

# INNOVATIVE FINANCE NEWS



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An Islamic Finance Primer

GARDINER ROBERTS LLP INNOVATIVE FINANCE GROUP APRIL 2011 V2, N1

This is the third issue of the Innovative Finance News, the newsletter of the Innovative Finance Group of Gardiner Roberts LLP. Each issue of our newsletter has focused on an area of acute interest to our clients and contacts. The first issue discussed SR&ED tax credits (get them before they're gone) and the second discussed prospectus exemptions in Ontario. In this issue, we discuss the cutting edge topic of Islamic finance. I hope you will find this article to be both interesting and informative. (Previous issues of the Innovative Finance News are available upon request. Just email or call me at the contact particulars below.) Gardiner Roberts LLP has extensive experience in the Islamic finance field. Feel free to contact us in this regard.

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## AN ISLAMIC FINANCE PRIMER

**BY WILLIAM P. LAMBERT  
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### INTRODUCTION

Shariah law, the legal and ethical code of Islam, prohibits investment in areas involving gambling, alcohol, pork and pornography and transactions involving explicit interest. Islamic finance largely consists of designing instruments that comply with the formal requirements of Islamic law, while at the same time bearing all the economic attributes of the conventional financial system. With the extreme wealth accumulating from petro resources in the Middle East, and the growing number of Islamic bonds in Malaysia and elsewhere, western banks, financial institutions and other businesses are looking towards Islamic finance in order to tap this growing pool of capital.

### WHAT IS ISLAMIC FINANCE?

The theories behind Islamic finance have been in place for centuries, but the Islamic finance sector only really gained momentum after the oil boom of the 1970s flooded the Middle East with wealth. Lending transactions under Islamic law are based on the concept of asset backing and specific credit participation in identified business risk. Islamic finance is governed by the Shariah,

which bans interest and stipulates that income must be derived as profits from shared business risk rather than guaranteed return. Therefore, the Islamic financial model works on the basis of risk-sharing and, as such, the customer and the bank share the risks and the profits of any investment.

Shariah is the legal and ethical code of Islam, which is based on the Quran and the Sunnah. The Quran is the holy book of Islam, which Muslims believe was provided to Muhammad by God through revelation. The Sunnah is the philosophy of the way of life of the prophet Muhammad, which serves as a model for Muslim conduct. The sayings of the prophet Muhammad, referred to as Hadith, which provide information about the Sunnah, were recorded in the two centuries following Muhammad's death.

### ISLAMIC FINANCIAL INSTRUMENTS

Many Islamic financial instruments have been developed over the years, which are essentially the Shariah compliant versions of the conventional asset based, equity based and debt based forms of financing. Both debt and asset-based contracts are initiated by a temporary transfer of existing assets from the borrower to the lender or the acquisition of third party assets by the lender on behalf of the borrower. Equity based contracts are more conventional. The most popular Shariah based contracts are known as Murabahah, Mudarabah, Musharakah and Al-Ijara.

## Murabahah (Debt Financing)

The most prominent form of Islamic debt-based financing arrangement is the Murabahah. In this structure the lender either purchases an asset held by the borrower and sells it back to the borrower at a markup or it purchases a tangible asset from a third party and sells it to the borrower at a higher price. The borrower usually pays the total cost of the asset to the lender in installments with the difference in the purchase price of the two back-to-back transactions resembling the conventional interest that would apply in a conventional loan transaction.

## Mudarabah ("Sweat" Equity)

Mudarabah is a form of an Islamic equity-based investment instrument. In a Mudarabah arrangement, the financier (*rab-ul-maal*) provides the entire capital required to finance the project, while the entrepreneur (*mudarib*) provides the expertise and labour. The entrepreneur shares equity ownership with the financier and the profits (or losses) from the project are shared between the financier and the entrepreneur at a predetermined ratio. Financial losses are borne exclusively by the financier, as the entrepreneur is obligated to repay the original amount of the loan only if the project has been profitable. The liability of the entrepreneur is therefore limited to his time and effort, except when losses are suffered due to the entrepreneur's misconduct, negligence or violation of the conditions mutually agreed to by both the financier and the entrepreneur.

There are two sets of contractual relationships applicable to this structure. The financier obtains funds from depositors pursuant to a contract known as unrestricted Mudarabah. Depositors agree that their funds may be used by the financier, at its discretion, to finance an open-ended list of potentially profitable investments and they expect to share with the financier the overall profits accruing to the financier's business. The second set of contractual arrangements, between the financier and the entrepreneur, is known as restricted Mudarabah. The financier agrees to finance a specific project carried out by a specific entrepreneur and to share any profits according to a certain percentage.

Three conditions must be met in the Mudarabah structure. First, the financier should not reduce credit risk by obtaining collateral and it must bear entirely and exclusively all the financial risk. However, collateral may be requested to reduce moral hazard, such as misconduct by the entrepreneur. Second, the rate of profit belonging to each party must be determined strictly as a percentage and not as a lump sum. Third, the entrepreneur should have the absolute freedom to manage the business. Mudarabah is usually employed in investment projects with short gestation periods and in trade and commerce. The structure may include a promise on behalf of the "borrower" to buy-out the financier after the completion of the project.

## Musharakah (Joint Venture)

Musharakah is another Shariah compliant equity-based investment structure, which resembles a conventional partnership. In this arrangement, unlike in Mudarabah, the financier is not the sole provider of funds to finance the project, as both the financier and the entrepreneur jointly contribute funds to an existing or future project. Ownership is shared in accordance with each party's financial contribution to the project. Profits and losses are shared strictly in relation to the respective capital contributions. Although profit sharing is similar to a Mudarabah contract, losses are generally borne according to equity participation. Musharakah contracts are usually employed to finance long-term investment projects.

## Al-Ijara (Long-Term Financing)

Al-ijara structures are analogous to conventional operating and finance leases. In these arrangements the lender acquires the asset either from the borrower (operating lease) or a third party at the request of the borrower (financing lease) and leases it to the borrower for an agreed sum payable in installments according to an agreed schedule. Legal title to the asset remains with the lender for the duration of the transaction and the borrower is provided with an option to (re)purchase the asset from the lender. While the borrower bears the costs associated with the use of the asset, all the costs associated with the ownership of the asset are borne by the lender.

In financing leases, where the asset is acquired from a third party, the lease payments might also include a portion of the agreed repurchase price, which allows borrowers to gradually acquire total equity ownership at a predetermined sales price (an Islamic mortgage). In an operating lease with a repurchase obligation, at the end of the lease term the asset is returned to the borrower for the original sale price or the negotiated market price, unless otherwise agreed by the parties.

## INTERNATIONAL GROWTH OF ISLAMIC FINANCE

Shariah scholars around the world have different interpretations of the Shariah rules and therefore there are no universal international Shariah compliant products. For example, in April, 2007, Suria Capital Holdings Bhd, a Malaysian state-run property developer, sold 80 million ringgit (\$23 million) of sukuk, Islamic financial certificates, that would not be accepted in the Persian Gulf. Further, regulatory differences in different regions prevent true cross-border Islamic banking and links between the two biggest Islamic banking hubs in Malaysia and the Gulf remain at a nascent stage.

In spite of the absence of an international standard in Islamic financial instruments, the world is witnessing a global movement by governments, banks and financial sectors towards this segment, which is one of the fastest growing segments of the financial services

industry. With Britain's 100-percent Islamic bank, the Islamic Bank of Britain, and Britain's first Shariah-compliant insurance company launched in 2008, London currently ranks as one of the leading Islamic banking centres in the West. In the 1990s, Islamic finance was a fledgling fringe industry, but today, it has grown from roughly US\$150 billion to about US\$1 trillion in size. Today, there is approximately US\$800 billion in Islamic banking funds, US\$100 billion in the sukuk market and another US\$100 billion in takaful (Islamic insurance) and fund management business.

After September 11, 2001, by some estimates, as much as \$800 billion in Arab money moved from the U.S. and Europe to other regions, much of it being invested in the Islamic banks of the Middle East. As a result, some leading world banks, such as HSBC, have established Islamic banking arms in the Middle East. Other banks, such as Lloyds TSB Group PLC and Deutsche Bank AG, are offering Islamic finance products. In Canada, RBC Capital Markets has established a Shariah Finance Group and Bank of Montreal is managing Shariah-compliant products for Middle Eastern clients through its London institutional management group, Pyrford International.

## CONCLUSION

The Muslim population in Canada has grown from 253,000 in 1991 to an estimated 750,000 to one million in 2007. Along with this population growth there has been growth in demand for Shariah compliant financial products. By 2017, Muslims are expected to comprise between 3.7% and 4.9% of Canada's population, which should provide a tremendous opportunity for financial firms prepared to serve this growing market. Toronto, the financial services capital of Canada and one of North America's premier financial centres, is also experiencing a rapid growth in its Muslim population. In response to the correlating growth in demand for Islamic financial products, the Toronto Financial Services Alliance, a public-private partnership developed by the City of Toronto and its financial cluster, has created an Islamic Finance Working Group with the goal to make Toronto the North American centre for Islamic finance.

Shariah compliant mutual funds, auto Takaful (insurance) products and Islamic mortgages have been multiplying across Canada. UM Financial, one of Canada's premier Islamic financial institutions, offers RRSPs, RESPs and home financing. UM services a \$120 million home finance portfolio that was offered through a Mudarabah financing agreement with Credit Union Central of Ontario. In addition, two mutual fund groups, FrontierAlt and Global Prosperata, have launched mutual funds that are designed to hold only investments that are Islamic commercial law compliant.

Canada is a desirable location for Islamic financial institutions. The global Islamic finance leader at Deloitte Corporate Advisory Services Sdn. in Kuala Lumpur, predicts that by 2013 a handful of Ca-

nadian companies will sell close to C\$1 billion of Islamic debt. The head of debt capital markets at Qatar Islamic Bank SAQ recently expressed an interest in investing in Canada and HSBC Bank Canada is considering offering \$500 million of sukuk. In addition, three Canadian government-related borrowers are considering issuing \$1.5 billion of sukuk. 

A footnoted version of this article is available on request.

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This article was originally published in the November, 2010 issue of the Catalyst, a York Biotech publication. Further information about York Biotech can be found by accessing their website: [www.yorkbiotech.ca](http://www.yorkbiotech.ca).



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## GARDINER ROBERTS LLP – INNOVATIVE FINANCE GROUP

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