

Legal and Risk Aspects of Islamic Banking Products

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KING & SPALDING

Agenda

- **From Paradigm shift to Coming of Age**
 - Brief Overview of the Islamic Finance industry
 - Brief Overview of Sukuk industry
- **Legal and Risk Aspects**
 - Risk allocation in Islamic Finance Products
 - *Shari'ah*-compliance/*Shari'ah* Board
 - *Shari'ah* v/s. contractual law
 - Legal and risk issues arising from *Sukuk* transactions
 - *Sukuk* and Bonds compared
 - Asset Backed v/s. Asset Based
 - Regulatory implications
- **The Judicial Approach**
 - *Shari'ah* v/s. contractual law

From Paradigm Shift to Coming of Age

THOMSON REUTERS

no.203.078

2010

Islamic Finance



While it was widely expected that Abu Dhabi would step in once again, the government of Dubai was Nakheel's saviour last week, ahead of its May 13 sukuk payment of \$980 million. Under the terms of the restructuring proposal, Nakheel will now be wholly owned by the Dubai government.

A Nakheel default would have served as another black eye for the Islamic finance industry, which experts said was already unfairly blamed for Dubai World's credit woes.

From Paradigm Shift to Coming of Age

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2012

Islamic Finance



When a natural gas producing company in the United Arab Emirates missed repaying a \$920 million Islamic bond last week, it became the first UAE company to fail to redeem a bond on time. But the region's debt market barely blinked.

Yields on some firms' outstanding Islamic bonds, known as sukuk, dropped to fresh record lows as investors continued pouring money into them. Other companies laid plans for new issues of sukuk.

The incident underlined the extent to which the Gulf's Islamic debt market, which is playing an increasingly important role in funding companies, has strengthened in the past year. Not long ago, a billion-dollar payment miss would have triggered a crisis of confidence in the market; now, it is almost ignored.

"The market has matured enough to appreciate that this is not a sukuk or Islamic finance issue but rather a credit issue," said **Rizwan Kanji**, debt capital markets partner at law firm **King & Spalding** in Dubai.

"After the potential defaults a few years ago, the market's reaction initially was that sukuk didn't work and as a result the market reacted negatively. Fast forward three years and we're in a similar scenario but the market has reacted differently. You're not seeing the headlines screaming that Islamic finance doesn't work."

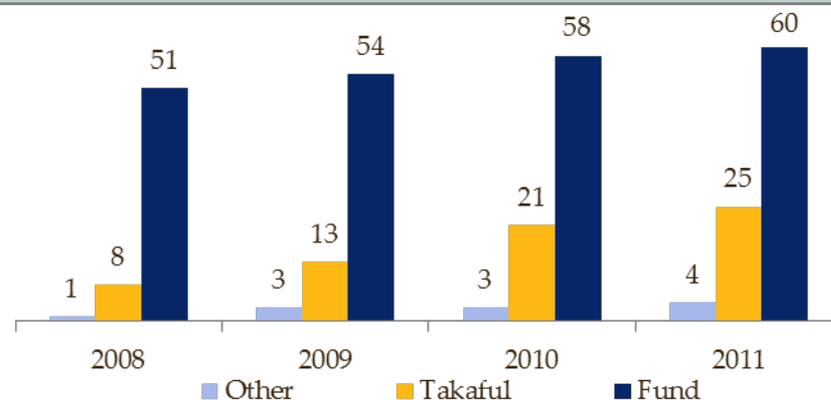
Brief Overview of Islamic Finance Industry

Global Banking assets of under Islamic Finance

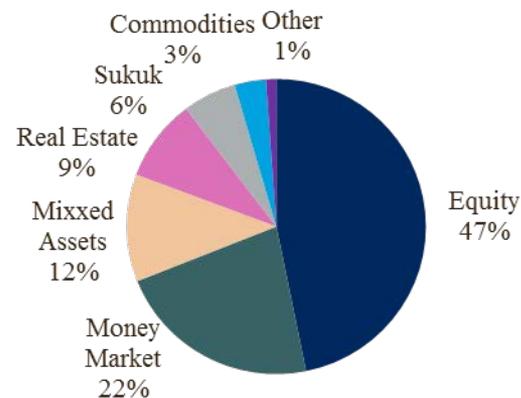


- Though, Islamic Finance assets form merely 1% of global finance assets, they have grown at a CAGR of 20% over past 5 years
 - Banks accounted for 93% of the total Islamic assets in 2011
- Assets are concentrated in Malaysia (12.3%) and GCC countries Saudi Arabia (13.9%), UAE (8.7%), Kuwait (7.3%), Bahrain (5.3%) and Qatar (4.8%)
- The takaful (insurance) segment is in early stage of development, with global aggregate premium of USD 16.5bn earned in 2011

Shariah Compliant Funds and Takaful Assets – USD bn



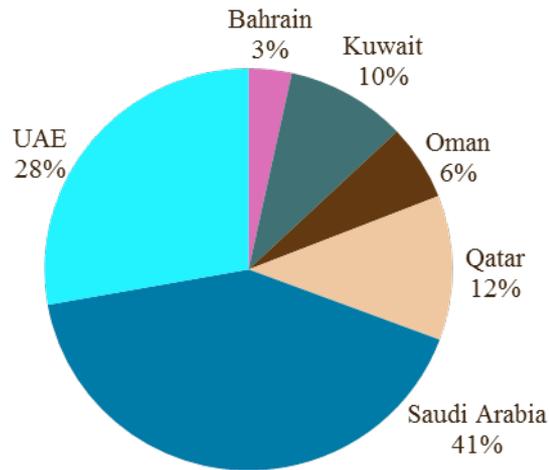
Islamic Funds by Asset Class of AUM, (December 2011)



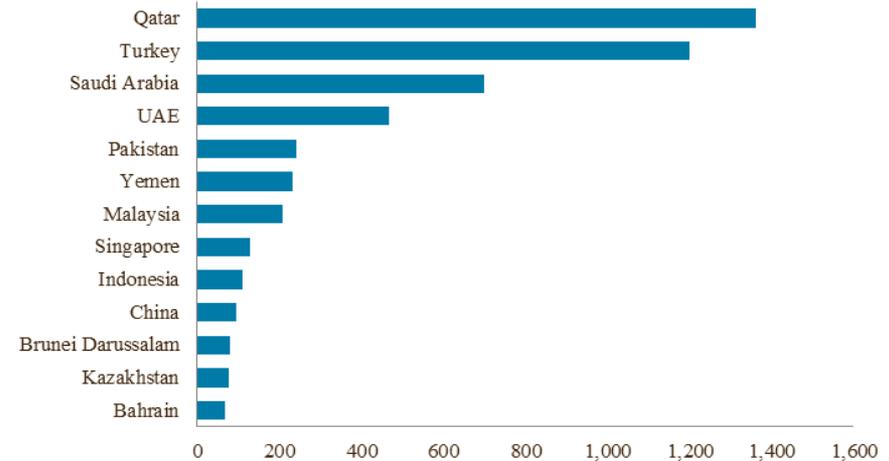
Brief Overview of Islamic Finance Industry (con't.)

■ The future prospects

Share of USD 1.9tn of Projects Underway (as on Sep 2012)



Average Issue Size of Sukuk by Country (USDm) – 2012



- Capital expenditure in GCC and Asian economies is expected to remain high over the coming years
- Recently increasing cross-border Sukuk issuance will increase avenues for raising capital
- Sukuk is expected to fund much of the capital demand, as growth in Bank deposits is inadequate to fund lending growth
- Recent decline in interest rate encourages corporations & banks to issue Sukuk

Brief overview of Sukuk Industry

- Significant market liquidity available for sukuk
- Global sukuk issuance in Q4 2012 up 41% from same period last year
- USD 139bn of sukuk, an all time high, issued globally in 2012, up 65% from 2011
- E&Y estimates demand to be 3x of supply
- Global sukuk market is expected to reach USD 292bn by 2016 as per Thomson Reuters report
- Turkey sovereign issued a Sukuk and many other sovereigns currently considering

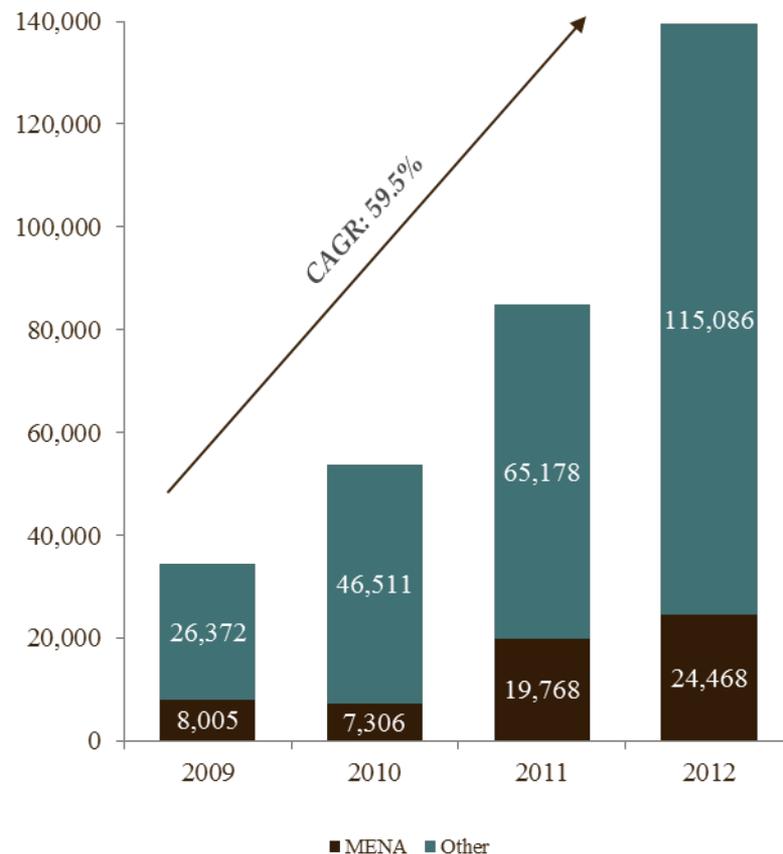
Advantages of Sukuk Issue

- Pricing advantage vs. conventional bonds
- Access to a wider (& diversified) investor pool
- Raises profile of issuer therefore assisting future funding
- Commercial terms and disclosure requirements similar to bonds
- Tenor now extend up to 10 years (USD)

Considerations

- Longer lead time relative to conventional bonds
- Need to ensure availability of Shariah-compliant assets
- Use of proceeds for Shariah compliant activities

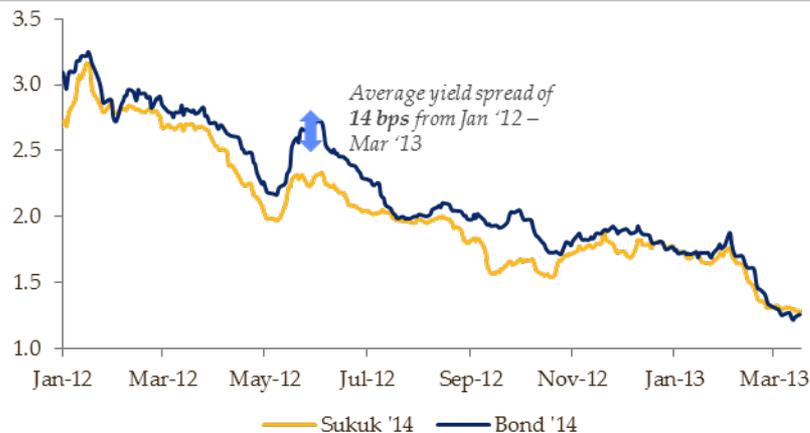
Global Sukuk Issuance (USDm)



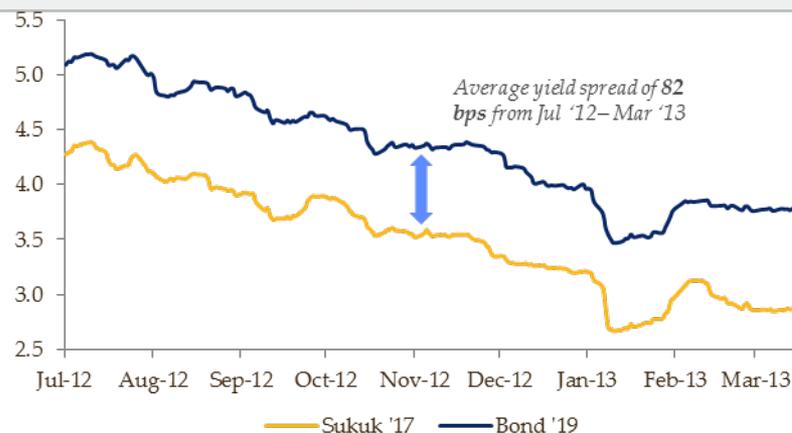
Brief overview of Sukuk Industry

■ Pricing Competitiveness of Sukuk

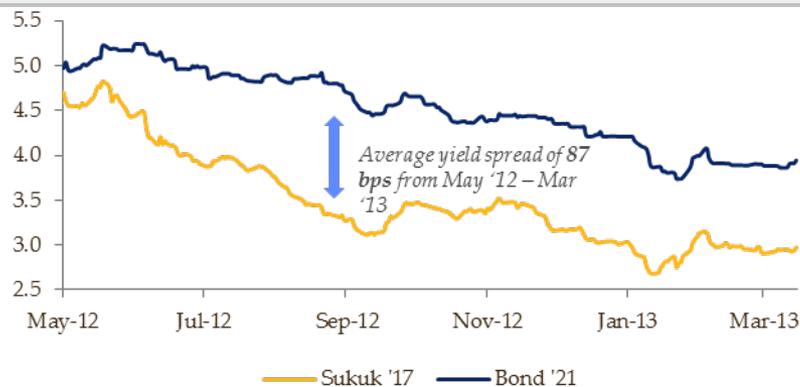
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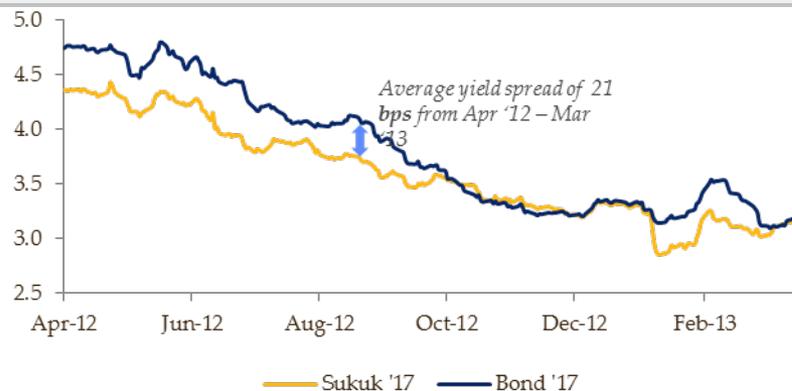


Dubai Sovereign



Note: The 2021 bond has a put option in year 5 (2017)

Emirates NBD



Note: The sukuk has been issued by Emirates Islamic Bank, a subsidiary of Emirates NBD

Brief overview of Sukuk Industry

■ Geographical Spread

Sovereign Issuers

- Dubai
- Bahrain
- Qatar
- Yemen
- Pakistan
- Gambia
- Singapore
- Malaysia
- Indonesia

Quasi-Sovereign Issuers

UAE

- JAFZA
- Nakheel
- RAK Capital
- DEWA
- DCAA
- TDIC

Germany

- Saxony-Arnhalt

Malaysia

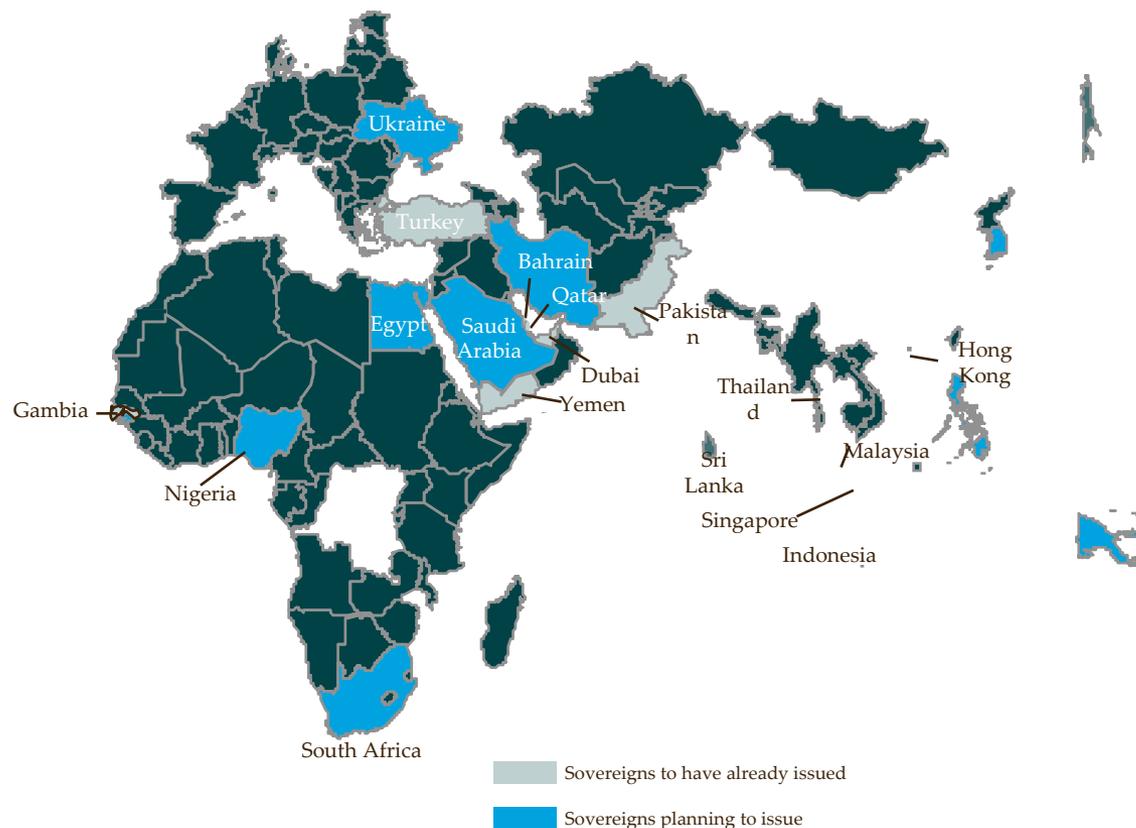
- Telekom Malaysia
- Malaysia Airport
- PLUS Toll Road
- Petronas

Saudi Arabia

- GACA
- SECO

Pakistan

- WAPDA Power
- PIA



Supra-National Issuers

- Islamic Development Bank
- IFC



Legal And Risk Aspects

Risk Allocation in Islamic Finance Products

- Sharing of risk and reward
- Risk allocation is different from conventional
- Islamic Finance derives returns from underlying *Shari'ah* compliant assets (cash flows)
- Risk allocation may be (i) corporate risk (asset based) (ii) underlying asset risk (asset backed)



Legal And Risk Aspects

Shari'ah Compliance & Shari'ah Boards

- *Shari'ah* compliance
 - different school of jurisprudence – different interpretation
 - consistency of *Shari'ah* scholars (Scholar shopping)
 - standardisation
 - continuity of *Shari'ah* compliance post transaction
 - limited number of scholars – continuity of this key service in the future



Legal And Risk Aspects

Shari'ah Compliance & Shari'ah Boards

- *Shari'ah* Board
 - Key supervisory institution within *Shari'ah* compliant entity
 - Populated predominantly by scholars
 - Same scholars across a number of boards
 - Other professionals to be included e.g. economists; lawyers and etc.

Legal And Risk Aspects – Regulatory Capital

Risk allocation and capitalisation of Islamic FI

Shari'ah-compliant banks face a religious prohibition on holding certain types of assets, such as interest-bearing debt securities. Even in jurisdictions that have a sufficient supply of HQLA, an insurmountable impediment to the ability of Shari'ah-compliant banks to meet the LCR requirement may still exist. In such cases, national supervisors in jurisdictions in which Shari'ah-compliant banks operate have discretion to define Shari'ah-compliant financial products (such as Sukuk) as alternative HQLA applicable to such banks only, subject to such conditions or haircuts that the supervisors may require. It should be noted that the intention of this treatment is not to allow Shari'ah-compliant banks to hold fewer HQLA. The minimum LCR standard, calculated based on HQLA (post-haircut) recognised as HQLA for these banks, should not be lower than the minimum LCR standard applicable to other banks in the jurisdiction concerned. National supervisors applying such treatment for Shari'ah-compliant banks should comply with supervisory monitoring and disclosure obligations.

- UK regulatory authority permitted Islamic FI in the UK to invest in Islamic Development Bank Sukuk – as HQLA

Legal And Risk Aspects *In relation to Sukuk*



Legal And Risk Aspects

Bonds and *Sukuk*: a comparison

Definition of a bond and Sukuk

Bond: In the simplest form, a bond is an instrument containing or evidencing the contractual debt obligation on part of the issuer

***Sukuk*:** In the simplest form an ‘Islamic bond’ (like a trust certificate). However, the claim is not simply a financial claim to the cash flow but an ownership claim

Legal And Risk Aspects Bonds and *Sukuk*: a comparison

	Bonds	<i>Sukuk</i>
Nature	Debt of issuer	Not a debt of issuer but undivided ownership share in specific assets/projects/services
Asset based	Generally not required	A minimum of percentage of tangible assets (or their contracts are required to back/based issuance of <i>sukuk al-jarah</i>)
Claims	Creditors claims on the borrowing entity, and in some cases liens on assets	Ownership claims on the specific underlying assets/project/service and so on
Security	Generally unsecured debentures except in cases such as first mortgage bonds, equipment trust certificates and so on	Secured by ownership rights in the underlying assets or projects in addition to any additional collateral enhancements structured
Principal and return	Guaranteed by issuer	Not guaranteed by issuer
Purpose	Can be issued for any purpose	Must be issued only for Islamically permissible (halal) purposes
Trading of security	Sale of a debt instrument	Sale of an ownership interest in a specific asset/project/service and so on



Legal And Risk Aspects Classification of *Sukuk*

- *Sukuk* may be classified as:
 - in accordance with the underlying Islamic structure
 - ‘asset based’ or ‘asset backed’

Legal And Risk Aspects Classification of *Sukuk* (con't)

Asset Backed

- *Sukuk*-holders have recourse to the *Sukuk* asset (true sale of)
- In the event of default *Sukuk*-holders would be able to recover their exposure by realising value from the *Sukuk* assets
- *Sukuk*-holders will be in a preferential position over other unsecured creditors
- Securitisation elements
 - True Sale – reflected in the originator's accounts (i.e. part with asset)
 - Bankruptcy remoteness – event of insolvency creditors cannot claw back assets sold to SPV Issuer
 - Enforceability
- The credit risk in Asset Backed *Sukuk* is performance and credit quality of underlying asset



Legal And Risk Aspects Classification of *Sukuk* (con't)

Asset Based

- *Sukuk*-holders have recourse to the originator (via purchase undertaking) and no recourse to the underlying assets
- In the Event of Default/termination/maturity *Sukuk*-holders have no rights over the *Sukuk* assets and rely wholly on the Originator's credit worthiness for repayment
- If the Originator is unable to meet obligation to repurchase the *Sukuk* assets - the *Sukuk*-holders are in no preferential position *vis a vis* creditors of the Originator and are considered unsecured creditors i.e. purchase undertaking ranks *pari passu* with any other creditors of the senior unsecured creditors

Legal And Risk Aspects Classification of *Sukuk*

	Asset Backed (Secured)	Asset Based (Unsecured)
Ownership of Asset	<ul style="list-style-type: none"> • Ownership of the underlying assets passes to the Issuer (held on trust for <i>Sukuk</i>-holders) • The sale is reflected in the accounting books of originator 	<ul style="list-style-type: none"> • Ownership of the underlying assets remain with Originator • The assets are still reflected in the originator's accounting books
Event of Default	<ul style="list-style-type: none"> • In the event of default <i>Sukuk</i>-holders have recourse to the underlying assets • <i>Sukuk</i>-holders can dispose of the assets to recover the amount outstanding (subject to enforceability) 	<ul style="list-style-type: none"> • In the event of default <i>Sukuk</i>-holders have NO recourse to the underlying assets • <i>Sukuk</i>-holder recourse lies in enforcing the contractual right of action
Credit Risk	<ul style="list-style-type: none"> • The credit risk for <i>Sukuk</i>-holders is the value and performance of the underlying assets 	<ul style="list-style-type: none"> • The credit risk for <i>Sukuk</i>-holders is the creditworthiness of the originator (corporate risk)
Insolvency of Originator	<ul style="list-style-type: none"> • General creditors unable to claw back the assets • <i>Sukuk</i>-holders are secured creditors (bankruptcy remoteness) 	<ul style="list-style-type: none"> • <i>Sukuk</i>-holders will be unsecured creditors will rank at least <i>pari passu</i> with all other unsecured creditors

Legal And Risk Aspects Summary

- To appreciate risk allocation differences between conventional and Islamic Finance products
 - Understand the underlying Islamic structure
- Risk as a result of additional layer in Islamic Finance products
 - *Shari'ah* compliance/Scholars
- Enforceability
 - Islamic Finance documents need to be enforceable under conventional legal structures



The Judicial Approach

- Choice of governing law – NOT *Shari'ah* law
 - *Shamil Bank of Bahrain v Beximco Pharmaceuticals*
 - “*Subject to the principles of the Glorious Shari'ah, this Agreement shall be governed by and construed in accordance with laws of England*”
 - *Beximco* defaulted under the *Murabaha* Agreements and raised the following:
 - (i) The finance documents were valid and enforceable under both *Shari'ah* law and in accordance to with English law;
 - (ii) Construction of the governing law clause had the effect that English law was governing law but stipulating a conditions precedent that contract enforceable only if consistent with *Shari'ah*



Legal And Risk Aspects *Shari'ah* versus Contractual Law

- The High Court and Court of Appeal held:
 - (i) Reference to “*Glorious Shari'ah*” merely reflected the Islamic religious principles to which the bank held itself as doing business. Not designed to trump the application of English law
 - (ii) There could not be two separate systems of law governing a contract. Rome convention indicates choice of law of a country, not a non-notional system of law such as *Shari'ah*

Legal And Risk Aspects *Shari'ah* versus Contractual Law

- *Islamic Investment Company of the Gulf (IICG) v Symphony Gems NV & Others*
 - IICG entered into Murabaha Agreement with Symphony Gems.
 - Agreement was subject to English law and jurisdiction of English courts and provided “*the purchaser wishes to deal with the seller for the purposes of purchasing supplies under this agreement in accordance with Islamic Shariah*”.
 - A dispute arose as to who took the risk of a failure to deliver. Under Sharia law (and according to the principles of a *Murabaha*), the risk of a failure to deliver falls on the IICG in as it receives a profit for accepting that risk.
 - However, contract provided risk differently and judge held that “*...it is a contract governed by English law. I must simply construe it according to its terms as an English law contract*”.

Conclusion

King & Spalding

Global Firm

- King & Spalding (“**K&S**”) is a Global 50 law firm with more than 850 lawyers based in 17 offices in the United States, Europe, Asia and the Middle East with business in more than 100 countries across six continents.
- K&S currently represents more than 250 public companies, including half of the Fortune 100 and, in corporate counsel surveys, K&S has been consistently named among the top firms representing Fortune 250 Companies.
- K&S represents 10 of the 25 largest bank’s in the world.

King & Spalding was awarded 28 practice area rankings in *Chambers Global 2012*. In addition, 43 King & Spalding lawyers earned 68 listings in the guide identifying them as leaders in their respective fields.

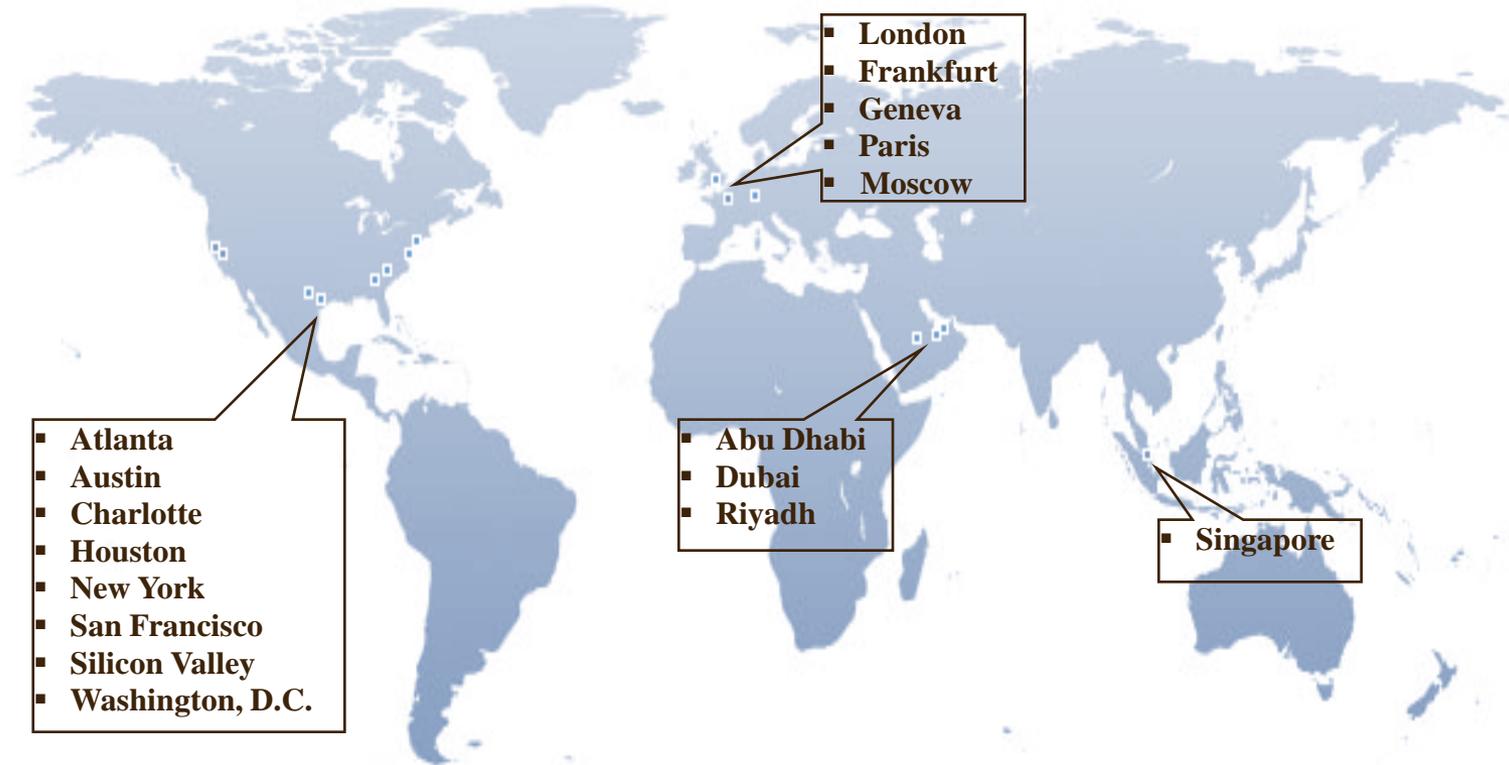
Practice Areas

- K&S is a full service law firm with leading practices covering both conventional and Islamic including, energy, asset finance (shipping and aviation), finance and debt capital markets.
- K&S has a global leading debt capital markets practice advising on both conventional and Islamic debt issuances. The firm has been involved in a number of first of its kind land mark transactions.

Award Winning Practice

- ‘**Deal of the Year**’ for the sovereign Kingdom of Bahrain Sukuk (*Islamic Finance News Awards 2008*).
- ‘**Deal of the Year**’ for the KT Turkey Sukuk Limited Sukuk (*Islamic Finance News Awards 2010*).
- ‘**Sukuk Deal of the Year**’ for the KT Turkey Sukuk Limited Sukuk (*Islamic Finance News Awards 2010*).
- ‘**Turkey Deal of the Year**’ for the KT Turkey Sukuk Limited Sukuk (*Islamic Finance News Awards 2010*).
- ‘**Europe Deal of the Year**’ for the AK Bars Bank transaction (*Islamic Finance News Awards 2011*).
- ‘**Turkey Deal of the Year**’ for the KT Sukuk Varlik Kiralama A.S. Sukuk (*Islamic Finance News Awards 2011*).

Our international practice



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