and guarantee (*kafala*) which can be terminated by any of the parties. But if the parties mutually agree that none of them will be able to terminate the contract for a specific period of time, then the contract will not be unilaterally terminated until such period has elapsed. Examples

http://www.pbookshop.com

of *lazim* contracts are assignment (*hawala*), lease (*ijara*) and sale (*bai'*). Some contracts are non-binding until delivery such as those for loan (*qard*) and pledge (*rahn*).

2.6 Combination of contracts

A prohibition on combining contracts is triggered when such a combination is used as an excuse for hidden *riba*. According to Accounting and Auditing Organisation for Islamic Financial Institutions (AAOIFI) *Sharia* Standards, it is permissible to combine more than one contract in one set, without imposing one contract as a condition in the other and provided that each contract is permissible on its own, unless such a combination is prohibited on the basis of an exceptional *Sharia* restriction.

3. Comparison of Islamic finance structures and their conventional finance equivalents

A practical way of understanding Islamic finance documentation is to consider the principal provisions of the most commonly used Islamic financing structures and compare these to their conventional finance equivalents, with regard, in particular to how, in each of these structures:

- The financing is disbursed;
- Profit (and not interest) is made on the financing; and
- The principal is paid and, in the event of default, the financing can be called in earlier than the specified maturity, or accelerated.

3.1 Commodity *murabaha* compared to loan

In a conventional loan, following submission of a properly completed utilisation request, financing funds are disbursed directly to the borrower. Under a commodity *murabaha* the utilisation process is more involved. There are a few intermediary stages under which the bank purchases metal from a London Metal Exchange (LME) metal broker (to a value equivalent to the amount to be utilised under the facility) and then sells it as cost price plus profit under a *murabaha* contract to the borrower. The metal will be sold on to a second LME metal broker either by the bank as the borrower's agent or occasionally by the borrower directly to justify the disbursement of the facility to the borrower's account.

Profit is calculated either on a floating rate (benchmarked to the London Interbank Offered Rate, LIBOR, or the applicable currency equivalent) or a fixed rate. Profit is usually calculated on a floating rate basis. The practice of setting the *murabaha* contract profit by reference to an interest rate, whether fixed or floating, is a subject in itself. But, when all is said and done, the end result is a firm profit figure that is payable under the *murabaha* contract. The philosophical justification sometimes employed is that there is nothing wrong with a bank making a return at the same rate as it could make on a loan provided; critically, that it is done in a *Sharia*-compliant manner.

The *murabaha* contract sale price principal is paid either in specified instalments, which are agreed in advance of creating the *murabaha* contract, or in a bullet payment on maturity.

In the same way that a conventional loan may be accelerated, in the event of a continuing default, the bank may declare that the *murabaha* facility is cancelled and

http://www.pbookshop.com

any outstanding *murabaha* contract price amounts become immediately due and payable. The difference in a *murabaha* as compared to the conventional loan is that under a loan the bank will receive principal and accrued interest, whereas under a *murabaha* the bank will receive the full amount of the *murabaha* contract price – that price is agreed on making the *murabaha* contract and consists of both principal and specified profit. It is at the bank's discretion whether to give a rebate or *hibba* (gift) of any profit element that has not 'accrued' in conventional loan speak.

3.2 True (or trade financing) *murabaha* compared to trade finance

The procedural steps and basis for disbursement, payment of profit and repayment terms are the same in a true *murabaha* as the commodity *murabaha*. The principal difference being that a true *murabaha* must be a fixed rate profit product.

A true *murabaha* involves the purchase and sale of assets or commodities (such as manufacturing materials or soft tradable commodities such as sugar), and as such lends itself very well to being used in the international trade finance market.

A true *murabaha* transaction can be, and is readily, applied to:

- letter of credit based domestic trade financing;
- import financing; and
- export financing.

3.3 *Ijara* compared to sale and leaseback

The *ijara* and the conventional sale and leaseback model are economically similar. There are many aspects of the conventional sale and leaseback model that are inherently *Sharia*-compliant. It is therefore easy to see why the *ijara* model is so adaptable to asset financing in particular.

Under an *ijara* (as with a conventional sale and leaseback model) disbursement is by way of initial payment for an asset, which is later leased back to the seller (or its affiliate). The consideration for the asset purchase may be made in a single payment or may be made in instalments dependent upon the commercial deal.

Once the asset has been purchased it is leased back to the seller (who is also the borrower) and the lessee agrees to pay rental. The rental will be calculated as the sum of the principal amount (ie, the sale price) plus the bank's required profit on that principal amount, divided by the number of rental payment dates agreed between the parties. There may be additional components of the rental such as taxes and other charges. The rental components may be separated to allow for payment of the profit element at different times to the principal element.

In circumstances where, commercially, there is an acceleration of the debt (whether due to the existence of a continuing event of default or a change in the law making it illegal for the bank to continue to participate) the *ijara* will need to be terminated and the asset purchased by the borrower. The obligation on the borrower to purchase the asset in such circumstances is documented in a purchase undertaking, which is signed concurrently with the lease. The consideration to be paid by the borrower to the bank for the purchase of the asset in these circumstances will be equal to the amount of the initial purchase by the bank for the asset (the base amount) together with all outstanding rental payments.

http://www.pbookshop.com

Following the acquisition of the asset, the lessor and the lessee will enter into a lease agreement. The lease agreement contains the provisions one would expect to see in a conventional lease agreement, specifically corporate representations and warranties, undertakings and events of default.

The lessee will pay rent to the lessor typically in the form of:

- payment towards the cost price of the asset;
- a variable rate (typically calculated using a benchmark such as LIBOR and a margin), and
- a supplementary rent to set off any sums the lessor may be obliged to repay the lessee under the service agency agreement (discussed below).

The use of fluctuating profit rates poses a potential problem in an *ijara* financing. *Sharia* requires certainty of all repayment terms in advance. To mitigate this problem, the lease agreement will be structured as a master lease agreement and new leases are entered into at the end of each lease period, at which point the amount of rent may be fixed for the subsequent period.

It is important that the terms of the lease do not oblige the lessee to pay compound profit in the event of late payment. The majority of *Sharia* scholars do accept, however, that penalties for late payment may be levied on the lessee so long as payment of these amounts is made to a *Sharia*-compliant charity.

It is imperative that the terms of the lease do not begin to operate until after the lessor has obtained title to the asset. This is because *Sharia* forbids (with certain exceptions that are not covered by this article) the sale of an asset that is not yet in existence or not yet owned by the party dealing with it as owner.

In general, all expenses relating to the asset, including maintenance, are the responsibility of the lessor. Specifically, *Sharia* prohibits the divestment of the asset owner's responsibilities for major maintenance and insurance – *Sharia* considers that if the lessee were forced to carry out these duties the lessor (being the owner of the asset) would be unjustly enriched as a result. Consequently, the lessee and the lessor will enter into a service agency agreement under which the lessee will carry out the lessor's responsibilities to insure and to perform major maintenance, such as remedial structural work, to the asset on the lessor's behalf. As with a conventional lease, minor maintenance and operating expenses in relation to the daily maintenance of the asset will be the responsibility of the lessee.

The lessor, as legal owner of the asset, must bear the risk for total loss of or damage to the asset, unless it occurs as a result of misuse or negligence by the lessee. If there is a total loss resulting in the inability of the lessee to use the asset for its intended purposes, the lease will terminate and the obligation for the lessee to pay rent will cease. Therefore, it is essential that a comprehensive insurance policy is obtained, and that the lessee (as service agent) observes its conditions – 'hell or high water' type provisions therefore do not apply to *ijara* leases. In the event that the asset is destroyed and the lessee is found not to have complied with its obligations under the insurance policy, including procuring that a payment under the policy is made within a particular amount of time, the lessee will be required to pay the relevant insurance proceeds under the service agency agreement.