THE ISLAMIC FINANCE AND MARKETS LAW REVIEW

THIRD EDITION

Editors
John Dewar and Munib Hussain

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Published in the United Kingdom
by Law Business Research Ltd, London
87 Lancaster Road, London, W11 1QQ, UK

www.TheLawReviews.co.uk

ISBN 978-1-92228-61-4

Printed in Great Britain by
Encompass Print Solutions, Derbyshire
Tel: 0844 2480 112

The publisher acknowledges and thanks the following law firms for their learned assistance throughout the preparation of this book:

ADNAN SUNDRA & LOW

AFRIDI & ANGELL

ALLEN & OVERY

ANDERSON MŌRI & TOMOTSUNE

BAKER McKENZIE LLP

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PREFACE

We are honoured to present the third edition of *The Islamic Finance and Markets Law Review*. The chapters that follow describe the manner in which Islamic, or *shariah*-compliant, finance is practised in various jurisdictions throughout the world. Although each country will have variations, one of the most striking features of Islamic finance as a legal discipline is that it includes core concepts and structures that cross jurisdictional boundaries. Given the importance and ubiquity of these concepts and structures, a short introduction to them is in order.

i Sources of Islamic finance

Islamic, or *shariah*-compliant, finance is concerned with the conduct of commercial and financial activities in accordance with *shariah*, or Islamic, law. Islamic finance emphasises productive economic activity over pure speculation, and encourages transaction counterparties to share profits and losses to promote collaborative efforts. Islamic finance practices are based upon a central core constituting (1) the Quran, the holy book of Islam; (2) the Sunnah, words or practices instituted or approved by the Prophet Muhammad, including the Hadith, which are oral traditions regarding the words and deeds of the Prophet Muhammad, as compiled by the *Sahabah* (closest companions of the Prophet Muhammad); (3) *ijma*, or consensus of the independent Muslim jurists qualified to exercise *ijtihad* (a *mujtahid*) on a particular interpretation of *shariah*; and (4) *qiyas*, which is interpretation by analogical reasoning where one situation is measured against another by the *mujtahids*, in each case subject to and in accordance with the Quran, Sunnah and *ijma*. The principles derived from the application of *ijma* and *qiyas* to *shariah* form the body of jurisprudence known as *fiqh* (understanding and knowledge applied to any branch of knowledge). The body of rules that underpin the derivation of *fiqh* is referred to as *usul al-fiqh*.

Certain *shariah* principles may be ambiguous, not least because of the numerous exegeses of the Quran, the voluminous Hadith and the *mujtahids* involved in the practice of *ijtihad*, interpreting *shariah* in different (yet equally permissible) ways because of the interpretation methodologies they may apply. This means that often there can be different legal opinions (*fatawa*) on the same aspect of *shariah*. This difference of methodology for interpreting *shariah*, and the body of *fatawa* derived thereby, is one reason why there have developed several schools of thought or *fiqh* (*madhabs*) to which a *mujtahid* would ordinarily be aligned. The renowned *madhabs* are *Hanafi*, *Maliki*, *Shaf'i* and *Hanbli*.

ii Principles of Islamic finance

Akin to Western legal systems, in Islam there is a presumption that everything is permissible (*halal*) unless there is an express law that rebuts that presumption by declaring it as forbidden (*haram*). Islamic financiers are therefore expected to carry out their activities subject to, and in accordance with, *shariah* principles. The pertinent *shariah* principles that relate to Islamic finance include:

a *Riba* (translated literally, excess): although *shariah* scholars debate the precise definition of *riba*, essentially it represents unearned excess or profit charged in connection with a transaction, and derived by the mere passage of time. This is generally thought to include a prohibition against charging interest in connection with the use of money. The philosophy behind the absolute prohibition of *riba* (which has the effect of rendering any contract harbouring *riba* as being void), is that *shariah* regards money as having no intrinsic value in itself (unlike commodities such as gold, silver, dates and wheat) and is merely a means of exchange to procure goods and services. Money cannot therefore derive a profit either from the exchange of money of the same denomination or as a result of the passage of time, as is the case with interest.

b *Gharar*: this refers to undue uncertainty in a transaction. For example, the sale of an object that a seller does not yet possess is considered to include *gharar*, because it is uncertain whether the seller will be able to obtain the relevant object and complete the sale transaction. Some *shariah* scholars assert that *maysir* and *gharar* prohibit life insurance contracts and financial derivatives.

c *Maysir*: this refers to impermissible speculation, meaning investments that depend chiefly upon chance for their outcomes. The prohibition of *maysir* does not prevent parties from taking on risks normally connected with business transactions.

d *Qimar*: this refers to transactions tantamount to gambling.

Two other relevant *shariah* principles are the prohibition on investing in, or being involved with, *haram* products and activities (such as alcohol and gambling establishments) and the prohibition of becoming unjustly enriched.

In practice, Islamic financial institutions and investors typically engage *shariah* scholars to establish investment guidelines and parameters for investment activity, in a manner consistent with the sources of Islamic finance, *madhabs* and Islamic finance structures referred to above. Efforts have been made to increase uniformity among these *shariah* advisers, in the hope of creating a more standardised market. For example, the Accounting and Auditing Organization for Islamic Financial Institutions, a non-profit industry-sponsored organisation, issues non-binding *shariah* standards developed in consultation with industry practitioners. Other influential bodies include the Fiqh Academy of the Organization of the Islamic Conference, the Shari'ah Supervisory Board of the Islamic Development Bank and the Islamic Financial Services Board in Kuala Lumpur. These bodies, and individual *shariah* scholars, provide the context for Islamic finance generally. The degree to which their rules are incorporated into legal regimes varies between jurisdictions.

iii Basic Islamic finance structures

Although structures differ across national boundaries, the basic structures outlined below tend to be widely used by market participants. Profit and loss sharing forms the bedrock of Islamic finance since Islam perceives that the ideal relationship between contract parties should be that of equals in which profit and losses are shared. *Shariah* by no means prohibits the making of profit, but it does scrutinise the basis upon which profit is made as, for example, charging interest could exploit the client in a time of hardship whereas the financier's wealth is increased by no effort of his or her own. Islam instead empowers the financier to derive a profit by investing money or another consideration directly (or indirectly through a joint venture arrangement, for example) in real assets using one or more of the Islamic finance structures discussed below. The financier will then generate a profit and recoup the principal sum invested in the asset by exercising his or her rights as an owner; using, leasing or selling the asset. Here, unlike conventional finance, the money itself has not yielded the profit; instead the assumption of the risks and responsibilities as owner of the asset, or as a partner in the venture, has yielded the profit made by the financier. This highlights the preference of Islamic finance for equity over debt and seeking to deal in tangible assets. This also explains why Islamic finance can be used as a form of both asset-backed financing and asset-based financing.

Combinations of the following Islamic finance structures can be used in project finance and other structured transactions. For example, a *mudarabah* or *musharakah* could be used to invest in a venture to commission the manufacture of an asset under an *istisnah*, which once constructed, can be leased through an *ijarah*.

Ijarah (lease)

The *ijarah* is a form of lease financing whereby the usage (usufruct) of an asset or the services of a person are leased by the lessor to the lessee for rental consideration. The *ijarah* can take effect as an operating lease, with the asset returning to the lessor at the end of the lease term, or akin to a finance lease, with title to the asset being transferred to the lessee at the end of the lease term or ownership units being transferred to the lessee during the term of the lease (an *ijarah wa iqtina*). Although *shariah* does not permit a forward sale, the *ijarah* can become effective at a future date provided the rent is only payable after the leased asset is delivered to the lessee. This type of forward lease is called an *ijarah mawsufa fi al-dhimma* and is most prevalent in the project financing context.

Istisnah

An *istisnah* is used for the manufacture or development of an asset. Under this structure, one party engages a counterparty to construct an asset in accordance with agreed specifications, and agrees to purchase or lease the asset upon completion. The manufacturing party must finance the manufacture or construction of the asset, although it may require a down payment or progress payments from its counterparty, or both. The manufactured asset must be accepted by the counterparty if it meets the given specifications. Once the asset has been constructed, title to the asset must be transferred by the manufacturing party to the counterparty, who will then either sell the asset or lease the asset to a counterparty pursuant to an *ijarah*. This structure may be employed for project finance, among other purposes.

Murabahah

A *murabahah* is an asset purchase transaction, in which a party purchases an asset from a third party at the request of its counterparty, and then resells the asset to that counterparty. The sale price payable by the counterparty equals the original acquisition price paid by the first party plus an agreed return (i.e., cost-plus), and is payable on a deferred basis. Under this technique, the counterparty is able to acquire an identified asset, but pay the purchase price for it over time. A *murabahah* can be used to finance the acquisition of a variety of assets, and its versatility makes the structure a favourite among market participants.

Mudarabah

A *mudarabah* is an investment fund arrangement, under which one party (the *rab-al-mal*) provides capital to an enterprise while a second party (the *mudarib*) contributes work. The *mudarib* manages the enterprise's capital, and in doing so usually has wide discretion. In return, the *mudarib* often earns a fee. The *mudarabah* parties also share any profits of the enterprise according to agreed percentages. However, only the *rab-al-mal* bears the risk of losing money on the enterprise. Guarantees of the capital by the *mudarib* are not permitted as this would depart from the principle that the *rab-al-mal* bears the risk of any loss. In *Dana Gas PJSC v. Dana Gas Sukuk Ltd & Ors* ([2017] EWHC 2928), Dana Gas attempted to (but ultimately was unable to) render its *mudarabah sukuk* unenforceable on a number of grounds, one of which was that the *sukuk* were not *shariah*-compliant because they featured what appeared to be a guarantee from the *mudarib* of the face amount of the *sukuk* contrary to the risk-sharing methodology reflecting a traditional *mudarabah*. The *mudarib*'s risk should solely be that its time and effort will not produce a return. Among other uses, a *mudarabah* may be employed for investment funds that make *shariah*-compliant investments.

Musharakah

A *musharakah* is a partnership arrangement in which transaction parties contribute cash or property, or both, to a collective enterprise. The parties share profits according to agreed percentages (as with a *mudarabah*), but also share losses in proportion to their capital investments. All *musharakah* parties may exercise control of the *musharakah*, although in practice there is usually a designated control party. Under diminishing *musharakah* (*musharaka muntahiya bittamleek*), one or more of the *musharakah* parties has the ability to buy out the interests of the other *musharakah* parties over time for an agreed price. The *musharakah* structure is considered the most ideal for profit-and-loss sharing.

Sukuk

Although *sukuk* (plural of *sakk*) are often referred to as 'Islamic bonds', they are more akin to Islamic trust certificates representing an undivided beneficial ownership interest in an underlying asset where the return is based on the performance of that underlying asset. A *sukuk* issuer pays an agreed amount of the revenue produced by the *sukuk* assets to the *sukuk* holders. A distinction is made between asset-backed *sukuk*, which provide *sukuk* holders with a claim to the subject assets, and asset-based *sukuk*, which derive cash from the assets, but do not grant *sukuk* holders direct rights in the assets. *Sukuk* do share certain features with conventional bonds, such as being in certificated form, being freely transferable on the secondary market if the *sukuk* is listed, paying a regular return, and being redeemable at maturity, but conventional bonds are also tradable debt, which *shariah* prohibits.

iv Conclusion

Islamic finance has grown rapidly during the past 20 years, in market participants, structuring expertise and transaction types. Islamic finance is vibrant and has proven its competitiveness with conventional financing products, often featuring alongside, or as an alternative to, conventional financing products. The chapters in this book illustrate the dynamic manner in which Islamic finance has adapted and continues to develop globally, and we recommend them to you.

We would like to thank the writers who have taken the time to contribute their insights on Islamic finance practice, and to the editors who made publication of this book a reality.

John Dewar and Munib Hussain
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London
September 2018

Chapter 1

BAHRAIN

Salman Ahmed, Brian Kelleher and Edward Rees[1]

I INTRODUCTION

Bahrain's financial sector is well developed and diversified, consisting of a wide range of conventional and Islamic financial institutions and markets,[2] all of which are subject to a sophisticated legal and regulatory framework.

Bahrain (through the Central Bank of Bahrain (CBB)) has one of the most comprehensive regulatory regimes for regulating *shariah*-compliant activities in the world. Oman and Pakistan are close competitors, though Malaysia is generally regarded as having the most comprehensive. The difference is that Oman and Pakistan have separate legislation dealing with *sukuk* issuances (as does Jordan), but other legislation in those jurisdictions either does not fully cater to non-commercial banking and capital markets activities or is quite nascent.

The CBB's legislative model differs from Oman and Pakistan in that it is less prescriptive and allows financial and other institutions to align their businesses with rapidly fluctuating global trends. This means the CBB maintains an open dialogue with all its licensees and regularly seeks their (and other market participants' input) on legislative updates and further regulation. This is one of the features that distinguish CBB's approach to regulation from the rest of the regulators in the Gulf Cooperation Council (GCC).

The term 'Islamic finance' or 'Islamic banking' in Bahrain has wider application than just applying to commercial banks and includes non-deposit-taking investment or merchant banks and private equity institutions operating in a *shariah*-compliant manner. The CBB licenses each of these institutions appropriately in accordance with their proposed activities. The ambit of this chapter does not include a discussion on each of these licences, as this information is available on the CBB's website.[3]

II LEGISLATIVE AND REGULATORY FRAMEWORK

i Legislative and regulatory regime

Persons wishing to undertake regulated Islamic banking services must be licensed by the CBB as an Islamic bank licensee. Regulated Islamic banking services consist of three determinant activities: (1) accepting *shariah* money placements or deposits; (2) managing

1 Salman Ahmed is a partner, Brian Kelleher is a senior associate and Edward Rees is a trainee solicitor at Trowers & Hamlins.

2 www.cbb.gov.bh/page-p-overview1.htm.

3 www.cbb.gov.bh/page-p-islamic_finance.htm.

shariah profit-sharing investment accounts; and (3) offering *shariah* financing contracts. If an institution has the requisite licence, it may be able to offer all three regulated activities alongside various supplementary activities. Islamic bank licensees must operate in compliance with *shariah* economic principles and only Islamic bank licensees may hold themselves out to be fully *shariah*-compliant institutions. Ultimately, it is the type of licence issued by the regulator that determines whether an institution is *shariah*-compliant.

Every individual Islamic bank in Bahrain has its own internal *shariah* board, which determines the *shariah* compliance of its products. In July 2018, there were 100 institutions registered in the banking sector of which 22 were Islamic banks licensed by the CBB. The CBB does not interfere with this internal process but is usually very helpful, and facilitates in discussions about new ideas and concepts. The CBB must approve new products before they can be offered to customers. The banks also need to inform their customers of associated risks and any unusual product features if the capital is not protected. If the capital is protected then the banks must inform the customers that there is a chance that the actual return may be lower than the anticipated or projected return.

Islamic bank licensees are divided into two subcategories: Islamic retail banks and Islamic wholesale banks. Specific regulatory requirements may differ between these two subcategories where appropriate to address their risk profiles.

Islamic retail banks may undertake transactions in any currency, with both Bahraini residents and non-residents. To qualify as an Islamic retail bank, the activity of offering *shariah* financing contracts must account for a significant portion of the institution's business. This is defined, broadly, as accounting for over 20 per cent of an institution's assets.

Islamic wholesale banks may also undertake transactions without restriction when dealing with the government of Bahrain and its agencies, CBB bank licensees and non-residents. However, they may only undertake transactions denominated in Bahraini dinars or with a resident of the Kingdom of Bahrain if these transactions are to be wholesale in nature. Wholesale transactions are defined in terms of transaction size (broadly, 7 million Bahraini dinars or more for the activities of accepting *shariah* money placements or deposits and offering *shariah* financing contracts, and US$100,000 or more for any of the other activities falling within the definition of regulated Islamic banking services). Islamic wholesale banks are allowed to transact in Bahraini dinars (or any other currency) for any amount with the government of Bahrain, Bahrain public sector entities (as defined in the guidelines for completion of the Prudential Information Returns for Islamic Banks Form) and CBB bank licensees. Islamic wholesale banks may also transact in Bahraini dinars for any amount (where required) to fund their normal operating expenses when investing for their own account in securities listed on a licensed exchange.

Islamic bank licensees are subject to certain licensing conditions. These licensing conditions are consistent with international good practice, such as the relevant Basel Committee and Islamic Financial Services Board standards.

Islamic bank licensees must satisfy the CBB that their controllers are suitable and pose no undue risks to the licensee. There are also certain procedures, as set out in Articles 52 to 56 of the Central Bank of Bahrain and the Financial Institutions Law (Decree No. 64 of 2006) (the CBB Law) on controllers. Licensees and their controllers must also observe the CBB's capital markets requirements in respect of changes in holdings of shares of listed companies. There are differing requirements for locally incorporated licensees (Bahraini Islamic bank licensees) and branches of foreign banks (overseas Islamic bank licensees). Requirements for overseas Islamic bank licensees are less onerous than those for Bahraini Islamic bank licensees.

A licensee that carries on an activity such as dealing in *shariah*-compliant financial instruments as agent (i.e., buying, selling or subscribing for *shariah*-compliant financial instruments on behalf of a client) should not determine the terms of the transaction and should not use its own financial resources for the purpose of funding the transaction. This means that the licensee must act as an agent and must not have a say in the terms of the transaction. Such a licensee may, however, receive or hold assets in connection with the transaction in its capacity as agent of its client. The following are examples of activities that, when taken in isolation, are unlikely to be regarded as acting in the capacity of an agent:

a appointing professional advisers;

b preparing a prospectus or business plan other than in connection with the Regulatory and Supervisory Module on Issuing and Offering of Securities and Sharia Compliant Sukuk of 2013 (the OFS Module);

c identifying potential sources of funding;

d assisting investors, subscribers or borrowers to complete and submit application forms other than in connection with the OFS Module, the CBB Rulebook Volume 6 (Capital Markets) and the CBB Rulebook Volume 7 (Collective Investment Undertakings); or

e receiving application forms for processing or checking and onward transmission other than in connection with the OFS Module, the CBB Rulebook Volume 6 (Capital Markets) and the CBB Rulebook Volume 7 (Collective Investment Undertakings).

Islamic bank licensees must maintain a minimum daily cash reserve balance with the CBB, set as a ratio of their total non-bank Bahraini dinar funds, whether placed by way of call or unrestricted investment accounts (or similar), as well as taken through the issuance of Bahraini dinar-denominated Islamic investment certificates. The current required ratio is 5 per cent and may be varied by the CBB at its discretion.

Islamic bank licensees must arrange for their external auditor to confirm the accuracy of the data reported on the eligible accounts report for the deposits or unrestricted investment account protection funds.

ii Regulatory and supervisory authorities

Conventional banks and *shariah*-complaint banks (referred to collectively as licensees) are both regulated by the CBB; however, the rules for each differ. The Accounting and Auditing Organization for Islamic Financial Institutions' accounting standards are compulsory for all Islamic banks and for conventional banks if they are maintaining Islamic units.

The CBB's supervision of licensees is a mixture of on-site assessment (including the quality of systems and controls, and of books and records) and off-site supervision (which focuses on the analysis of regulatory returns, as well as of audited financial statements and other relevant public information). The CBB has plans to strengthen its supervisory role by implementing a *shariah* board of scholars to oversee Islamic banks.

On-site examinations are undertaken by the CBB's own examiners, as well as by experts appointed for the purpose by the CBB (such as accountants and actuaries). Off-site supervision also includes regular prudential meetings with licensees to review performance, strategy and compliance matters (such as capital adequacy, large exposures and liquidity).

For banks, a risk profiling system has been developed to underpin the above supervisory efforts, by providing a detailed framework for assessing the impact and risk profile of individual licensees, and prioritising subsequent supervisory efforts. Work is under way to extend this profiling system to insurance companies.

Should a licensee fail to satisfy the CBB's regulatory requirements, then the measures outlined in the enforcement modules of the applicable volumes of the rule book may be applied. Enforcement measures include formal warnings, directions (e.g., to cease or desist from an activity), formal requests for information, adverse fit and proper findings, financial penalties or investigations. Extreme violations of the CBB's regulatory requirements may entail cancellation of a licence, putting into administration or criminal sanctions.

III COMMON STRUCTURES[4]

Type of products offered	Description of product
Mudarabah savings account	A *mudarabah* savings account is based on the *shariah* principle of 'unrestricted *mudarabah*'. Under the *mudarabah* principle the customer will act as a capital provider and the bank will act as a *mudarib* (entrepreneur) using its expertise. The bank pools all customer funds with its own capital and invests it in *shariah*-compliant modes of investments. The resulting profit is shared between the bank and customers according to predetermined ratios. *Mudarabah* is a profit-and-loss sharing product and the better the bank performs, the higher the profits earned.
Term investment deposit (*mudarabah*)	Term investment deposit is based on the *shariah* principle of 'unrestricted *mudarabah*'. Under the *mudarabah* principle the customer is an investor (*rab-al-mal*) for a fixed period and the bank will act as a *mudarib* (entrepreneur) using its expertise. The bank pools all customer funds with its own capital and invests it in *shariah*-compliant investments for a specified investment term and expected profit rate. The resulting profit is shared between the bank and customers according to predetermined mutually agreed ratios.
Izdihar savings account	An *izdihar* account is a savings account based on the Islamic principle of 'unrestricted *mudarabah*', which means customers can earn profit on their savings. Funds are placed in a common investment pool where they are invested in strict compliance with *shariah* principles to generate the best possible returns. Profits generated from the investments are shared between the bank and the customers according to a pre-agreed profit-sharing ratio.
Current account (*qard hasan*)	The current account is based on the Islamic contract of *qard hasan* (interest-free loan). You as a depositor will be the lender and the bank will be the borrower. The deposited funds are invested in *halal* activities only. Irrespective of the profit or loss generated by the bank from the investments, the funds are guaranteed payable on demand without any profit or penalty.
Wakalah investment	*Wakalah* investment is based on the Islamic concept of *wakalah* istithmar, under which you become the principal (*muwakkil*) and the bank becomes the investment agent (*wakeel*) of your funds. The bank invests these funds in *shariah*-compliant financing and investment activities. The targeted profit earned from the investments is distributed to the customers upon maturity of the account. The bank (as *wakeel*) deducts its agreed agency fee (*wakalah* fee) and, at maturity, pays both the targeted profit amount and the principal funds to the customers as per the terms of the *wakalah* agreement.

i Private equity investments

In Bahrain and from Bahrain private equity funds, whether they are to be established in a *shariah*-compliant manner or generally established as a conventional fund, no particular structure is used.

Common structures would be Cayman Islands exempt limited partnerships (if in the form of a partnership or a Cayman Islands exempt corporate fund). The investment may also be set up in Bahrain as a private investment undertaking. This is a flexible type of fund that only needs to be registered with the CBB rather than be approved by the CBB, and that has very limited restrictions on its ability to invest, although there are very high thresholds on the type of investor and the minimum investor amount in respect of investing in such a fund.

4 In relation to certain *mudarabah*-, *wakalah*- or *musharakah*-based savings accounts and products that are not capital guaranteed, it is possible that a customer may not be guaranteed a return and may even lose its principal. The CBB has strict criteria for offering these types of products, including suitable disclosures (i.e., product summary, risk factors, etc.). The customer must therefore assume complete performance risk, although, in practice, it is unusual for the banks not to provide the anticipated profit and return principal.

In general, any fund that is to be *shariah*-compliant would have to obtain a *fatwa* and make its investments in *shariah*-compliant products and in compliance with the various tenets of *shariah*.

ii Real estate investments

In respect of real estate funds, no particular structure is used and the same considerations in respect of a conventional fund would be taken in establishing a *shariah*-compliant real estate fund.

The common structures are offshore limited partnerships and companies, locally domiciled funds and real estate investment trusts. In Bahrain, a law was introduced in late 2016 to enable the establishment and listing of real estate investment trusts, known as a Bahrain real estate investment trust (BREIT).

BREITs can be established as either an expert collective investment undertaking (CIU) or an exempt CIU. Expert CIUs may be offered only to expert investors, who must deposit a minimum of US$10,000. Exempt CIUs are lightly regulated but may only be offered to accredited investors who invest at least US$100,000. BREITs are gaining more attention in Bahrain, though very few have been launched to date.

GCC nationals and wholly owned GCC entities may own land in Bahrain on a freehold basis. A non-Bahraini person or legal entity can own real estate or land in certain designated areas where foreign ownership is permissible.

iii Investment funds

Investment funds are generally established in Bahrain as companies, partnerships or trusts. No particular type of fund structure is used to enable it to be *shariah*-compliant.

A common structure used when the fund is to be marketed to retail investors would be a *shariah*-compliant expert fund. This type of fund requires a minimum investment of US$10,000 and can only be offered to investors who already hold financial assets of at least US$100,000. Expert funds can be leveraged by borrowing up to a limit of 20 per cent of the value of assets under management.

A further example of a type of investment fund used in Bahrain is a *shariah*-compliant exempt fund. This can only be marketed to accredited investors (who already hold assets worth US$1 million) and the minimum investment amount is US$100,000. This type of fund is lightly regulated.

Bahrain introduced the Investment Partnership Law in 2017 and in doing so is the first country in the GCC region to have introduced national legislation enabling the formation of limited partnerships in a manner comparable to structures utilised in reputable offshore fund domiciles. Key features of the new law include the ability for a general partner of a Bahrain investment limited partnership to be established as a subsidiary or a special purpose vehicle of an investment business. This would allow sponsors not to be unduly exposed in terms of liability and while using one of the preferred and widely recognised international models for private equity funds. The new law also aims to make Bahrain a more attractive market for investors by setting a high liability standard in respect of general partners.

The Protected Cell Companies Law, enacted in Bahrain in 2016, allows for the formation of protected-cell companies (often called segregated portfolio companies or sub-funds). Both a limited partnership fund and a segregated portfolio fund can be established as a *shariah*-compliant fund. A protected-cell company is a corporate structure in which a single legal entity is comprised of a core legal entity under which there are several divided cells or portfolios. The protected-cell company allows for each cell to be managed by a single or separate investment manager. As a fund develops, expands and targets under or varying asset classes, new cells can be established, which enables long-term flexibility and provides opportunities for investors to be exposed to new asset classes or sectors at lower costs for the fund promoter or manager. Each cell's assets can be ring-fenced and are therefore only available, or exposed to, the creditors and shareholders of each particular cell. The development of this law signifies a will to develop the funds industry in Bahrain.

As at the end of April 2018, the number of mutual funds stood at 2,325, of which 80 were Bahrain-domiciled, compared with 2,611 funds as at April 2017. The number of *shariah*-compliant funds stood at 80, as at April 2018.

iv Trusts

On 12 November 2016, legislation introducing the Trust Law Bahrain (Legislative Decree No. 23/2016) came into effect, replacing the Bahrain Financial Trusts Law of 2006. The Trust Law Bahrain aims to provide detailed guidance on the creation and administration of financial trusts within the Kingdom. While these are widely used in other jurisdictions, this is a new introduction in the Middle East, and Bahrain is one of the first countries to put in place this type of legal framework. It is anticipated and hoped that these updates will allow for the development of onshore *shariah*-compliant structures to hold assets, particularly for families who have tended to use offshore jurisdictions in doing so. These trusts are also used in the development of BREITs, which can be established pursuant to the CBB fund regulations.

IV TAXATION

Bahrain currently has no income, corporation (except for oil, gas and petroleum companies that are engaged in exploration, production or refining, regardless of their place of incorporation) or capital gains tax, and no estate duty, inheritance tax or gift tax. However, Islamic finance transactions involving real estate may be subject to taxes. For example, if the legal ownership of the land is transferred or registered, this could result in registration fees. A registration fee is levied at 2 per cent on all property purchases, such amount being reduced to 1.7 per cent if registration and payment are completed within 60 days of the relevant transaction. If an Islamic financial transaction involves payments under an *ijarah*, this will generally not be subject to taxation. In Bahrain, Islamic finance transactions typically involve no actual movement of legal ownership and only the economic or beneficial value or ownership is transferred, which is not subject to any taxes.

Under existing Bahraini laws, payments under the bonds, *sukuk* or notes will not be subject to taxation in Bahrain, no withholding will be required on such payments to any holder of notes, and gains derived from the sale of notes will not be subject to Bahraini income, corporation or capital gains tax. In the event of the imposition of any such withholding, the issuer has undertaken to gross up any payments subject to the withholding.

Following an extraordinary meeting of finance ministers in Jeddah in June 2016, the GCC countries approved the introduction of value added tax (VAT) in the GCC. Bahrain signed the GCC Unified VAT and Excise Treaties on 1 February 2017. It is anticipated that Bahrain will not introduce VAT at the expected rate of 5 per cent until early 2019. There can be no doubt that VAT will, when implemented, herald a significant development in the region from a commercial and legal perspective. While the exact details of how VAT will be applied across Bahrain have yet to be confirmed, it is expected that VAT will be broad in its scope and shall apply to all business in Bahrain with only limited exceptions and consumption tax reliefs.

The introduction of VAT by GCC governments may be regarded by many as a constructive measure to (1) assist, diversify and strengthen the GCC countries' respective fiscal revenue streams in an era of falling oil prices; and (2) promote economic stability in the long term. It is important to note in this regard that the International Monetary Fund has previously encouraged GCC countries to introduce VAT.

Each GCC Member State will have its own domestic VAT legislation, adopting the principles of a GCC framework agreement. VAT is, however, unlikely to affect Islamic financial transactions in Bahrain owing to the manner in which they are structured.

As with the introduction of VAT in Saudi Arabia and the United Arab Emirates from 1 January 2018, it is likely to take some time for businesses and the tax authorities to absorb the changes. It is therefore hoped that the tax authorities will operate with a light touch during the introduction phase.

It is also important to note that the proposed VAT will be introduced as part of a GCC-wide customs union. Therefore, it will be vital that the design of both regimes takes the other into account so as to avoid overload and unnecessary complexity for governments and businesses alike.

V INSOLVENCY

There is no separate insolvency regime for Islamic finance in Bahrain. The Bankruptcy and Composition Law (Law No. 11 of 1987) and Commercial Companies Law (Law No. 21 of 2001), as amended, apply to bankruptcies, reorganisations and insolvency matters in Bahrain. There are separate insolvency rules for financial institutions licensed by the CBB under the CBB Law. A new draft Insolvency Law is being reviewed by the Legislation and Legal Opinion Commission following the consultation period during which all CBB licensees, listed companies in Bahrain, law firms and audit firms provided their feedback on the draft law to the CBB.

VI JUDICIAL FRAMEWORK

i Courts

Bahrain has a dual court system, consisting of civil and *shariah* courts. *Shariah* courts deal primarily with personal status matters (such as marriage, divorce and inheritance). *Shariah* courts of first instance are located in all communities. A single *shariah* Court of Appeal sits at Manama. Appeals beyond the jurisdiction of the *shariah* Court of Appeal are taken to the Supreme Court of Appeal, which is part of the civil system.

The *shariah* acts only as a 'guiding principle' and as such the terms and conditions of Islamic finance products are determined by national laws. In Bahrain, disputes revolving around Islamic finance contracts and products are heard before the civil courts.

VII OUTLOOK

Islamic finance is on the rise in Bahrain and internationally, although annual growth of up to 15 per cent per year as seen in recent years is unlikely in the near future. A recent report[5] estimates that Islamic finance assets will reach US$3.8 trillion by 2022. His Excellency Rasheed Mohammed Al Maraj (governor of the CBB) predicts 5 per cent annual growth over 2018 and 2019 for the Middle East Islamic banking sector.

Bahrain is growing in influence as a leading centre of innovation for Islamic finance. A number of amendments were made to the CBB's codes and rules between 2014 and 2018, with the aim of promoting best practice and on the basis of certain rulings of the primary global committee of banking supervision (the Basel Committee).

At present significant moves are being taken to strengthen banks' capital bases and to promote transparency and better governance. Banks in Bahrain are being encouraged to consider merging to strengthen themselves and compete more effectively. Several Islamic lenders have already merged (e.g., the three-way merger of Capivest, Elaf Bank and Capital Management House in 2013) and it is suggested that more mergers are likely to take place with the highest profile being the proposed merger of Kuwait Finance House Bahrain with Bahrain's Ahli United Bank.

The Basel Committee recommendations made in light of the global financial crisis have led to a number of reforms and initiatives. Banks are now being asked to be more transparent, for example by making more useful data available to stakeholders so that they can make informed choices.

These changes have resulted in major reforms. The governor of the CBB has said that 'the overall outcome is that Islamic finance is benefiting from these changes. The over-reliance on real estate and infrastructure projects is being systematically replaced with recognition that fixed income assets, which in turn provide identifiable, sustainable profits for the future, are the way forward'.

The CBB is working with bodies such as the non-profit International Islamic Finance Market (IIFM) to standardise Islamic banking practices further. One of its recommendations has been to ensure that Treasury product transactions are governed by the International Swaps and Derivatives Association (ISDA/IIFM Tahawwut Master Agreement). This agreement is designed to govern the relationship between the parties in a *shariah*-compliant hedging transaction. The use of these agreements is not mandatory in Bahrain.

The CBB has also urged Islamic banks to have their institutions rated by the Islamic International Rating Agency (IIRA), which has its headquarters in Bahrain. The IIRA ratings inform investors about corporate and *shariah* governance practices in addition to the financial risk profile of the entity.

The CBB has proposed further rules in an attempt by Bahrain to regain prominence in the Islamic finance industry. In August 2017, the CBB imposed a requirement that Islamic banks should be audited externally by *shariah* experts rather than be subject to self-regulation. Furthermore, banks would be required to disclose any non-permissible income and state how they intend to dispose of assets generated by non-*shariah*-compliant earnings or acquired

5 'The State of the Global Islamic Economy Report 2017/18', published by Thomson Reuters and the Islamic Corporation for the Development of the Private Sector.

through prohibited expenditure. It has been argued that the current approach allows more diversity and flexibility; however, there is growing support in Bahrain for reforms to increase transparency in this field.

Bahrain has become a world leader in Islamic finance, accommodating the largest concentration of Islamic financial institutions in the Middle East. At present, there are seven Islamic *takaful* insurance companies and two *retakaful* companies operating in Bahrain. Bahrain is a market leader for Islamic securities (*sukuk*).

Finally, Bahrain hosted the 24th World Islamic Banking Conference in early December 2017, at which more than 1,300 leaders gathered to address economic uncertainties and unlock opportunities in the global Islamic finance industry. The event produced a road map for 2018 and beyond by showcasing new technology and cutting-edge research.

Chapter 2

CAYMAN ISLANDS

Anthony Oakes[1]

I LEGISLATIVE AND REGULATORY FRAMEWORK

i Legislative and regulatory regime

The Cayman Islands are a British overseas territory of the United Kingdom. They were also a dependency of Jamaica for administrative purposes between 1863 and 1962. Cayman law is therefore a common law system largely based on English common law and statutes, with some influences from Jamaica.

The legal system has not diverged far from that of England and Wales. Many of the divergences are a result of the Cayman Islands being an international financial centre (IFC). Companies and partnerships established in IFCs are commonly used in structuring financial transactions, including Islamic finance transactions. Accordingly, many of the divergences between Cayman and English laws have arisen because of the Cayman Islands' legislature's desire to facilitate, and provide confidence around, financial transactions. For example, there is no restriction on a Cayman company giving financial assistance for the purposes of the acquisition of its own shares or shares of a holding company.

The financial services industry in the Cayman Islands is regulated by the Cayman Islands Monetary Authority (CIMA).

The relevant legislation is summarised below.

Banking

'Banking business' is a regulated activity. Section 2 of the Banks and Trust Companies Law (2013 Revision) (the Bank Law) defines 'banking business' as: 'the business of receiving (other than from a bank or trust company) and holding on current, savings, deposit or similar account money that is repayable by cheque or order and may be invested by way of advances to customers or otherwise'.

The Monetary Authority Law (2016 Revision) and the Bank Law give CIMA the responsibility for both licensing and regulating 'banking business'. In relation to licensing, CIMA may issue the following categories of banking licences:

a Category A Banking Licence;
b Category B Banking Licence; and
c Restricted Category B Banking Licence.

The Category A Licence is the broadest and permits domestic business with residents of the Cayman Islands as well as offshore business. The Category B Licence permits only business

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conducted outside of the Cayman Islands. The Restricted Category B Licence is subject to the same limitations as the Category B Licence, but the licensee is further restricted to a pre-approved customer base.

CIMA further categorises each type of bank into two further categories – home-regulated banks and host-regulated banks. CIMA's policy has different requirements for each type of entity. Home-regulated banks are banks incorporated in the Cayman Islands and are financially regulated by CIMA. Host-regulated banks are usually branches of a foreign parent bank that are subject to regulation by the parent's home regulator. CIMA's approach to the licensing (and continuing regulation) of home-regulated banks is stricter, including in relation to:

a capital adequacy requirements;
b financial resources;
c information required to be provided to key shareholders;
d financial resources of key shareholders;
e audit requirements; and
f the bank's local presence in the Cayman Islands.

While Section 17(1)(a) of the Bank Law states that it is the duty of CIMA to maintain a general review of the banking practice, Cayman statute does not regulate the type of banking products that can be offered by licensee banks. Accordingly, there is no regulation in relation to Islamic banking products.

In addition to the regulation of 'banking business', 'money services business' is also regulated by CIMA. The Money Services Law (2010 Revision) defines 'money services business' as including:

a money transmission;
b cheque cashing;
c currency exchange; and
d the issuance, or sale or redemption of, money orders or travellers cheques.

Capital markets

The Securities Investment Business Law (2015 Revision) (the Securities Law) provides for the regulation of persons carrying on 'securities investment business', including market makers, broker-dealers, securities arrangers, securities advisories and securities managers in or from the Cayman Islands.

'Securities' are broadly defined in Schedule 1 of the Securities Law as including:

a shares;
b debentures, bonds and certificates of deposit;
c warrants;
d options;
e futures; and
f certain types of swaps.

The regulated activities are set out in Schedule 2 of the Securities Law and include:

a dealing in securities;
b arranging deals in securities;
c managing securities; and
d advising on securities.

No distinction is made in the Securities Law between Islamic securities and other securities.

Under the Securities Law, a person who engages in securities investment business must hold a Securities Investment Business Licence unless exempted under:

a Schedule 3 – Excluded Activities; or
b Schedule 4 – Excluded Persons.

Excluded Activities include where a company is dealing in securities on its own account or providing finance to enable a person to deal in securities. Excluded Persons include persons who carry on a securities investment business exclusively for sophisticated or high net worth persons and persons regulated by a recognised regulatory authority in the jurisdiction where the securities investment business is being conducted.

Offering of securities

In relation to the specific issue of the offering of securities:

a if the issuer of securities is a Cayman exempted company, pursuant to Section 175 of the Companies Law (2018 Revision), it is prevented from offering its securities to members of the public in the Cayman Islands unless it is listed on the Cayman Islands Stock Exchange; and
b if the issuer of securities is not incorporated or established in the Cayman Islands, it can offer its securities to investors established or operating in the Cayman Islands, but subject to the provisions of the Securities Law.

Again, there is no distinction between Islamic securities and other types of securities.

Insurance

Engaging in 'insurance business' is also a regulated activity. Section 2 of the Insurance Law 2010 defines 'insurance business' as: 'the business of accepting risks by effecting or carrying out contracts of insurance, whether directly or indirectly, and includes running-off business including the settlement of claims'.

The Insurance Law gives CIMA the responsibility of regulating the insurance business in the Cayman Islands. This includes licensing, ongoing supervision and enforcement. The day-to-day regulatory oversight of the sector falls to CIMA's insurance supervision division.

Similarly to the Bank Law, the Insurance Law focuses on the licensing requirements for insurers and their continued monitoring (particularly in relation to capital requirements, solvency, reporting and risk management).

Also, similarly to the Bank Law, the Insurance Law does not stipulate what insurance products (be they Islamic or otherwise) a licensee may provide. However, Section 23(1) of the Insurance Law does state that CIMA may direct a licensee, in relation to a policy, a line of business or the licensee's entire business, to refrain from conduct that constitutes unsafe or unsound practice.

Funds

The Mutual Funds Law (2015 Revision) (the MF Law) is the principal legislation applicable to investment funds, and determines whether an investment fund is required to be registered, administered or licensed with CIMA. In general terms, the MF Law applies to open-ended funds whose interests are redeemable at the option of the investor and that do not qualify or elect for exemption or other exclusion. One of the most commonly used exemptions is for funds with no more than 15 investors (the majority of whom are capable of appointing or removing the operator of the fund). We shall refer to funds to which the MF Law applies as 'regulated funds'. As a general rule, regulated funds tend to be hedge funds and in the form of a Cayman exempted company.

Under the MF Law, a regulated fund must not carry on business in or from the Cayman Islands unless a current offering document is filed with CIMA. The offering document must contain such information as is necessary to enable a prospective investor in the fund to make an informed decision as to whether or not to subscribe for equity interests in the fund.

The MF Law also imposes on regulated funds a number of continuing obligations, including:

a to file with CIMA material amendments to the current offering document within 21 days;
b to have its accounts audited annually by an auditor approved by CIMA and to file those accounts with CIMA within six months of the end of its financial year;
c to pay an annual filing fee; and
d to have appointed to its board of directors at least two directors at any one time. Generally, these should be individuals.

If CIMA is satisfied that a regulated fund:

a is or is likely to be unable to meet its obligations as they fall due;
b is carrying on or attempting to carry on business or is winding up its business voluntarily in a manner that is prejudicial to its investors or creditors;
c has not been directed and managed in a fit and proper manner; or
d has a person holding a position as a director, manager or officer who is not a fit and proper person to hold that position,

then CIMA may:

a cancel the fund's registration;
b require the substitution of any promoter or operator of the fund;
c appoint a person to advise the fund on the proper conduct of its affairs; or
d appoint a person to assume control of the affairs of the fund.

The MF Law applies equally to Islamic and non-Islamic funds. However, the majority of Islamic funds tend to be closed-ended private equity or property funds, which are structured either as exempted limited partnerships or exempted companies (see Section II.ii, below).

ii Regulatory and supervisory authorities

As discussed in subsection i, above, CIMA is the principal regulator in the Cayman Islands. As discussed above, each governing legislation gives CIMA certain powers in relation to the particular regulated sector and lists the measures that CIMA may take, as regulator. CIMA's principal functions are set out in the Monetary Authority Law (2018 Revision). Its regulatory functions not only include regulating and supervising financial services business, but also monitoring compliance with money laundering regulations. In August 2017, CIMA published a revised regulatory handbook that sets out the policies and procedures to be followed by CIMA. In particular, the handbook describes the policies and procedures for:

a giving warning notices to persons affected adversely by proposed actions of CIMA;
b giving reasons for CIMA's decisions; and
c receiving and dealing with complaints against CIMA's actions and decisions.

The handbook further states that CIMA is to have due regard to international standards governing banking, insurance and securities supervision.

The handbook also describes CIMA's approach to:

a licensing approval and cancellation – including for the banking, insurance and funds sectors;

b reviewing licensees' financial statements and on-site inspections of licensees' premises;

c anti-money laundering procedures to be followed by licensees; and

d enforcement – including applying for court orders.

The handbook is binding on all of CIMA's committees and officers.

Also worthy of mention is the Government General Registry. Its primary function is to develop and implement policies and procedures for all registers under its administration to ensure continued effective contribution to the financial services industry and the public. The registers maintained by the General Registry include the register of Cayman companies and Cayman partnerships. As discussed below, Cayman companies and partnerships are widely used in Islamic finance transactions.

II COMMON STRUCTURES

i Islamic transactions

As described in Section I.i, above, the Cayman Islands is an IFC. The benefits of companies incorporated in IFCs have been well documented – including stable legal systems (typically based on English law), low cost and efficient company incorporation, little or no taxation, no exchange control, trusted court systems and sophisticated professional infrastructure (with an array of experienced professional service providers).

Accordingly, Cayman exempted companies are used as the issuer (often described as the trustee) in many Islamic financing transactions, including *sukuk*, *wakalah* and *ijarah*. Exempted companies are the most common type of company incorporated in the Cayman Islands and are formed to conduct business outside of the Cayman Islands. Exempted companies are similar in structure to companies formed in other common law jurisdictions: shareholders' liability is limited (typically by shares) and the directors manage the business of the company.

Specifically, the Cayman company is set up as an 'orphan' special purpose vehicle (SPV). The company is referred to as an SPV because it is formed solely for the purpose of the relevant financing transaction. The SPV is referred to as an 'orphan' because the beneficial interest in the shares of the SPV, rather than being held by a parent company, are held by a trustee (either pursuant to a charitable trust or Cayman STAR Trust)[2] for charitable or other specific purposes. As a result of the trust structure, the SPV is not part of the company group that is the ultimate borrower in the financing transaction. In that way, in the event of the insolvency of the borrower, a court is unlikely to find that the SPV should be included within the assets of the borrower's insolvent estate. The SPV is also made 'bankruptcy remote' under its constitutional documents or the transaction documents, or both, because it is prohibited

2 A STAR Trust is a form of statutory trust that can be established for persons or purposes (charitable and non-charitable) or both. The STAR Trust statutory provisions only apply where the trust instrument expressly states that they are to apply.

from undertaking any activities other than the financing transaction. In that way, the SPV is unlikely to be liquidated, with a view to the transaction remaining intact and the lenders being repaid.

The *sukuk* structure essentially works as follows:

a The Cayman SPV issues certificates to investors.
b The proceeds are used by the Cayman SPV to purchase an asset from the borrower. The asset is then leased back to the borrower.
c The borrower pays rent to the Cayman SPV so that the SPV may pay principal and coupon payments on the certificates.
d If specific events of default occur, the borrower is obliged to repurchase the asset at a certain exercise price, so that the SPV may redeem the certificates.

ii Closed-ended funds

As discussed in 'Funds' in Section I.i, above, open-ended funds are typically regulated by CIMA. These funds are usually hedge funds established in the form of Cayman exempted companies.

On the other hand, closed-ended funds (i.e., funds whose interests are not redeemable at the option of investors) are not regulated by CIMA. These funds typically include private equity and property funds and are often established as Cayman exempted limited partnerships (ELPs) under the Exempted Limited Partnership Law 2014.

The structure of an exempted limited partnership is essentially as follows:

a The general partner (GP) is solely responsible for the management of the ELP. Limited partners (LPs) are excluded from the management.
b Any debt or obligation incurred by the GP in the conduct of the business of an ELP is a debt or obligation of the ELP.
c In order to meet such debts or obligations, the GP may call on the capital commitments of the LPs.
d That is, under the terms of the ELP agreement, each LP will agree to contribute amounts to the ELP up to a certain fixed amount (i.e., its total capital commitment).

The Cayman ELP is one of the most commonly used investment vehicles in the world, both for Islamic and non-Islamic funds. Islamic funds are established in compliance with applicable *shariah* principles. For example, an Islamic fund may only invest in industries or properties that comply with Islamic law, but will be established using an ELP, similar to a conventional fund.

III TAXATION

Being an IFC, there is little taxation. The Cayman Islands have no form of income or capital gains tax nor do they have any estate duty, inheritance tax or gift tax. Where transaction documents are executed in, or taken into, the Cayman Islands, stamp duty will generally be payable. In most cases, the stamp duty will be nominal. However, *ad valorem* stamp duty will be payable where the transaction involves a transfer of, or security over, Cayman real property or shares in a Cayman company that holds Cayman real property. In relation to transfers, stamp duty is payable at the rate of 7.5 per cent on the purchase price or market value of the property, whichever is higher. In relation to security, stamp duty is payable on a sliding scale of 1 to 1.5 per cent depending on the amount secured by the mortgage. The Cayman Islands is not party to any double tax treaties. The tax position is the same for both Islamic and other types of finance transactions.

IV INSOLVENCY

i Rescue procedures

Adopted to address the needs of the Cayman Islands as an IFC, the Cayman insolvency regime focuses on the rights of creditors. The Cayman insolvency regime has rescue procedures aimed at resuscitating near-insolvent companies, notably:

a provisional liquidation – the company itself or its creditors or shareholders may apply for a provisional liquidator to be appointed. The objective is usually to preserve or protect the company's assets until the hearing of the winding-up petition. However, a provisional liquidator may give the company time to restructure its business or to obtain financing; and

b schemes of arrangement – the objective is to allow the company to enter into an agreement with its shareholders or creditors, or both, to either:
- restructure its affairs while solvent so that it can continue to trade and avoid liquidation; or
- reach a compromise or arrangement with shareholders or creditors, or both, after liquidation proceedings have commenced.

A scheme of arrangement requires the sanction of the Grand Court in order for it to be binding on the company and its creditors.

ii Liquidation

In relation to liquidation proceedings, a company may be wound up:

a compulsorily by the court;

b voluntarily; or

c under the supervision of the court – this is in the scenario where the company voluntarily appoints a liquidator but it becomes clear that:
- the company is or is likely to become insolvent; or
- court supervision will facilitate a more effective, less expensive or quicker liquidation.

iii Creditor protection

The insolvency regime is friendly to creditors in a number of ways:

a there is an express provision that secured creditors may enforce their security without the permission of the court or reference to the liquidator;

b there are provisions dealing with fraud in anticipation of the winding up, with criminal penalties applying; and

c the court may require liquidators to assist in the criminal investigation of liquidated companies.

The Cayman insolvency regime applies equally to Islamic and non-Islamic transactions.

V JUDICIAL FRAMEWORK

The Cayman Islands (Constitution) Order 2001 establishes the Grand Court, the Court of Appeal and an independent judiciary. The Grand Court has five divisions to manage cases: the Admiralty, Civil, Criminal, Family and Financial Services. The majority of commercial cases are held in the Financial Services Division.

The Court of Appeal sits as a three-judge bench. Final appeal lies to the Judicial Committee of the Privy Council, in London.

In the absence of specific Cayman decisions, relevant decisions of the superior courts of England and Wales and of the countries of the Commonwealth, while not strictly binding, are highly persuasive. There have been no significant cases in relation to Islamic finance products or structures.

VI OUTLOOK

There has been a recent development in Cayman law that may affect the type of Cayman entity used in Islamic finance transactions: the Limited Liabilities Companies Law 2016 has created a new class of Cayman entity – a limited liability company (LLC), which is similar to a Delaware limited liability company. Going forward, these LLCs may be used as hedge fund vehicles, orphan SPVs or as GPs of ELPs, rather than Cayman exempt companies, particularly where the transactions are structured in jurisdictions that are familiar with Delaware limited liability companies. The advantages of an LLC include flexible treatment of profits and losses free from capital maintenance rules and the ability to stipulate, in the LLC agreement, that a person appointed to the board by a particular member may act in the interests of that member, rather than the LLC.

Chapter 3

EGYPT

Mahmoud Bassiouny[1]

I LEGISLATIVE AND REGULATORY FRAMEWORK

i Legislative and regulatory regime

Egyptian law does not have a codified definition as to what constitutes Islamic finance or an Islamic financial instrument, as the Egyptian Civil Code is meant to be compliant with Islamic *shariah*. However, the following points are worth mentioning:

a banks can offer corporate or retail products denominated as 'Islamic', upon obtaining a relevant licence from the Central Bank of Egypt (CBE) (e.g., an *ijarah* licence or a *sukuk* licence). Only licensed banks can request said licence from the CBE;

b *takaful* insurance is also regulated by the Financial Regulatory Authority (FRA) and there are licensed *takaful* insurance companies operating in Egypt. It is expected that a new version of the Insurance Law (Law No. 10 of 1981) will be issued to take *takaful* insurance into account. Non-banking financial activities are generally subject to FRA supervision with the FRA board regulating said activities by way of decrees and FRA board resolutions; and

c *sukuk* are the most specifically regulated by virtue of Law No. 95 of 1992, as amended by Law No. 17 of 2018 (the Capital Markets Law), which covers all envisaged *sukuk* types, the issuance regime and redemption rights, with FRA being the competent regulator. Note, however, that as a matter of practice, there has been no major *sukuk* issuance to date. It is also worth noting that the Egyptian Real Estate Finance Law (Law No. 148 of 2001), as amended, recognises *ijarah* as a method of financing real estate and defines it as the leasing of real estate ending with ownership. The Capital Markets Law prescribes different structures, including, *inter alia*, *sukuk murabahah*, *sukuk istisnah* and *sukuk ijarah*. In addition, the Egyptian Real Estate Finance Law allows for all types of *ijarah* in relation to real estate in Egypt.

ii Regulatory and supervisory authorities

The two main bodies competent to regulate and supervise Islamic finance activities are (1) the CBE, which is the competent entity for granting licences to Egyptian banks for offering Islamic finance products; and (2) FRA, which grants licences for *takaful* insurance activities (in addition to its general competence of overseeing financial non-banking activities, including those activities that are structured or branded as 'Islamic'). Only banks

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registered with the CBE can request the licence mentioned under (1) and such banks must have established a competent *shariah* board, as a matter of standard market practice based on best international market practice.

Regarding financial non-banking activities, FRA Board of Directors' Resolution No. 8 of 2014 provides that an investment fund or a *takaful* provider that offers products marketed as 'compliant with *shariah* provisions' must establish a board to ensure compliance with *shariah* principles (i.e., the *shariah* board, similar to the board established by banks offering 'Islamic products'). *Takaful* companies as such are subject to *shariah* audit by FRA. The board's members must be chosen from a list of scholars and professionals registered with FRA, in a special register made for that purpose. FRA also has its own *shariah* board, which, as a matter of practice, serves to provide supervision and follow-up to the FRA board on products deemed 'Islamic'.

II COMMON STRUCTURES

Most major Egyptian banks offer a range of Islamic corporate and retail finance products, and have their own *shariah* boards. Such banks may also offer conventional finance products in addition to Islamic products. For large-scale greenfield projects or asset acquisition financing, it is typical to have an international bank or development finance institution participate in the financing (with a *shariah*-compliant mandate forming a part of the finance scheme), with *ijarah* being the most commonly used tool. Because there is no specific regime under Egyptian law for ownership in Islamic finance transactions (since Egyptian law only recognises the transfer of title of real estate by way of official notarisation, which can be impractical in the case of Islamic financing owing to timelines involved), Egyptian banks must proceed with an Islamic transaction as if it is a conventional one. For example, in an *ijarah*, whenever a bank is leasing an asset to a lessee, it is considered as the owner of said asset under the finance documentation, but the lessee will remain the registered owner and will provide a security on said asset to the bank. Egyptian companies must also adopt the Egyptian Accounting Standards for auditing purposes, even if the documentation provides for another accounting standard (e.g., AAIOFI).

Egyptian banks with a licence from the CBE offer a range of *shariah*-compliant products, including *murabahah*, for consumer goods purchases (with purchase of cars being relatively successful) and banks have also started to offer service *ijarah* to finance service needs, in particular in the healthcare and education sectors.

III TAXATION

There is no specific treatment for Islamic financial products under Egyptian law. As long as the provider of the financing is a licensed bank, the transaction will be treated as a financing by the Egyptian tax authorities and, accordingly, the general tax provisions under Egyptian law would apply, including withholding tax, stamp duties, income taxes and VAT.

IV INSOLVENCY

There is no specific insolvency or bankruptcy regime for Islamic finance participants under Egyptian law. The Egyptian bankruptcy regime was previously set out in the Egyptian Commercial Code; however, a new Bankruptcy Law (Law No. 11 of 2018) has recently been issued. The competent Egyptian commercial courts would adjudicate insolvency and bankruptcy-related disputes, regardless of whether the creditors or debtors have used *shariah*-compliant products in their dealings. As a matter of Egyptian law, the main criterion for the determination of an Egyptian court in relation to any bankruptcy proceeding would be the debtor's general inability to meet its debts when they fall due. The Bankruptcy Law introduces a new approach in dealing with persons and entities who are facing financial or administrative distress, such as: mediation, restructuring procedures and company rescue procedures, giving both debtors and creditors a higher degree of flexibility in dealing with debts.

V JUDICIAL FRAMEWORK

i Courts

There is no separate court system for Islamic finance products or participants. Civil courts or the economic courts would have jurisdiction to oversee such disputes (or arbitration, if agreed upon by the parties in their contractual arrangements). There is no separate legal regime for *shariah* under Egyptian law. However, it is worth noting that the Egyptian Constitution provides that *shariah* is one of the principle sources of legislation. To the extent that a *shariah* principle is claimed, Egyptian courts would have a discretionary authority in light of Egyptian legislation and public order to apply such principles.

ii Cases

There have been no recent cases in Egyptian courts relevant to the topic of Islamic finance.

VI OUTLOOK

Although one of the earliest modern finance initiatives intended to be *shariah*-compliant was in Egypt (Mit Ghamr Saving Bank, 1963), Islamic finance has not yet picked up in Egypt. The association made by the general public between Islamic finance and various pyramid schemes dubbed 'Islamic' in the 1980s and, more recently, certain political groups, is often said to be part of the reason for this. This is changing, however, as several 'Islamic banks' have started operating in Egypt, whether directly (such as Abu Dhabi Islamic Bank, which has an Egyptian presence) or through specific project financing, often with a development angle. The Islamic Development Bank's Islamic Corporation for the Development of the Private Sector is a notable example of this. There are also signs that the regulatory landscape is starting to integrate Islamic financial concepts. As of 2013, *sukuk* are regulated, and there have been announcements that a new Insurance Law will explicitly recognise and regulate *takaful*. Also, as clarified above, FRA is increasingly adapting its tools to oversee financial non-banking products marketed or intended as *shariah*-compliant.

Chapter 4

GERMANY

Murad M Daghles[1]

I INTRODUCTION

The German financial market offers growth potential for Islamic finance-compliant products and structures. Islamic finance products are not only appealing for foreign investors and around 5 million Muslims currently living in Germany, but also to non-Muslim investors who believe that investments must adhere to certain ethical standards.

The Federal Financial Services Supervisory Authority (BaFin) promoted two international conferences in 2009 and 2012 to outline the distinguishing factors of Islamic financial instruments and the potential economic benefits that Germany might gain from establishing an Islamic finance industry in the country.

II LEGISLATIVE AND REGULATORY FRAMEWORK

i Legislative and regulatory regime

The law in Germany does not differentiate between religious or ethical backgrounds.[2] The German legal system differs fundamentally from the common law system of England and Wales, in which courts rely mainly on precedents. As opposed to relying on precedents, German judges apply the law according to the principles and standards set in various legal codes. The cornerstone of German civil law is the German Civil Code (BGB). Next to general rules such as legal capacity and conclusion of contract, it contains, *inter alia*, specific regulations regarding (1) typical contracts (such as sale and purchase agreements or renting agreements, (2) rights *in rem* and (3) torts. The laws concerning commercial, corporate and capital markets and banking law can be found mainly in five national codifications, comprised of the BGB, as well as the following codes:

a the German Commercial Code (HGB) containing regulations on merchants and regulations concerning commercial partnerships, such as general partnerships and limited partnerships;

b the German Act on Limited Liability Companies and the German Stock Corporation Act regulate the establishment and operation of the most common German corporations: limited liability companies and stock corporations; and

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2 Casper/Allali, 'Islamic Finance Made in Germany – A Case Study on Kuveyt Türk (KT Bank): Germany's First Islamic Bank', *Preprints and Working Papers of the Center for Religion and Modernity* (2017), p. 6, at www.unimuenster.de/imperia/md/content/religion_und_moderne/preprints/crm_working_paper_15_casper_allali.pdf.

c the German Banking Act (KWG) covers, *inter alia*, the licensing requirements for banks, ownership control and the national regulation of banks and other investment institutions.

As Germany is an EU Member State, the national legislative and regulatory regime is complemented by certain EU regulations that claim direct application in Germany, which are also relevant to Islamic finance products:

a the Market Abuse Regulation (Regulation (EU) No. 596/2014) includes rules on *ad hoc* publicity, insider trading and market manipulation;

b the Single Supervisory Mechanism Regulation (Council Regulation (EU) No. 1024/2013) (SSM) confers the nature and scope of the European Central Bank's (ECB) duties and its cooperation with national competent authorities such as the BaFin; and

c the Capital Requirements Regulation (Regulation (EU) No. 575/2013) that sets certain capital requirements for credit institutions and investment firms.

Legal qualification of Islamic finance products under German law

Since Islamic finance products are not regulated separately in Germany, the corresponding structures will be legally assessed and qualified in accordance with the general rules of the applicable civil, commercial, corporate, banking and tax laws. Thus, the *sharia*-compliant structures have to be reviewed from a German law perspective, which applies to these structures accordingly.

Murabahah

This is a financial structure that enables immediate asset purchase but with deferred payment would legally be comprised of two purchase agreements. Thus, under German law, these would be subject to the regulations of the BGB covering sale and purchase agreements and the transfer of ownership *in rem*. If such agreement is concluded between business people and consumers, it could be qualified as financial assistance and thus be subject to the special consumer protection regulations set forth in the BGB.[3]

Istisnah

An *istisnah* is an agreement to manufacture an asset. One party engages another to develop or manufacture an asset, which the bank agrees to purchase. The engaging party then buys the manufactured asset from the bank with deferred payment. The *istisnah* is similar to the *murabahah* structure; however, it is not constituted of two sale and purchase agreements, but instead, a contract for development and a sale and purchase agreement.[4]

3 Becker, RNotZ 2014, 22, 30, 32.

4 Becker, RNotZ 2014, 22, 26.

Mudarabah

This is an arrangement under which two partners contribute to a partnership. While one partner contributes capital, the other partner contributes its know-how and work. Such an arrangement is comparable to a German silent partnership[5] or a profit-participating loan[6] and therefore falls under the corresponding regulation within the HGB.

Musharakah

Musharakah describes a partnership dedicated to achieve a joint purpose. Both or all partners provide cash or assets. Such arrangement would qualify as a joint venture in Germany. There are no specific rules applicable to joint ventures in Germany. The applicable law rather depends on the type of partnership or corporation that is used for the joint venture. Parties in general would use a limited liability company for such joint ventures; therefore, the rules on limited liability companies would apply.

Ijarah

Ijarah is similar to operating leasing, whereas an *ijarah wa iqtina* qualifies as financial leasing.[7] Operating leasing agreements are qualified as rental agreements and are therefore directly subject to the relevant regulations in the BGB.[8] *Ijarah wa iqtina* as a financial lease agreement could qualify as a financial instrument and therefore fall within the scope of the regulations of the KWG,[9] or as financial assistance, and be subject to the consumer protection regulations.

Sukuk

Sukuk are asset-based certificates that differ depending on the asset they are based on. *Sukuk* are often referred to as Islamic bonds, owing to their resemblance to conventional bonds.[10] In turn, *sukuk* would be subject to the regulations on bonds in the KWG.

Depending on the individual structure of each transaction, further legal regulations may apply. However, as a guiding principle, the freedom of contract applies to any of the aforementioned transaction structures, so that the parties are free – subject to the application of fundamental principles of German law – to agree and stipulate the specifics and details of their contractual relationship.

5 Gehrlein, in Ebenroth/Boujong/Joost/Strohn, HGB, 3rd edition, 2017, Section 230, recital 2 et seq.; Roth, in Baumbach/Hopt, HGB, 38th edition, 2018, Section 230, recital 1 et seq.; Karsten Schmidt, in MüKo HGB, 3rd edition, 2012, Section 230, recital 3; Wedemann, in Oetker, HGB, 5th edition, 2017, Section 230, recital 1 et seq.

6 Gehrlein, in Ebenroth/Boujong/Joost/Strohn, HGB, 3rd edition, 2014, Section 230, recital 77; Roth, in Baumbach/Hopt, HGB, 38th edition, 2018, Section 230, recital 4; Karsten Schmidt, in MüKo HGB, 3rd edition, 2012, Section 230, recital 57 et seq.; Wedemann, in Oetker, HGB, 5th edition, 2017, Section 230, recital 36, 37.

7 Becker, RNotZ 2014, 22, 26.

8 Koch, in MüKo BGB, 7th edition, 2016, financial leasing, recital 5; Alexander Scheuch/Ina Ebert, in Schulze, BGB, 9th edition, 2017; introduction to Sections 535 to 580a, recital 11; Weidenkaff, in Palandt, BGB, 77th edition, 2018, introduction to Section 535, recital 38, 40; Zehelein, in BeckOK BGB, 45th edition, 2017, introduction to Section 535, recital 68.

9 Gramlich/Manger-Nestler, WM 2009, 1634.

10 Grieser, WM 2009, 592.

Legal prerequisites

Islamic finance products are generally compatible with German law and can be structured to comply with the rules of German law as well as the requirements set by *sharia*. As *sharia* presents certain legal boundaries with regards to such transactions (e.g., based on Chapter 2, verse 276 of the Quran), taking interest is forbidden. Similarly, the German rule of law also stands, and as a result, German laws must be adhered to. In structuring the transaction, both legal systems must be aligned. In hindsight, it can be seen that this is possible:

a the *sharia* board must be compliant with standards set by German corporate law. If a German stock corporation, limited liability company or partnership is involved in a transaction, the principles concerning the authority of the management board should be observed. This means that the *sharia* board (internal or external) cannot have the power to make final management decisions, such as whether or not a certain product shall be issued. Although a *sharia* board may not take any managerial decisions, it may assess the extent to which products are compliant with the Islamic rules on finance.[11] From our perspective and experience in dealing with such *sharia* boards, it is not its intention to take managerial decisions or roles, but it provides assessment advice and help in structuring transactions and monitors activities of the management board in order to qualify the transaction as *sharia*-compliant; and

b Islamic financial institutions should be aware of consumer protection law being integrated into general German civil law (Sections 305 et seq., 312 et seq., 355 et seq., 474 et seq., 491 et seq. and 506 et seq. of the BGB). The provisions of German consumer protection law are based on several European directives on consumer rights and are therefore regulated consistently throughout the European Union. Consumer protection law applies to contracts between customers and businesses (Section 310, Paragraph 3 of the BGB). This is not an Islamic finance specific issue, but applies to any international investor.

ii Regulatory and supervisory authorities

There is no special regulator in Germany dealing specifically with Islamic finance structures or products. Islamic and conventional financial institutions alike are supervised by (1) the ECB; (2) the German national central bank (Deutsche Bundesbank); and (3) the BaFin.

The ECB is responsible for banking supervision in the Eurozone under the SSM. Under such mechanism, the ECB aims to ensure harmony in the European banking system and consistency in the application of regulations and supervisory policies. The ECB is the competent authority to, in particular, (1) grant and withdraw banking licences, (2) conduct supervisory reviews and inspections and (3) supervise the institutions' compliance with the corresponding regulatory regime.

Despite the fact that many functions of the Deutsche Bundesbank have been taken over by the ECB, the Deutsche Bundesbank is, alongside the ECB, responsible for, *inter alia*, national supervision, drawing up the fiscal and monetary policies, foreign currency reserves and statistics regarding the market and its participants.

In addition to regulating the banking sector on a national level, the BaFin is also responsible for (1) regulating and applying the relevant applicable rules on the insurance market, (2) the offering of securities and (3) approving prospectuses. Depending on the

11 Sorge, ZBB 2010, 366.

specific circumstances of the transactions, either the BaFin or the ECB would be the competent authority to approve the issuance of *sukuk* and regulate the Islamic insurances and reinsurances known as *takaful* and *retakaful*.

III COMMON STRUCTURES

The Capital Investment Act was adopted in 2013 for the creation of a unified standard for the management of investment funds, and provides the general regulatory framework that all financial products – regardless of whether they are structured to comply with *sharia* principles – must comply with.

i Islamic bank

In 2015, KT Bank was granted a banking licence by the BaFin and became the first bank in Germany to offer dedicated Islamic finance products.[12] Since then, *sharia*-compliant financial products have been introduced to the German market and offer retail and investment banking solutions to both individuals and businesses alike.[13]

ii Insurance

With regards to *sharia*-compliant insurance products, the most common structure is demonstrated by ForwardU AG (FWU AG), a financial services company based in Munich, which offers insurance solutions in the form of *takaful*. In accordance with *sharia* principles, FWU AG has allowed its customers to enjoy the benefits of life insurance.[14]

iii Investment funds

Sharia-compliant investment funds have been made available in recent times in Germany.[15] Such funds provide investors with the opportunity to invest in an index that deals solely with businesses whose activities do not include activities that are forbidden in Islam, such as interest-bearing financial services or derivatives, or the sale of alcohol, pork, tobacco, arms or gambling products, among other things. As such, the certificates offered to investors in this index have been certified by the Central Council of Muslims in Germany as being *sharia*-compliant.[16]

KT Bank offers participatory accounts that involve investing in *sharia*-compliant products. These accounts are based on the principles of *mudarabah*. They operate on the basis of profit sharing, whereby the allocation of profits is dependent on the initial investment deposit and the duration of the deposit. The duration of the term varies between three and 36 months, whereas the investment size has a minimum requirement of €1,000.[17]

12 Meijer/Vizcaino, 'Kuveyt Turk preps July launch of Germany's first Islamic bank', 2015, at www.reuters.com/article/islam-financing-germany/kuveyt-turk-preps-july-launch-of-germanys-first-islamic-bank-idUSL6N0WO0UW20150322.

13 See footnote 2.

14 www.forwardyou.com/what-we-do/takaful.html.

15 www.fondsprofessionell.de/upload/attach/1323870781.pdf.

16 ibid.

17 Footnote 2, p. 5.

iv Consumer finance

The primary structures used for consumer finance in line with Islamic finance principles are based on *murabahah lil amri bi-schira*, whereby a contract between the customer and the bank is entered into that gives the customer authority to purchase the good to be financed in the name of the bank. It is imperative that the good conforms to the principles of Islamic finance and is deemed *halal*. Subsequently, the contract of purchase between the customer (signing in proxy in the bank's name) and the seller of the good is signed, and the purchase price is paid to the seller. The bank will then have ownership and good title over the good, and sells the good in question to the consumer, having calculated a profit margin on top of the original purchase price.[18]

v Home financing

Customers seeking *sharia*-compliant home financing are able to do so in accordance with both the principles of Islamic finance and the general provisions under German law. KT Bank provides such financial products by utilising the *musharakah* structure.[19]

vi Other areas

In 2004, the state government of the German federal state of Saxony-Anhalt issued a *sharia*-compliant bond in the form of a *sukuk* for €100 million. The federal state allocated the legal rights of use of some of its real estate to a trust and the trust released the legal rights of use back to the federal state. The issue was traded on the Luxembourg Stock Exchange and was fully subscribed.[20] The structure involved the use of a leasing rate, as opposed to receiving interest in order to maintain compliance with *sharia* principles. Subsequently, the *ijarah sukuk* structure became the most common form of Islamic finance structure used with regards to German real estate transactions.[21]

IV TAXATION

The German tax system applies to all taxpayers equally. The guiding principle of German taxation is the ability-to-pay principle as a specific expression of the general principle of equality stipulated in Article 3, Paragraph 1 of the German Federal Constitution.[22] Accordingly, the tax burden is measured on the basis of income of the respective taxpayer (i.e., on purely economic factors).[23] Although social aspects and responsibilities are considered,[24] there is in principle no special treatment on the basis of ethnicity or religion. As such, the tax burden of a transaction is determined based on the merits of the individual transaction. This might result in disadvantageous taxation of certain structures used for Islamic finance compared to the taxation of a conventionally structured transaction. Below are two summarised examples of such potential taxation issues that need to be taken care of when doing such transactions:

18 Footnote 2, pp. 24 et seq.

19 Footnote 2, p. 34.

20 Footnote 2, p. 5.

21 Fawzy, VuR 2009, 39, 40.

22 BVerfGE 105, 73, 125; Hey, in Herrmann/Heuer/Raupach, EStG and KStG, 2017, introduction to EStG, recital 42.

23 Hey, in Herrmann/Heuer/Raupach, EStG and KStG, 2017, introduction to EStG, recital 44.

24 Hey, in Herrmann/Heuer/Raupach, EStG and KStG, 2017, introduction to EStG, recital 45.

a Islamic finance *ijarah* and *murabahah* structures require, in principle, at least a two-step acquisition of the underlying asset, first by the financial institution and then by the customer.[25] In the case of a real estate transaction, such structure may trigger real estate transfer tax twice, for each case of acquisition of the underlying real estate asset. In contrast, a conventional product would only result in one taxable acquisition,[26] and thus, real estate transfer tax would be triggered once. At first glance, the structure of *murabahah* products is seen to give rise to double taxation issues in Germany, as the transaction is comprised of two distinct purchase agreements, and therefore each respective transaction may be liable for taxation under German real estate transfer tax laws. However, KT Bank suggests a solution with regards to the tax implications by electing to constitute a civil law partnership with the customer.

b The term 'interest' might be interpreted differently under German law compared with *sharia*. Under *murabahah*, the profit of the bank – being the surplus between the amount paid to the seller and the amount received from the customer – would not qualify as income from interest, but as commercial income. That is to the disadvantage of the bank as the tax rate for trading and commercial income is higher in Germany than that of income derived from interest. For the customer who has paid an extra amount as surplus to the bank, such surplus would be qualified under German tax law as interest expenses, irrespective of the qualification under *sharia*. The customer would therefore be treated equally as any taxpayer in a conventional structure.

Thus, Islamic finance products are not subject to tax (dis)advantages in general. Nevertheless, they have to be structured carefully and with a special view on German tax law to minimise the risk resulting from German taxation.

V INSOLVENCY

There is no separate insolvency regime for Islamic finance products in Germany, making them subject to the German Insolvency Act (InsO). Within an insolvency proceeding, all creditors are generally treated equally.[27] After the application for insolvency has been filed, the court passes a resolution to commence insolvency proceedings. The creditors are then required to file their claims. The insolvency administrator now has administrative authority over the debtor's assets, and subsequently the debtor's disposals of insolvency assets are generally invalid.[28]

Individual enforcement of a ruling in favour of the creditors is not permitted, as the revenue of the liquidation is divided among the creditors *pro rata*. However, some creditors are favoured, such as creditors who are entitled to have specific property released from the

25 Klein, in *Islamic Finance Tax Considerations Around the World*, 2012, pp. 26–27.

26 ibid.

27 Ganter/Lohmann, in MüKo InsO, 3rd edition, 2013, Section 1, recital 52; Madaus, in Fridgen/Geiwitz/Göpfert, BeckOK InsO, 10th edition, 2018, Section 1, recital 3; Pape, in Uhlenbrock, InsO, 14th edition, 2015, Section 1, recital 12.

28 Mock, in Uhlenbrock, InsO, 14th Edition, 2015, Section 81, recital 25; Ott/Vuia, in MüKo InsO, 3rd edition, 2013, Section 81, recital 5; Riewe, in Fridgen/Geiwitz/Göpfert, BeckOK InsO, 10th edition, 2018, Section 81, recital 7.

bankrupt's estate and creditors who are entitled to separate satisfaction. A right to release a certain property requires a personal right or a right *in rem* concerning the property, such as a right of ownership.[29]

VI JUDICIAL FRAMEWORK

i Courts

Courts in Germany have jurisdiction over disputes arising out of Islamic finance-related transactions, unless there is an arbitration clause or a contractual clause that gives jurisdiction to any other courts.

ii Cases

To our knowledge, there have been no recent (publicly known) litigation cases in German courts that are related to Islamic finance matters.

VII OUTLOOK

Germany offers an open market for Islamic finance that provides a solid foundation for growth. Additional development in the regulatory framework will further facilitate Islamic finance products and enhance both inbound and outbound investment streams with investors caring for *sharia*-compliant or ethical products in general. Owing to the fact that the BaFin is in charge of the oversight of the financial sector, potential customers would always be protected by a supervisory authority, which ensures that the respective law is followed in light of potential developments.[30] Although *sharia*-compliant products are still relatively rare in the German financial market, the existence of the KT Bank proves that it is possible to successfully embed them into the German legal framework.

29 Brinkmann, in Uhlenbrock, InsO, 14th edition, 2015, Section 47, recital 10; Ganter, in Kirchhof/Eidenmüller/Stürner, MüKo InsO, 3rd edition, 2013, Section 47, recital 37; Haneke, in Beck InsO, 10th edition, 2018, Section 47, recital 26.

30 Kloft, 'Geld anlegen nach Scharia', 2017, at www.faz.net/aktuell/finanzen/finanzmarkt/muslimische-kt-bank-arbeitet-als-erste-ohne-zinsen-15220758-p2.html.

Chapter 5

JAPAN

Naoyuki Kabata and Satoshi Kato[1]

I LEGISLATIVE AND REGULATORY FRAMEWORK

Japanese law does not provide a special legal framework for supporting and regulating Islamic finance. Consequently, Islamic finance needs to be implemented under the legal framework for conventional finance in Japan. Under the laws and regulations governing conventional finance, an Islamic finance product that has legal characteristics that are equivalent to those of a conventional finance product or that is otherwise substantially equivalent or similar to a conventional finance product might be permitted as a type of conventional finance product. Further, certain types of Islamic finance products are plainly permitted pursuant to special clauses of the laws and regulations governing conventional finance. The scope of such permitted Islamic finance products has gradually been expanded over the past 10 years.

i Legislative and regulatory regime

Islamic banking

There is no special legal framework for banks that engage in Islamic finance. In general, Japanese law requires an entity engaging in the business of deposits, lending or money transfers (exchange transactions) to be licensed. A deposit or money transfer business (exchange transaction business) must have, in principle, a banking licence pursuant to the Banking Act of Japan (BA). A licensed bank may also engage in the lending business. However, when a person or entity only conducts a lending business (i.e., not concurrently with a deposit-taking business), that person or entity is required to be registered as a money lending business operator under the Money Lending Business Act of Japan (MLBA).

In addition, a sale transaction with instalment payments and a lease transaction with rent payments, which provide functions that are economically similar to lending, are regulated differently. Under the Instalment Sales Act of Japan (ISA), sales transactions with instalment payments can be conducted with or without registration depending on the specific type of transaction at issue. By contrast, lease transactions with rent payments can generally be conducted without any licence or registration.

Generally, transactions that target a customer in Japan from a foreign country are subject to the same licence requirements stated above. As a result, a foreign bank that engages in the banking business involving customers in Japan typically opens a Japanese subsidiary or branch and obtains a banking licence under the BA.

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The BA and its subordinate rules and guidelines that are applicable to licensed banks clarify the types of Islamic finance products that may be provided by a licensed bank and its subsidiaries (including those outside of Japan). The following are identified as permissible Islamic finance products for licensed banks:

a a commodity sale and purchase transaction that is economically equivalent to lending, provided that (1) the commodities involved in the transaction are tradable in an exchange; and (2) the bank has removed all risks related to such commodities other than the purchaser's credit risk in paying the sale price, including the risk arising from the failure to sell or buy the commodities;

b an asset lease transaction that is economically equivalent to lending, provided that (1) the bank has removed all risks related to the asset involved in the transaction other than the lessee's credit risk in paying the rent; (2) the transaction must possess the characteristics of a financing lease transaction that the bank licensed under the BA is permitted to perform; and (3) the transaction does not involve any business or transaction that banks are prohibited from conducting, such as construction work;

c an acquisition of interest in a customer's business that is economically equivalent to lending, provided that (1) the cash flow generated by the interest is similar to that generated in a lending transaction; and (2) the bank has removed all risks related to the customer's business other than the customer's credit risk;

d a commodity sale and purchase transaction that is economically equivalent to a deposit, provided that the bank has removed all risks related to the commodities involved in the transaction; and

e a commodity sale and purchase transaction that is economically equivalent to an interest rate swap or currency swap, provided that the bank has removed all risks related to the commodities involved in the transaction.

Transactions referenced in items (*a*), (*d*) and (*e*) correspond to commodity *murabahah* transactions, while the transaction referenced in item (*b*) corresponds to *ijarah* and *istisna* transactions. The transaction described in item (*c*) corresponds to *musharakah* and *mudarabah* transactions. However, whether a particular Islamic finance product is permissible must be determined by analysing if the specific terms and conditions of that product meet the requirements of the BA and its subordinate rules and guidelines.

Further, the following are identified by the BA and its subordinate rules and guidelines as permissible Islamic finance products for a subsidiary of a licensed bank:

a those Islamic finance products that are deemed permissible for a licensed bank; and

b a transaction that does not involve cash lending, but that should be deemed to constitute the equivalent of cash lending, provided that (1) the customer of such transaction (i.e., deemed borrower) is in a jurisdiction where the receipt of interest is prohibited owing to religious restrictions; and (2) the transaction is conducted pursuant to a judgment authorising such transaction from a board that is constituted by members who have special knowledge (which effectively refers to a *shariah* board) confirming that the transaction does not fall within the category of cash lending from the perspective of the applicable religious discipline.

In addition to those described above, other types of Islamic finance products might be permissible if such products are substantially the same as or similar to a conventional finance product. For example, a *mudarabah* transaction might be regarded as being similar to the acquisition of interests under a silent partnership agreement or partnership agreement. As a result, although certain filing requirements would apply, a licensed bank might be permitted to conduct such transaction depending on the specific characteristics of the products and the business conducted by the *mudarabah* business operator.

Capital markets

Japanese law also does not provide any special legal framework for Islamic finance in terms of capital markets products. Under the laws and regulations governing conventional finance, a securities brokerage business is subject to a registration requirement. More specifically, the Financial Instruments and Exchange Act of Japan (FIEA) requires a securities brokerage business to register as either a Type I financial instruments business operator or a Type II financial instruments business operator depending on the types of securities that the broker handles. Thus, if an Islamic finance product is classified as a type of security under Japanese law, the broker of such product must register as either a Type I or Type II financial instruments business operator as described above. While a foreign securities broker is also subject to the registration requirements when it has customers in Japan, certain exemptions are provided by the FIEA for the benefit of a foreign securities firm (i.e., a foreign entity that is licensed to conduct a securities brokerage business under its home country's law). For example, without registering under the FIEA, a foreign securities firm may promote securities from outside of Japan to certain limited categories of sophisticated investors such as banks, insurance companies, trust companies, broker-dealers and discretionary securities investment managers (all of which must be licensed in Japan).

With respect to the origination of *sukuk* in Japan, amendments to tax legislation enabled the issuance of *sukuk* using a specified purpose trust created under the Act on Securitisation of Assets of Japan (ASA). Based on a typical *sukuk* scheme that uses a sale and leaseback arrangement (*sukuk al-ijarah*), the originator entrusts its asset (such as real property) to a specified purpose trust and, in exchange, obtains special beneficial interests (a quasi-bond beneficial interest), which are to be distributed to investors as *sukuk*. The amendments to tax legislation, for example, have caused distributions payable under such special beneficiary interests to be treated the same as interest payable under corporate bonds. They have also resulted in exemptions to the imposition of real property registration tax and acquisition tax on the buy-back of real property by the originator upon the redemption of *sukuk*. Such amendments to the tax legislation have provided a level playing field to *sukuk* issued through a specified purpose trust. See Section III, below, for details.

With respect to the distribution in the Japanese market of *sukuk* originated outside of Japan, the conventional regulatory framework that applies to the sale of bonds will apply. Consequently, assuming that the foreign *sukuk* is classified as a Type I security because of its high-liquidity, there are primarily two routes to distribute the *sukuk* that originated outside of Japan. If those who have been solicited to purchase the foreign *sukuk* include one or more qualified institutional investors and 49 or less non-qualified institutional investors (i.e., private placement or private sale), then the foreign *sukuk* may be sold via a relatively simple procedure that does not require the filing of a securities registration statement. However, if the foreign *sukuk* is distributed via a public offering or public sale, securities registration statements typically must be filed, which is a fairly cumbersome and costly process.

Insurance

There is no special legal framework for Islamic insurance (*takaful*) under Japanese law. Further, because the legal structures of conventional insurance and *takaful* insurance are different, a Japanese insurance company, which is licensed under the Insurance Business Act of Japan (IBA), is unlikely to be permitted to handle *takaful* insurance. However, Japanese law does not fully discuss whether a Japanese insurance company is permitted to handle *takaful* insurance.

Funds

There is no special legal framework for Islamic funds under Japanese law. However, under the laws and regulations governing conventional finance, there are several legal frameworks for funds in Japan. Consequently, it may be possible to establish Islamic funds by restructuring one such legal framework to satisfy the Islamic finance requirements, such as by (1) restricting the investment portfolio to *shariah*-compliant business or products; and (2) managing the funds through a *shariah* board. Note that using existing investment management companies as fund managers or existing trust companies as trustee might cause *shariah* issues since most of these companies in Japan are affiliates of a licensed bank and engage in a large number of conventional finance transactions.

Under the FIEA, a discretionary securities investment manager is required to register as an investment management business operator, while a non-discretionary securities investment adviser is required to register as an investment advisory business operator. Accordingly, the fund managers of Islamic funds established in Japan are likely to be required to register either as investment management business operators or investment advisory business operators, depending on the specific roles of each fund manager under the respective fund scheme.

ii Regulatory and supervisory authorities

The Financial Services Agency of Japan implements the BA, the FIEA, the MLBA and the IBA. The Ministry of Economy, Trade and Industry implements the ISA, which governs sale transactions involving instalment payments.

Islamic finance business is treated like any other finance business in Japan. Accordingly, it is subject to the supervision and authority of the regulatory authorities. The regulatory authorities monitor the activities of a finance business through a combination of on-site and off-site inspections. If any issue or failure respecting compliance is found, the regulatory authorities conduct additional examinations. If the issue or non-compliance is material, the regulatory authorities may impose administrative sanctions, such as an order for business improvement, an order for suspension of business or an order for revocation of the relevant licence. Moreover, if there is any breach of criminal law, criminal penalties may also be imposed.

II COMMON STRUCTURES

To date, our understanding is that no Islamic finance product governed by Japanese law has been created. Nonetheless, Japanese financial institutions, such as Japanese banks and securities firms, engage in Islamic finance business in Malaysia and Middle Eastern countries through their subsidiaries or branches.

III TAXATION

Special tax treatment is applied to Japanese *sukuk*, which is structured using a specified purpose trust under the ASA. Although the Japanese *sukuk* is a trust beneficiary interest, as a result of a series of amendments to the tax legislation, the Japanese *sukuk* is now treated more like a bond than a trust beneficiary interest from the tax perspective. Under Japanese tax law, the dividends to be paid to the foreign holders of a trust beneficiary interest are subject to taxation. However, the foreign holders of a Japanese *sukuk* are exempted from such taxation when they register the Japanese *sukuk* with the Japanese depository system and receive the dividends of the Japanese *sukuk*.

In addition, special tax treatment that reduces the transactional costs of typical Japanese *sukuk* backed by real property has been introduced. When an originator buys real property back from the trustee upon redemption, such buy-back transaction is normally subject to the registration and licence tax and real property acquisition tax. However, if such transaction is conducted as part of a Japanese *sukuk* transaction, it is not subject to such taxation under certain conditions.

Other than the special tax treatment described above, no special tax treatment is given to Islamic finance. Islamic finance transactions are subject to general taxation rules under Japanese law. For example, a sale and purchase in a *murabahah* transaction will be subject to consumption tax, registration and licence tax and real property acquisition tax depending on the types of assets at issue.

IV INSOLVENCY

No special legal framework is provided for the treatment of Islamic finance under Japanese bankruptcy procedures. Further, no court precedent is available. Consequently, Islamic finance products may be subject to the rules that are applicable to conventional financial products that are similar to the relevant Islamic finance products.

V JUDICIAL FRAMEWORK

i Courts

Because no *shariah* court has been established in Japan, a conventional Japanese court will have jurisdiction over a dispute in relation to Islamic finance. Even if the parties agree to designate *shariah* as the governing law, it is unlikely that a Japanese court will apply *shariah* as the law governing the judgment in that case.

ii Case

There is no available case in which a Japanese court has handled a dispute in relation to Islamic finance.

VI OUTLOOK

The legal framework supporting and regulating Islamic finance is being gradually developed, primarily in the area of banking and *sukuk*. Because of the *de minimis* Muslim population in Japan, the Islamic finance retail business is unlikely to become prevalent in Japan. By contrast, the wholesale Islamic finance business, in particular for Muslim investors or domestic companies engaging in business in Muslim countries, is likely to be the subject of increasing demand. Further development with respect to the legal, accounting and taxation framework in response to the demand from private sectors engaging in Islamic finance business is strongly expected to propel Islamic finance in Japan forward.

Chapter 6

LUXEMBOURG

Frank Mausen, Christopher Dortschy, Evelina Palgan and Zofia White[1]

I INTRODUCTION

The Grand Duchy of Luxembourg (Luxembourg) has long embraced Islamic finance as an important area of international finance and has taken an active role in fostering cooperation with firms and institutions engaged in *shariah*-compliant transactions. To create an environment conducive to the carrying out of such transactions in or via Luxembourg, Luxembourg has undertaken multiple initiatives designed to identify the particular needs of Islamic financial players and how they can be catered for. Often-cited examples of Luxembourg's credentials as an Islamic finance centre include the establishment in Luxembourg, in 1978, of the first Islamic finance institution in a non-Muslim country (the Islamic Banking System); authorising, in 1983, the first *shariah*-compliant insurance company in Europe; and the listing, in 2002, of *sukuk* on the Luxembourg Stock Exchange for the first time in Europe.[2] More recently, in 2009, the Luxembourg Central Bank (BCL), as the first European central bank, joined the Islamic Financial Services Board, and the following year the BCL became one of the founding members of the International Islamic Liquidity Management Corporation.[3]

One of the conclusions reached on the basis of the research conducted by the various working groups, set up under the auspices of the Luxembourg government, was that Luxembourg's legal system provides investors and promoters interested in *shariah*-compliant products with a choice of suitable vehicles.[4] The confirmation of the tax treatment of *shariah*-compliant vehicles and the development of best practice guidelines for Islamic financial services followed soon afterwards.[5] The time and effort put in by Luxembourg's financial services sector into growing its Islamic finance competencies have paid off – Luxembourg has become a prime location for the listing of *sukuk* and, in terms of the number of Islamic funds set up in the market, Luxembourg is the largest Islamic fund hub outside the Muslim world and the third largest globally.[6]

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2 Luxembourg for Finance, *Islamic Finance*, January 2017.
3 Ernst & Young, *Luxembourg: the gateway for Islamic finance and the Middle East*, EY Luxembourg, May 2017.
4 See footnote 2.
5 ibid.
6 See footnote 3.

II LEGISLATIVE AND REGULATORY FRAMEWORK

In Luxembourg, there are no laws dedicated specifically to Islamic financial products or services. The existing legal framework has proved both flexible and innovative enough to accommodate the demands of Islamic financial practitioners, implementing various *shariah*-compliant structures through the use of Luxembourg vehicles and legislation. It is also relatively common and straightforward to combine, in a single transaction, elements of Luxembourg law with foreign law-governed agreements and structuring tools, such as, for instance, a trust governed by English law. Although it currently has no equivalent under Luxembourg law, an English law trust will generally be recognised, subject to certain conditions, by Luxembourg courts on the basis of the Convention on the law applicable to trusts and on their recognition concluded at The Hague on 1 July 1985. An English law trust declared in favour of *sukuk* holders over the underlying assets held by the issuer of *sukuk* will allow *sukuk* holders to retain a form of ownership over those underlying assets as prescribed by *shariah* law.

i Legislative and regulatory regime

Banking

The regulatory regime applicable to credit institutions in Luxembourg is mainly shaped by the European directives and regulations dealing with the banking and the investment sectors,[7] as further completed by national law. All the provisions and requirements in force in Luxembourg relevant for credit institutions would apply to Islamic banks as no specific regime is provided, or indeed required, for this type of institution. This was confirmed by the findings of a cross-sector task force set up by the Luxembourg government in 2008. The relevant provisions of European law are implemented in large parts in the Luxembourg act of 5 April 1993 on the financial sector, as amended (the Banking Act), and in the Luxembourg act of 18 December 2015 on the failure of credit institutions and certain investment firms.

According to the Banking Act, no person established under Luxembourg law may carry on the business of a credit institution without holding a written authorisation from the Minister responsible for the *Commission de surveillance du secteur financier* (CSSF), which is the Luxembourg banking and financial supervisory authority. This licensing requirement to carry out banking and financial activities also applies to Islamic banks. Since 2014, Luxembourg has been a participating member of the Single Supervision Mechanism (SSM), which means, among other things, that entities willing to carry out banking activities in and from Luxembourg must obtain their licence from the European Central Bank (ECB), through the services of the CSSF (which remains the point of entry of the licence applications).

Except for covered bond banks (the exclusive activity of which is to issue covered bonds), Luxembourg banks (including Islamic banks) qualify as 'universal' banks (which means that Luxembourg credit institutions are authorised to carry out any activity of the financial sector). According to the principle of the European passport, a Luxembourg bank may provide services, either through a branch or on a cross-border basis, in any other country of the European Economic Area (EEA) without any further licensing requirement in a host

7 The most recent and fundamental pieces of legislation being Directive 2013/36/EU and Regulation (EU) No. 575/2013 in the banking field and Directive 2004/39/EC, repealed by Directive 2014/65/EU on markets in financial instruments (MiFID) in the investment field.

country. A Luxembourg branch of a third-country institution (from outside the EEA) would, however, need a specific type of licence in Luxembourg, which would not allow it to benefit from the European passport.

Luxembourg banks are subject to two main sets of requirements:

a those relating to prudential supervision aimed at preventing systemic risks; and

b those relating to investors' and clients' protections that mainly stem from Directive 2014/65/EU[8] and the EU consumer protection rules.

The prudential regulation imposes a number of requirements and ratios in terms of internal governance, own funds, liquidity and risk management, whereas the client and investor protection corpus requires certain conduct of business rules to be implemented and a high level of contractual formalism when dealing with clients.

As mentioned above, the CSSF is Luxembourg's national competent authority for banks with respect to both the prudential aspects and the client protection aspects. However, in the context of the SSM, the competence of the CSSF in relation to prudential matters is delegated to it by the ECB, which is now, as a matter of principle, the competent supervisory authority in the eurozone. Any credit institution that will qualify as a significant institution would be under the direct supervision of the ECB for those aspects. The CSSF remains the competent authority for less significant institutions.

Investment funds

Shariah investment funds may be set up under the general legal framework applicable to investment funds in Luxembourg as there is no specific legal requirement concerning these products.[9] Therefore, these funds fall, depending on their structure, within the scope of the Companies Act,[10] the Alternative Investment Fund Managers Act (AIFM Act)[11] or one of the Product Acts.[12] The Association of the Luxembourg Fund Industry (ALFI) has also published a set of best practice guidelines for setting up and servicing Islamic investment funds,[13] which have become an international standard in the financial sector.[14] Thus, from a supervisory and regulatory perspective, there is no particular distinction between a *shariah* investment fund and any other type of fund.

The common regulatory principles applicable to managers of a regulated investment fund or its regulated external manager set up under Luxembourg law must also be fulfilled. For these investment funds, *shariah* board members who have a decision-making role must therefore be of sufficiently good repute, and be sufficiently experienced in relation to the investment policy of the concerned investment fund.[15]

8 MiFID.

9 CSSF, *Investment Funds and Islamic Finance*, 11 May 2011.

10 The Luxembourg act of 10 August 1915 on commercial companies, as amended.

11 The act of 12 July 2013 on alternative investment fund managers, as amended.

12 The term refers to the act of 15 June 2004 relating to the investment company in risk capital (the SICAR Act); the act of 13 February 2007 concerning specialised investment funds (SIF) (the SIF Act); the act of 17 December 2010 relating to undertakings for collective investment (UCI) (the UCI Act); and the act of 23 July 2016 on reserved alternative investment funds (the RAIF Act); each as amended or replaced from time to time.

13 ALFI, *Recommendations for setting up and servicing Islamic funds*, December 2012.

14 See footnote 2.

15 CSSF, *Investment Funds and Islamic Finance*, Luxembourg, 11 May 2011.

Capital markets

Traditional *shariah*-compliant structures can be replicated using Luxembourg vehicles, with the full benefits of the applicable Luxembourg tax and legal regime. A Luxembourg securitisation undertaking subject to the Securitisation Act[16] (discussed in more detail below) is frequently the vehicle of choice for clients who seek to raise finance in compliance with *shariah* principles, in particular using *murabahah* and *ijarah* structures.[17]

As regards the offering of securities in Luxembourg – whether by way of private placement, an offer to the public or admission to trading on the regulated market or the Euro MTF market of the Luxembourg Stock Exchange, the same rules apply to *sukuk* as to conventional bonds. While private placements are not subject to any regulation and can be carried out without any form of offering document, an offer of securities to the public will (unless an exemption is available) have to be conducted in accordance with the Prospectus Act,[18] which requires the publication of a prospectus drafted in accordance with the Prospectus Regulation.[19] The Prospectus Act also requires a prospectus to be published in connection with the admission of securities to trading on the regulated market of the Luxembourg Stock Exchange. Once approved in Luxembourg by the CSSF (in circumstances where Luxembourg is the issuer's home Member State within the meaning of the Prospectus Act), a prospectus prepared in compliance with the Prospectus Act and the applicable annexes of the Prospectus Regulation can be used for public offers or admission to trading on regulated markets in other countries of the EEA without the need for a separate approval from the local competent authorities (subject to the CSSF notifying the competent authorities of its approval). Issuers of securities traded on the regulated market of the Luxembourg Stock Exchange will have to comply with the highly harmonised ongoing obligations relating to transparency and prohibition of market abuse. Alternatively, securities may be admitted to trading on the Euro MTF market of the Luxembourg Stock Exchange, which is not included in the list of regulated markets published by the European Commission, but which has built up a strong international reputation among issuers and investors. An offering circular to be prepared in connection with trading on the Euro MTF market will be approved by the Luxembourg Stock Exchange and it must comply with the disclosure requirements set out in the Rules and Regulations of the Luxembourg Stock Exchange – these requirements are lighter than those under the Prospectus Act but they do not offer the possibility of 'passporting' the offering circular to other jurisdictions. The Rules and Regulations of the Luxembourg Stock Exchange also prescribe most of the ongoing disclosure requirements applicable to issuers of securities admitted to trading on the Euro MTF market.

On 26 January 2011, the CSSF published a press release on rules applicable to *sukuk* in the context of preparing a prospectus compliant with the Prospectus Act.[20] In that press release, the CSSF clarifies that *sukuk* may be regarded as asset-backed securities within the meaning of Article 2.5 of the Prospectus Regulation or, where the payment of principal and periodic distributions are guaranteed on a contractual basis (as opposed to being dependent

16 The Luxembourg act of 22 March 2004 on securitisation, as amended.

17 See footnote 2.

18 The Luxembourg act of 10 July 2005 relating to prospectuses for securities, as amended.

19 Regulation No. 809/2004 of the European Commission, as amended.

20 CSSF, *Rules applicable to 'sukuk'*, 26 January 2011.

on the performance of the underlying assets), as guaranteed debt securities. Using these criteria, it is possible to determine with certainty the content requirements for a prospectus relating to *sukuk*, as set out in the Prospectus Regulation.

Those interested in issuing or investing in *sukuk* should note that the Luxembourg Stock Exchange is a prime listing location for *sukuk* in Europe. At the end of 2016, the aggregate amount of *sukuk* traded on the markets of the Luxembourg Stock Exchange reached US$95 billion.[21] Issuers of *sukuk* who have chosen the Luxembourg Stock Exchange come from Muslim countries as well as Europe, Hong Kong, South Africa and the United States.[22]

ii Regulatory and supervisory authorities

In Luxembourg, there is no office or authority charged with the supervision and monitoring of Islamic financial transactions or market participants using *shariah*-compliant structures. The CSSF is a secular institution, which will treat Islamic financial transactions in the same way as any other financial activity subject to its supervision. The extent of the CSSF's supervisory role is very broad and covers a wide range of actors in the financial sector, including regulated investment funds (also those that are *shariah*-compliant), regulated securitisation vehicles and credit institutions, to name just a few (but excluding insurance undertakings, which are supervised by the Insurance Commission). If a particular project falls within the scope of the CSSF's competence, the regulator will aim to ensure compliance with all relevant Luxembourg laws and regulations. Whether the project also meets the conditions set under *shariah* law would, from a Luxembourg law perspective, be a matter of contractual arrangements between the parties.

III COMMON STRUCTURES

i Investment funds

In Luxembourg, a large variety of *shariah*-compliant vehicles are available to asset managers and investors. The choice of investment structure depends on the investment policy, the investors targeted and the level of regulation desired. *Shariah*-compliant asset allocation can be achieved by setting out a strong investment strategy together with a *shariah*-oriented selection process. For instance, a *shariah*-compliant fund must follow the principles of equal treatment of shareholders and the prohibition of undue enrichment. In practice, this means that shares subscribed for by investors must be of equal value. Consequently, preference shares in an investment company (generally permitted under the Companies Act) are not allowed.[23]

21 Luxembourg Stock Exchange, 'LuxSE Listing services for Sharia-compliant securities', available at www.bourse.lu/documents/brochure-LISTING-Sharia.pdf.

22 ibid.

23 Muhammad Ayub, *Understanding Islamic Finance*, 2009.

ii Available structuring options

From a legal standpoint, any Luxembourg investment vehicle can be used to set up a *shariah*-compliant fund. Generally, a Luxembourg investment fund can take either a corporate form[24] or a contractual form.[25]

From a regulatory standpoint, *shariah*-compliant investment funds can either be structured as undertakings for collective investment in transferable securities (UCITS) governed by Part 1 of the UCI Act of 17 December 2010[26] or alternative investment funds (AIF) within the meaning of Directive 2011/61/EU, as amended (the AIFMD). The main difference between the two kinds of funds is that only UCITS can be marketed on a pan-European cross-border basis to retail and professional clients under the UCITS passport, whereas AIFs can principally only be marketed to professional investors[27] under the AIFMD passport[28].

A specialised investment fund (SIF) is a lightly regulated, operationally flexible and tax-efficient multipurpose investment fund for a pool of well-informed investors.[29] Even though a SIF does not have to comply with specific investment restrictions, it must follow the principles of risk diversification.[30] An investment company in risk capital (SICAR) is a regulated and tax-efficient structure, specifically designed for private equity and venture capital investments.[31] As opposed to a SIF, a SICAR may concentrate its assets in one single project as long as it invests in risk capital. Investments of a SICAR must be characterised by a high risk and an intention to develop the target entities. The purpose of the SICAR may consequently be in contradiction with the prohibition of *gharrar* (i.e., uncertainty and speculation) in Islamic finance. A reserved alternative investment fund (RAIF) is a vehicle reserved to well-informed investors encompassing the characteristics and structuring flexibilities of SIFs or, alternatively, SICARs, without being subject to any regulatory approval or supervision by the CSSF. The supervision is, however, operated indirectly as the manager must be regulated under the AIFMD.

Another option available to *shariah* promoters and investors is a Part II Fund, which is a flexible but regulated vehicle open to both retail investors and professional investors. They must invest their assets according to the principles of risk diversification but are not limited as to the type of assets they can hold.

24 The most commonly used corporate forms are those of a public limited company (*société anonyme*), a private limited liability company (*société à responsabilité limitée*), a corporate partnership limited by shares (*société en commandite par actions*), a common limited partnership (*société en commandite simple*) or a special limited partnership (*société en commandite spéciale*).

25 This refers to the *fonds commun de placement* (FCP). Investment funds in the form of an FCP can only be set up under the UCI Act, the SIF Act and the RAIF Act.

26 UCITS are UCIs that are compliant with Directive 2009/65/EC, as amended.

27 UCIs under Part II of the UCI Act (Part II Funds) qualify as AIFs but can, from a Luxembourg perspective, be marketed to retail investors.

28 If such AIFs are managed by a fully authorised alternative investment fund manager under the AIFMD.

29 ALFI, 'sif-specialised investment funds', available at www.alfi.lu/setting-luxembourg/alternative-investment-funds/sif.

30 ibid.

31 ALFI, 'sicar – investment company in risk capital', available at www.alfi.lu/setting-luxembourg/alternative-investment-funds/sicar.

UCITS are open-ended funds investing in transferable securities such as units, bonds, money-market instruments and certain types of derivatives.[32] These funds are harmonised on an EU level and widely sold to Islamic investors. The UCITS regime lays down common requirements for the organisation, management and oversight of such funds, and imposes rules relating to diversification, liquidity and use of leverage.[33] UCITS offer, therefore, high levels of investor protection and may incorporate *shariah* features, such as:

a a ban on investment in any interest-bearing assets or debt instruments and cleansing of cash and dividends receipts;

b a ban on futures or forward contracts, derivatives or short sales;[34]

c prohibition of investment related to *haram* activities such as gambling, alcohol and tobacco (including the advertising and marketing of these activities); and

d creation of a *shariah* advisory board.[35]

For further illustration purposes, government *mudarabah* certificates (i.e., a non-debt-creating mode of finance issued by the sovereign state) and commodity *murabahah* deposit (i.e., a short-term fixed income deposit) would generally qualify as eligible investments for UCITS.[36] However, specific consideration should be given to commodity *murabahah*, as the CSSF would only consider these as UCITS-eligible investments if the issuer is a credit institution that has its registered office in the EU or a non-EU state with equivalent rules.[37]

iii Real estate and private equity investments

Real estate and private equity investments are characterised by their long-term and illiquid nature. The financing aspect of these investments is challenging because *shariah* law prohibits the use of conventional debt structures. In Luxembourg, this challenge can, however, be overcome by using alternative *shariah*-compliant instruments, such as *sukuk al-murabahah* (i.e., sales-based financing) or *sukuk al-ijarah* (i.e., lease-based financing) to finance the acquisition of assets.[38]

With respect to leverage, under *shariah* law, debt financing and the payment of interest are proscribed (*riba*).[39] In practice, however, it is usually accepted that a *shariah*-compliant fund may engage in leverage through the use of *shariah*-compliant financing instruments.[40] Conventional loans or interest-bearing instruments are not permitted. It is also conceivable to open investment to additional equity-based investors using a *musharakah* contract whereby each investor has management rights in proportion with its investment in the

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32 European Commission, 'Background note: Draft Commission directive implementing Council Directive 85/611/EEC as regards the clarification of certain definitions', available at http://ec.europa.eu/internal_market/investment/docs/legal_texts/assets/070117_memo_en.pdf.

33 European Commission, White paper on enhancing the single market framework for investment funds, 2006.

34 See footnote 13.

35 Oliver R Hoor and Pierre Kreemer, Luxembourg, *Une localisation de choix pour structurer des investissements immobiliers conformes à la Sharia*, Les Cahiers du Droit Luxembourgeois.

36 See footnote 13.

37 ibid.

38 ibid.

39 Karim Ginema and Azhar Hamid, *Foundation of Shariah Governance of Islamic Banks*, 2015.

40 Luxembourg for Finance, *Islamic Finance*, available at www.luxembourgforfinance.com/sites/luxembourgforfinance/files/lff_brochure_islamic_finance.pdf.

fund.[41] *Shariah*-compliant property investments can also be achieved by using a *mudarabah* or an *ijarah* contract.[42] The *mudarabah* contract is similar to the relationship between a Luxembourg general partner (i.e., fund manager) and the limited partners (i.e., investors).[43] By contrast, an *ijarah* contract is a lease contract for a specified asset or the usufruct of a specified asset.[44] The rules governing *ijarah* may be considered similar to those governing conventional leases,[45] subject to limitations provided for by the *shariah* law.

iv Capital markets

Benefits of the Luxembourg securitisation regime

Many issuances of *sukuk* in Luxembourg have been structured using a Luxembourg securitisation undertaking subject to the Securitisation Act. The securitisation undertaking may be set up in the form of a company or a securitisation fund managed by a Luxembourg management company. Securitisation funds do not have legal personality; they are constituted by one or more co-ownerships of assets or fiduciary estates, which provide a closer connection between the investors and the underlying assets – a considerable advantage from the point of view of *shariah* law.[46] While the vast majority of securitisation undertakings are unregulated, a securitisation undertaking that offers securities to the public more than three times per year needs to apply for a licence from the CSSF to qualify as a regulated securitisation vehicle for the purposes of the Securitisation Act.

A securitisation undertaking's primary activity must be to engage in securitisations, defined by the Securitisation Act as transactions whereby a securitisation undertaking:

a acquires or assumes, directly or through another undertaking, risks; and

b to finance the acquisition or assumption of those risks, issues securities whose value or yield depends on those risks. Risks to be securitised may be related to all kinds of assets, including claims, receivable or equity interests, with no requirement of risk diversification.

Unlike funds, securitisation undertakings must not actively manage securitised assets. The Securitisation Act allows a securitisation undertaking to set up multiple compartments by a simple decision of its board of directors. Each compartment forms a distinct and independent part of the securitisation undertaking's assets and is segregated from its other compartments and general estate. One or more securitisations can be carried out independently out of each individual compartment, which significantly reduces transaction costs as one vehicle can be used for an unlimited number of distinct transactions. For instance, it would be possible for one securitisation undertaking to create several compartments, some of which would be dedicated to *shariah*-compliant transactions, while the other compartments could be used for issuing conventional securities. Investors (irrespective of whether they hold equity or debt securities) will only have recourse to the assets comprised in the compartment to which the securities they hold have been allocated.

41 Monzer Kahf, *Islamic finance contracts*, 2013.

42 See footnote 40.

43 See footnote 13.

44 ibid.

45 Bayt al-Tamwīl al-Kūwaytī, National Commercial Bank (Saudi Arabia), *Islamic Asset Management: Forming the Future for Shari'a-compliant Investment Strategies*, 2004.

46 ibid.

A securitisation vehicle is considered insolvency remote – a feature much valued by rating agencies. The main characteristics of Luxembourg's sophisticated securitisation regime – the ring-fencing of compartment assets, priority of payments, limited recourse, prohibition of seizure of assets and non-petition for bankruptcy – are protected not only by contractual arrangements, but are also expressly recognised by the Securitisation Act. Legal proceedings initiated against a securitisation undertaking in breach of those provisions will, in principle, be declared inadmissible by a Luxembourg court.

It should also be mentioned that a securitisation undertaking issuing exclusively debt instruments (and *sukuk* is regarded as such from a Luxembourg law perspective) will be able to rely on an exemption from the scope of the AIFM Act. Other exemptions from the AIFM Act may also be available.

Raising finance in a shariah-compliant manner

One of the popular Islamic finance structures that have been put in place in Luxembourg using a securitisation vehicle is *murabahah*. A pioneering transaction, which combined a reducing revolving convertible *murabahah* with a note issuance, involved a Luxembourg securitisation company that acted both as the issuer of conventional bonds and as the lender under the *murabahah* facility. The issuer used the proceeds of the bonds to purchase certain commodities, which it subsequently sold, on deferred payment terms, to an Islamic investment bank for a sale price equal to the acquisition cost plus profit. The cash payments of the deferred sale price were used by the issuer to meet its obligations towards the bond investors. Additionally, the bondholders had the option to convert the cash distributions due to them under the bonds into shares of the lender under the *murabahah* contract (which constituted the securitised asset for the purpose of the bond issue).

Luxembourg issuers, some of them ordinary companies as opposed to securitisation undertakings, are regularly used to issue *sukuk*, the proceeds of which may be invested, directly or indirectly, in assets such as real estate or aircraft. A stream of rental income generated by those underlying assets is then distributed to investors via payments under the *sukuk*. Notably, Luxembourg has played host to a joint venture formed among prominent Islamic and conventional financial actors who invested, through a mixture of equity and *sukuk*, in a Luxembourg special purpose vehicle (LeaseCo) to acquire a string of retail properties leased to tenants. In return for the right to control the target properties and receive rents, LeaseCo paid the issue proceeds of the *sukuk* to a Luxembourg joint venture vehicle (PropCo), thereby enabling it to purchase the shares of the company whose subsidiary owned the relevant properties. Any rewards associated with the ownership of the properties were to be extracted by the joint venture members via payments made by LeaseCo in respect of the *sukuk*.

Another example of the successful application of Luxembourg law in the implementation of Islamic financial transactions is the issue of *sukuk* using a two-tier securitisation structure by an international Islamic organisation. This type of set-up is expressly permitted under the Securitisation Act and involves two securitisation undertakings: an issuing vehicle and an acquisition vehicle. In the case at hand, the issuing vehicle issues, on an ongoing basis, trust certificates and contributes the proceeds to the acquisition vehicle in exchange for the undivided beneficial ownership interest in *shariah*-compliant assets purchased by the acquisition vehicle using the contribution from the issuing vehicle. Those assets are held by the acquisition vehicle for the benefit of the issuing vehicle under an English law trust. The issuing vehicle, for its part, holds the undivided ownership interest on trust for the holders of the trust certificates as well as acting as their agent (*wakeel*). Through its undivided beneficial ownership, the issuing vehicle is entitled to receive profits and redemption amounts generated by the underlying assets and uses the sums so received to honour its obligations under the trust certificates.

One of the prominent issuers of *sukuk* is the Luxembourg state itself, which, in 2014, became the first eurozone country to issue sovereign *sukuk*. For the purpose of the transaction, Luxembourg arranged for the set-up, and became the sole shareholder, of Luxembourg Treasury Securities SA, a special purpose vehicle that has acted as the formal issuer of the instruments. The Luxembourg *sukuk*, which is of the *al-ijarah* type, is backed by three administrative buildings that have been purchased by the issuer from the Luxembourg State using the issue proceeds of the *sukuk*. The buildings will be transferred back to the Luxembourg State for a pre-agreed purchase price when the *sukuk* matures. The Luxembourg *sukuk* have been admitted to trading on the Euro MTF market of the Luxembourg Stock Exchange.[47]

IV TAXATION

Whereas there is no specific framework regulating Islamic finance transactions in Luxembourg from a legal perspective, there are two circulars issued by the directors of the direct tax administration and the indirect tax administration regarding the Luxembourg direct and indirect tax treatment of *murabahah* transactions and *sukuk*.

i Direct taxation

Murabahah transactions

For the purposes of the following paragraphs a *murabahah* transaction is to be understood as an agreement transaction consisting of two consecutive sales of a certain asset whereby, at the first stage, a party (the financier) purchases an asset from a third party upon the request of its counterparty (the purchaser), and then, at the second stage, resells the asset to the purchaser at a marked-up price, payable by the purchaser on a deferred basis.

From a Luxembourg general tax perspective, the 'capital gain' generated at the hands of the Luxembourg financier upon the mere execution of the second sale and purchase agreement between the financier, as seller, and the purchaser, would, in principle, be fully taxable at a current combined rate of 26.01 per cent (corporate income tax, increased by the solidarity surcharge, and municipal business tax for companies established in Luxembourg City).

However, Circular LG-A No. 55 issued by the director of the Luxembourg direct tax administration on 12 January 2010 (the Direct Tax Circular) provides for deferred taxation of the capital gain on a straight-line basis over the full period of the payment deferral under the *murabahah* agreement (which usually corresponds with the duration of the *murabahah* agreement), notwithstanding any reimbursements made during this period.

From an economic perspective,[48] the Direct Tax Circular compares the 'capital gain' generated in the hands of the Luxembourg financier to the remuneration for giving the purchaser the possibility of deferred payment (i.e., it is treated for Luxembourg tax purposes

47 *Le Luxembourg place son premier Sukuk souverain*, Agefi Luxembourg, Mensuel de octobre 2014 – Fonds/Bourse.

48 Based on the fundamental principle of 'economic analysis' in Luxembourg tax law (*wirtschaftliche Betrachtungsweise*).

as ordinary interest income, which would have been earned by the Luxembourg financier under conventional financing). It should be noted that the deferred taxation is available only for remuneration earned by the financier for giving the possibility of deferred payment to the purchaser and not, for example, any intermediation fee that the financier may receive.

The treatment of the 'capital gain' realised by the financier as interest income under the Direct Tax Circular is subject to the following conditions, which must be met by the *murabahah* transaction:

a the *murabahah* agreement must clearly state that the financier is acquiring the asset for immediate resale to the purchaser (within a maximum of six months);

b the *murabahah* agreement must clearly define the various elements constituting the financier's profit:
- the remuneration for deferred payment;
- the intermediation fee; and
- the exact acquisition price of the asset to be paid by the financier and subsequently by the purchaser;

c the *murabahah* agreement must provide for a clear and explicit acknowledgment and acceptance by all parties of the financier's profit;

d the *murabahah* agreement must explicitly define the financier's profit as being the consideration for the service provided to the purchaser, being the possibility of deferred payment given to the purchaser; and

e from an accounting and tax perspective, the financier's profit must be booked in the same way. In other words, the pure profit (i.e., the remuneration for the possibility of deferred payment) must be spread over the period of the deferred payment contained in the *murabahah* agreement, regardless of the actual dates of repayment.

If the purchaser is a Luxembourg tax resident, any payments remunerating the financier for giving the purchaser the possibility of deferred payment under the *murabahah* agreement should, in principle, be exempt from Luxembourg withholding tax and should also be deductible for tax purposes unless they relate to items of income, which are exempt in Luxembourg (e.g., foreign real estate) and provided that the above conditions are met.

Sukuk

Pursuant to the Direct Tax Circular, *sukuk* may be considered as a conventional debt instrument (i.e., as a bond (its return, or interest, being dependent on the performance of the underlying asset)). Any profit distributions made under the *sukuk* to its holders are, in principle, deductible in the hands of the issuer and such distributions are not subject to Luxembourg withholding tax.[49]

49 The 15 per cent withholding tax under Luxembourg tax law levied on payments made under certain participating debt instruments is explicitly excluded in the Direct Tax Circular.

ii Indirect taxation

Registration duties

Murabahah

Depending on the underlying asset of a *murabahah* agreement, Luxembourg registration duties could be due, in principle, on each sale and purchase of the said asset (e.g., Luxembourg *situs* real estate).

Pursuant to Circular No. 749 issued by the director of the Luxembourg indirect tax administration on 17 June 2010 (the Indirect Tax Circular), the registration duties payable in Luxembourg on a *murabahah* agreement concerning real estate located in Luxembourg City are limited to 2.8 per cent under the condition that:

a both notarial deeds (documenting the purchase and the resale) are registered with the indirect tax authorities at the same time; and

b the financier explicitly declares in the first notarial deed (documenting the purchase) that the real estate asset will be subsequently resold.

The amounts on which registration duties are calculated are limited solely to the acquisition price paid by the financier on the first sale. The profit of the financier, which is considered as interest, is thus not subject to registration duties in Luxembourg under the following conditions:

a the purchaser must take possession of the real estate asset immediately after the second sale and purchase agreement;

b no more than 10 days must separate the first sale and purchase agreement from the second; and

c the first sale and purchase agreement must contain a clause stating that the transaction is being carried out as a *murabahah* agreement, a copy of which must be annexed to the notarial deed relating to the first sale and purchase agreement.

Sukuk

The issue of *sukuk* should, in principle, not give rise to any registration duties in Luxembourg, provided that the terms and conditions of the *sukuk* are not physically attached to a public deed or to any other document subject to mandatory registration in Luxembourg. If the proceeds derived from the issue of *sukuk* are used for instance to purchase Luxembourg *situs* real estate, registration duties would, in principle, be due with respect to the purchase agreement relating to the real estate properties.

Value added tax

The Indirect Tax Circular states that financiers created for the purpose of a *murabahah* transaction are treated under Luxembourg value added tax (VAT) law as taxable persons.

iii Taxation of shariah-compliant funds

Shariah-compliant funds structured as UCITS, Part II Funds, SIFs and certain types of RAIFs (SIF-type) are exempt from any Luxembourg income, withholding, capital gains or net wealth tax. They are, however, subject to an annual subscription tax ranging between 0.01 and 0.05 per cent, calculated and payable quarterly on their aggregate net assets as valued at the end of the relevant quarter. Certain exemptions and reductions can apply.

SICARs and certain types of RAIFs (RAIFs carrying out risk capital investments and opting for a special tax regime identical to the regime applicable to SICARs) may be incorporated in the form of a fiscally opaque vehicle or as a tax transparent vehicle. If set up as tax-opaque vehicles, these are considered as fully taxable companies (i.e., subject to corporate income tax, municipal business tax and the solidarity surcharge), but benefit from an exemption on any income derived from transferable securities connected with investments in risk-bearing capital or for cash held for the purpose of a future investment. These types of funds may, however, be subject to the minimum net wealth tax regime.

Further, with respect to VAT, pursuant to Circular No. 723 of 29 December 2006, undertakings for collective investment are, in principle, considered as VAT-taxable persons. Thus, Luxembourg VAT may be applicable under the reverse charge mechanism whereby a fund domiciled in Luxembourg receives taxable services from suppliers located in other EU Member States, unless a specific VAT exemption may be secured (such as fees on the negotiation of securities, for example). A fund would, in principle, have no right to deduct input VAT as it should normally carry out activities that are exempt from VAT only.

iv Taxation of securitisation undertakings

Securitisation undertakings subject to the Securitisation Act benefit from a favourable tax regime. If set up as a company, they are, in principle, fully taxable companies, subject to corporation tax at a current combined rate of 26.01 per cent (corporate income tax, increased by the solidarity surcharge, and municipal business tax for securitisation undertakings established in Luxembourg City). However, the Securitisation Act states that the obligations assumed by securitisation undertakings towards their investors (including shareholders) and any creditors are to be considered as tax deductible expenses. In other words, securitisation undertakings are able to deduct any payments due or made to any investors, or creditors, from their taxable profits.

Securitisation undertakings are exempt from net wealth tax, except for the minimum net wealth tax.

Further, there is no Luxembourg withholding tax on payments of interest or on profit distributions made by the securitisation undertaking to its investors.[50]

With respect to VAT, securitisation undertakings are considered VAT-taxable persons if they are deemed to be carrying out an economic activity. If a securitisation undertaking qualifies as a VAT-taxable person, Luxembourg VAT may be applicable under the reverse charge mechanism if a securitisation undertaking domiciled in Luxembourg receives taxable services from suppliers located in other EU Member States. A securitisation undertaking would, in principle, have no right to deduct input VAT as it solely carries out activities that are exempt from VAT.

V INSOLVENCY

In Luxembourg, there is no special insolvency regime with respect to *shariah*-compliant products.

50 Except for certain interest payments to Luxembourg resident individuals.

In insolvency or restructuring scenarios, holders of *sukuk* should, in principle, be treated in the same way as holders of conventional bonds. This is in line with the position of the Luxembourg direct tax administration, expressed in the Direct Tax Circular, according to which there should be no difference in the tax treatment of *sukuk* and conventional bonds.[51]

In this respect, it is important to highlight the advantages of using Luxembourg securitisation undertakings subject to the Securitisation Act, which frequently act as issuers of *sukuk*. As discussed above, such securitisation undertakings are bankruptcy-remote and their investors benefit from a high level of protection and legal certainty embedded in the law. Thanks to provisions such as the compartmentalisation of rights and claims relating to different transactions and the limitation of investors' recourse to the assets available in the compartment in which they have invested, the risk of the entire vehicle becoming insolvent is very small.

VI JUDICIAL FRAMEWORK

Luxembourg does not have a specific court or tribunal for Islamic finance disputes. Luxembourg conventional courts will hear claims relating to transactions governed by Luxembourg law over which they have jurisdiction, including those involving aspects of *shariah* law. In the case of a conflict between Luxembourg laws and the principles of *shariah* law, Luxembourg laws will prevail.[52]

Any conflicting matter in relation to regulated funds or their Luxembourg-regulated manager may potentially be dealt with by the CSSF following the out-of-court resolution of the complaints procedure. The CSSF's out-of-court resolution of disputes procedure is provided on a voluntary basis. It aims to simplify the resolution of disputes without the need for legal proceedings. Opening an out-of-court complaint resolution procedure with the CSSF is subject to the condition that the complaint has been dealt with by the management of the relevant professional beforehand. In this respect, the complaint must have been first submitted in writing to the individual responsible for complaint handling.[53] If the CSSF does not manage to resolve the issue, the parties are free to bring their claim before the relevant tribunal.

To the best of our knowledge, there has been no Luxembourg court case that would have impacted the treatment of Islamic finance products or structures implemented under Luxembourg law or using a Luxembourg vehicle.

VII OUTLOOK

The CSSF has signed memoranda of understanding (MoU) with the supervisory authorities of a number of major markets in the area of Islamic finance, such as Bahrain, Malaysia, Oman, Qatar and United Arab Emirates (including Dubai and Abu Dhabi).[54] Following the

51 Florence Stainier and Bishr Shiblaq, 'Luxembourg', *Getting the Deal Through – Islamic Finance and Markets 2014*, Law Business Research Ltd.

52 ibid.

53 CSSF, 'Customer complaints: Out-of-court complaint resolution', available at www.cssf.lu/en/consumer/complaints/.

54 CSSF, 'List of Memoranda of Understanding signed by the CSSF', available at www.cssf.lu/en/eu-international/memoranda-of-understanding/.

European Securities and Markets Authority's approval of cooperation agreements between EU securities regulators and their international counterparts, the CSSF has also signed MoU with supervisory authorities of third countries, such as Dubai, Egypt and Malaysia,[55] meeting the requirements of the AIFMD in view of developing cooperation agreements. Luxembourg has also signed double taxation treaties with major actors in Islamic finance, such as Malaysia, Qatar and Saudi Arabia,[56] and other treaties are currently under negotiation with Kuwait, Lebanon and Oman.[57] These developments highlight the growing interest in Islamic finance, and are in line with the proactive approach adopted by the Luxembourg government aimed at making Luxembourg an attractive place for Islamic financial players.[58] Although *shariah*-compliant products and structures have become a regular feature on the list of services offered by Luxembourg's diverse and dynamic financial sector, there is still potential for growth and numerous opportunities are waiting to be explored.

55 See footnote 3.

56 Luxembourg Inland Revenue, 'Conventions en vigueur', available at www.impotsdirects.public.lu/fr/conventions/conv_vig.html.

57 Luxembourg Inland Revenue, 'Conventions en négociation', available at www.impotsdirects.public.lu/fr/conventions/conv_neg.html.

58 Journal des Tribunaux Luxembourg, *Fonds Islamiques – Le guide des bonnes pratiques de l'Association Luxembourgeoise des Fonds d'Investissement*, Larcier, No. 26, 5 April 2013.

Chapter 7

MALAYSIA

Rodney Gerard D'Cruz and Murni Zuyati Zulkifli Aziz[1]

I LEGISLATIVE AND REGULATORY FRAMEWORK

Malaysia presently finds itself in the unfamiliar state of a new government at the helm after the opposition Pakatan Harapan's historic victory in the 14th General Election in May 2018, the country's first change of government after 61 years of rule by the previous Barisan Nasional government. Pakatan Harapan had campaigned on the basis of its plan for fiscal reforms entitled, the 'First 100 Days Fiscal Reforms', which outlined its full commitment to undertake responsible and progressive fiscal reforms to both enhance fiscal equity, transparency and accountability, and to accelerate productive investment and economic growth in Malaysia. As such, and given that the ministers of the new government were only sworn-in in early July 2018 and the Malaysian parliament only first convened in mid-July 2018, it remains to be seen exactly how such fiscal reforms will affect the contents of this Chapter.

Malaysia has developed a sophisticated Islamic finance sector over the past 30 years, which in turn has generated a vibrant business environment for financial institutions, intermediaries, investors, issuers and service providers alike. In the course of this development, Malaysia successfully established a mature and robust Islamic finance regulatory framework and pioneered the dual banking system, wherein both Islamic and conventional financial systems operate and co-exist within a single regulatory framework.

The financial services industry of Malaysia has always been championed as a key driver of Malaysia's economic development. It is one of the 12 national key economic areas (NKEAs) under Malaysia's Economic Transformation Programme (ETP), the national strategic initiative formulated by the government of Malaysia to elevate the country to developed-nation status by 2020,[2] and is the foundation of the Financial Sector Blueprint (FSB), the 10-year master plan implemented by the country's central bank (Bank Negara Malaysia (BNM)), for the management of Malaysia's transition towards becoming a high value-added, high-income economy.[3] A key recommendation under the FSB is for Malaysia to consolidate its success and position itself as a leading international centre and global hub for Islamic finance. Further, the Malaysian government has also committed under its financial services NKEA for Islamic finance in Malaysia to constitute 40 per cent of total financing in Malaysia by 2020.

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2 See http://ntp.epu.gov.my/images/ntp/report/NTP_AR2017_ENG.pdf and http://ntp.epu.gov.my/nkea.

3 See http://ntp.epu.gov.my/nkea and the BNM website at www.bnm.gov.my/index.php?ch=en_press&pg=en_press&ac=130&lang=en.

In January 2017, the Securities Commission Malaysia (SC) announced the launch of a five-year Islamic Fund and Wealth Management Blueprint (the Blueprint)[4] to drive further development and growth of Malaysia's Islamic capital market. The Blueprint envisages leveraging Malaysia's Islamic capital market ecosystem to establish the country as a leading international centre for Islamic fund and wealth management[5] (see also Section VI.iii). The SC has achieved early success in implementing the Blueprint, as 2017 witnessed the maiden public offering of *waqf* shares by Larkin Sentral, green *sukuk* issuances, as well as new players in the fund administration and fund management business in Malaysia.[6]

In July 2017, BNM, in collaboration with certain Islamic banking and finance institutions, embarked on the development of several strategies aimed at strengthening the roles and impact of Islamic banking institutions. These strategies, called value-based intermediation, were to focus on delivering the intended outcomes of *shariah* through the adoption of practices, conduct and offerings that generate a positive and sustainable impact on the economy, community and environment.[7]

i Legislative and regulatory regime

Islamic banking

In line with the FSB, the regulatory and supervisory framework in Malaysia in respect of the Islamic banking and finance sector was recently consolidated and updated under the Islamic Financial Services Act 2013 (IFSA),[8] the governing law of Malaysia's Islamic finance sector.

As the primary source of legislation governing the licensing and operation of Islamic and international Islamic banking businesses conducted by financial institutions, the IFSA, together with guidelines and circulars issued by BNM,[9] contains extensive provisions on end-to-end *shariah* compliance, governance and enforcement, which include the following basic premises:

a establishing BNM as the *shariah* regulator over the financial sector;
b providing the legal basis for the rulings of BNM's Shariah Advisory Council (BNM SAC);
c prohibiting financial institutions that conduct Islamic and international Islamic banking businesses from carrying out non-*shariah*-compliant activities; and
d empowering BNM to direct and penalise financial institutions for breaches of the IFSA and offences committed thereunder.[10]

4 www.sc.com.my/wp-content/uploads/eng/html/icm/ifwm_blueprint_170112.pdf.
5 Securities Commission Malaysia Annual Report 2016. See www.sc.com.my/home/sc-annual-report/.
6 Securities Commission Malaysia Annual Report 2017. See www.sc.com.my/post_archive/2017-annual-report/.
7 The BNM 'Value-based Intermediation: Strengthening the Roles and Impact of Islamic Finance', www.bnm.gov.my/index.php?ch=57&pg=137&ac=612&bb=file; and see www.thestar.com.my/business/business-news/2017/07/20/bank-negara-releases-strategy-paper-on-vbi/.
8 The IFSA repealed and consolidated the Islamic Banking Act 1983 and the Takaful Act 1984.
9 BNM is empowered under Section 59 of the Central Bank of Malaysia Act 2009 to issue circulars, guidelines or notices on any *shariah* matter relating to the Islamic financial business carried on by any Islamic financial institutions in accordance with the advice or ruling of the BNM SAC.
10 Section 28(3) of the IFSA provides that any financial institution becoming aware that its activities are not in compliance with *shariah* or the advice of its *shariah* committee or the advice or ruling of BNM

Under the IFSA, BNM was conferred regulatory and supervisory powers and was also empowered to issue guidelines and circulars on *shariah* requirements to promote financial stability and ensure *shariah* compliance. Following therefrom, the IFSA provides that the operations, structure and the terms and conditions of Islamic financial products and services provided by financial institutions must be *shariah*-compliant. Any entity that conducts Islamic banking business[11] or international Islamic banking business[12] must possess the licences granted by the Minister of Finance (the Minister) on the recommendation of BNM. There are various measures taken by the authorities to strengthen consumer protection, including (1) the issuance of the revised BNM's Rules on Prohibited Business Conduct in 2016[13] to supplement the prohibitions on financial institutions from engaging in conduct deemed to be inherently unfair to consumers under Schedule 7 of the IFSA; (2) the establishment of the Financial Ombudsman Scheme under the Islamic Financial Services (Financial Ombudsman Scheme) Regulations 2015; and (3) the setting up of the Malaysia Deposit Insurance Corporation (MDIC) pursuant to the Malaysia Deposit Insurance Corporation Act 2011 (MDICA), under which the MDIC insures consumers against the loss of their deposits (including Islamic deposits) in financial institutions in Malaysia[14] for up to 250,000 ringgit per depositor per financial institution in the event of loss caused by failure of a financial institution holding such deposits.

Islamic capital markets

The Capital Markets and Services Act 2007 (CMSA)[15] constitutes a single framework regulating the licensing of both conventional and Islamic capital market services, market conduct and offering and issuances of securities, including unlisted Islamic securities or *sukuk*, with the exception of specific laws, regulations and guidelines that apply exclusively to the operation of the Islamic capital market. This marked a major milestone in the SC's continuous efforts to strengthen the capital market regulatory framework.

In this regard, the CMSA provides, *inter alia*, as follows:

a that Islamic securities are securities for the purposes of securities laws;[16]

SAC shall notify BNM and cease the non-*shariah*-compliant activity whereas Section 37(1) of the IFSA empowers BNM to compel any financial institution to appoint any person as BNM may approve, to carry out an audit on *shariah* compliance on the said financial institution.

11 Section 2 of the IFSA defines 'Islamic banking business' as the business of (1) accepting Islamic deposits on current accounts, deposit accounts, savings accounts or other similar accounts, with or without the business of paying or collecting cheques drawn by or paid in by customers; or (2) accepting money under an investment account; and (3) provision of finance; and (4) such other business as the Minister may prescribe, on the recommendation of BNM. For the avoidance of doubt, the provision of finance by itself would not fall under the definition of 'Islamic banking business' save if the same were specifically prescribed by the Minister under Section 3 of the IFSA.

12 Section 2 of the IFSA defines 'international Islamic banking business' as Islamic banking business in currencies other than ringgit or such other business as the Minister may prescribe, on the recommendation of BNM. For international Islamic banking business, see BNM Guidelines on International Islamic Banks.

13 This was issued pursuant to Section 135(3) as well as Section 136(2) of the IFSA and supersedes the previous BNM's Rules on Prohibited Business Conduct, which were issued in 2014.

14 Pursuant to Section 42 of the MDICA.

15 The CMSA repealed and consolidated the Securities Industry Act 1983, the Futures Industry Act 1993 and parts of the Securities Commission Malaysia Act 1993.

16 See Section 316B(1) of the CMSA.

b that any proposal, scheme, transaction, arrangement, activity, product or matter relating to Islamic securities shall comply with the relevant requirements under securities laws and guidelines issued by the SC;[17] and

c that the Minister may, for the purposes of securities laws, and on the recommendation of the SC, *inter alia*, prescribe any instrument or product or class of instruments or products to be:
- Islamic securities;
- Islamic derivatives; or
- Islamic capital market products.[18]

The following features of the CMSA accord greater protection to investors of securities (including Islamic securities) in Malaysia: (1) the SC's power to take civil and administrative actions; (2) the SC is allowed to recover three times the amount of losses through civil action for a wider range of market misconduct; (3) the standards of trustees for debenture holders are enhanced; and (4) investor protection is extended to clients of financial institutions.

With the CMSA, there are various guidelines and practice notes issued by the SC to regulate the Malaysian capital markets, including Islamic capital markets. In 2015, the SC introduced the Guidelines on Unlisted Capital Market Products Under the Lodge and Launch Framework as part of its initiative to promote process efficiency, shorten time-to-market and provide certainty of product offering.

Takaful (Islamic insurance)

Under the IFSA, any companies that are in the *takaful* business or international *takaful* business must hold a valid licence granted by the Minister on the recommendation of BNM. *Takaful* operators must also comply with the relevant BNM guidelines on *takaful*,[19] and have in place an effective *retakaful* management strategy that is appropriate to the overall risk profile of the *takaful* business, and ensure that risks are ceded to *takaful* or *retakaful* operators.[20] In addition, *takaful* operators shall not accept inwards reinsurance from insurance or reinsurance companies except where the risk is *shariah*-compliant and the arrangement is based on *shariah*-compliant *retakaful* contracts.[21] In May 2018, BNM issued an exposure draft following a review of the former guidelines to further clarify the application of *shariah* contracts that complement the *shariah* standards and operational requirements issued by BNM, which will come into effect six months after its date of publication. It provides additional guidance related to the specifics of the *takaful* business. This document also seeks to strengthen *takaful* fund management practices to ensure its sustainability and prudent management. Collectively, these revisions seek to spur greater innovation in the *takaful* industry while further safeguarding the position of *takaful* participants.[22]

17 See Section 316B(2) of the CMSA.
18 See Section 5 of the CMSA.
19 See Section 10 of the IFSA.
20 See Paragraph 10.09, Guidelines On Takaful Operational Framework issued by BNM on 26 June 2013.
21 ibid., Paragraph 10.11.
22 See Guidelines on Takaful Operational Framework (Exposure Draft) issued by BNM on 18 May 2018; for BNM's notices and announcements, see www.bnm.gov.my/index.php?ch=en_announcement&pg=en_announcement&ac=639.

Collective investment schemes (funds)

The BNM Guidelines on Investment in Shares, Interest-in-Shares and Collective Investment Schemes for Islamic Banks (the BNM Guidelines) constitute the main guidelines governing for collective investment schemes (CIS) offered by Islamic banks. The BNM Guidelines adopt a more principle-based regulatory approach to enable financial institutions to define the scope of their equity-related investments according to capacity and capability. Other than guidelines issued by BNM, the SC has also issued various guidelines governing CIS.[23]

Generally, under the BNM Guidelines, there are two categories of investments that may be made by financial institutions: (1) investment in shares or interest-in-shares of any corporation; or (2) investment in CIS, which includes unit trusts.[24] In addition, the SC has issued various guidelines on the establishment of a variety of collective investment schemes that can be invested by financial institutions.[25]

Midshore financial centre

Labuan International Business and Financial Centre (Labuan IBFC) is the midshore financial centre in Malaysia and provides a platform for local as well as international financial institutions to offer Islamic financial products or services and Islamic capital market instruments in foreign currencies.

The Labuan Islamic Financial Services and Securities Act 2010 (LIFSSA) is the governing law of the Islamic financial industry in Labuan IBFC. The LIFSSA provides for the registration of business vehicles used by financial institutions and the licensing of financial institutions to conduct regulated business activities. The LIFSSA must be read together with any guidelines or circulars issued by the Labuan Financial Services Authority (Labuan FSA).

The LIFSSA provides for the establishment of the Shariah Supervisory Council (SSC),[26] and for the SSC to (1) ascertain Islamic law for the purposes of any business regulated or supervised by the Labuan FSA and issue rulings; and (2) advise on any *shariah* issue relating to any business regulated or supervised by the Labuan FSA.[27] The SSC, however, may only make rulings upon reference being made to it by licensed or regulated entities under the LIFSSA or as determined by the Labuan FSA.[28] While the rulings of the SSC shall, upon issuance,

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23 CIS are broadly defined under the BNM Guidelines as follows: Any arrangement made for the purpose, or having the effect, of providing facilities for persons to participate in or receive profits or income arising from the acquisition, holding, management or disposal of securities, futures contracts or any other property, or sums paid out of such profits or income. In such schemes, participants do not have day-to-day control over the management of the schemes' assets.

24 Unit trusts include institutional funds, real estate investment trusts, property trust funds and exchange-traded funds.

25 These include (1) Guidelines on Islamic Fund Management 2007; (2) Guidelines for Real Estate Investment Trusts 2018; (3) Guidelines on Unit Trust Funds 2017; (4) Exchange-Traded Funds Guidelines 2009; (5) Guidelines for Public Offerings of Securities of Closed-end Funds; (6) Guidelines for the Offering, Marketing and Distribution of Foreign Funds; (7) Handbook for CIS Operators of ASEAN CISs; and (8) Prospectus Guidelines for Collective Investment Schemes 2016. Note that this also falls under the purview of BNM vide Guidelines on Investment In Shares, Interest-in-Shares and Collective Investment Schemes for Islamic Banks.

26 See Section 7 of the LIFSSA.

27 See Section 8 of the LIFSSA.

28 See Section 9(1) of the LIFSSA. In addition, consumer complaints may be made to the Labuan FSA by completing the web forms available on the Labuan IBFC website at www.labuanibfc.com/contact-us.

be binding upon the Labuan FSA and the entity making the referral, the rulings shall not be binding on any other licensed entity, entity regulated under LIFSSA or *shariah*-compliant entity unless specified as such by the Labuan FSA.[29]

ii Regulatory and supervisory authorities

BNM

BNM was established under the Central Bank of Malaysia Act 1958 and continues to operate under the Central Bank of Malaysia Act 2009 (CBA). BNM reports to the Minister and keeps the Minister informed of policies governing the monetary and financial sector.

BNM is empowered to act as the regulator of financial institutions under the IFSA, the Financial Services Act 2013 and the CBA. The CBA confers the necessary powers and instruments on BNM to achieve its mandates effectively and legitimises the duality of both the conventional and Islamic financial systems in Malaysia and in doing so, establishes the legal foundation for development of an Islamic financial system within the overall Malaysian financial system. BNM is also the financial adviser to the Malaysian government and its primary objectives include the prudent conduct of monetary policy, financial system stability and the development of a sound and progressive financial sector.[30] Other functions of BNM include the monitoring and supervision of payment systems, money markets and foreign exchange markets by adopting a risk-based supervisory approach that monitors and reviews the manner in which all financial institutions identify, control and deal with their respective business risks.

Notwithstanding the above, it is the Minister who is the authority for the issuance and revocation or imposition of conditions of licences to carry on the businesses provided for under the IFSA on the recommendations of BNM.[31]

SC

The SC is a regulatory body established under the Securities Commission Malaysia Act 1993 (SCMA), which is mandated to regulate the Malaysian capital market (including the Islamic capital market) and which is directly responsible for the regulation, supervision and monitoring of all persons licensed under the CMSA with the main objective of protecting investors. It is also primarily responsible under the CMSA for encouraging and promoting the development of the securities and derivatives markets in Malaysia and for the monitoring and supervision of public listed companies to ensure compliance with securities laws.

Bursa Malaysia Berhad

Bursa Malaysia Berhad (Bursa) operates a fully integrated exchange under Section 15 of the CMSA. It not only provides a complete range of exchange-related services such as trading, clearing, settlement and depository services but also offers various Islamic market products, namely equities, derivatives, commodities and debt securities across all sectors and industries. In order to perform the tasks and duties assigned under the CMSA, Bursa has

29 See Section 9(3) and 9(4) of the LIFSSA.

30 This is an excerpt from page 357, Chapter 24 on Malaysia by Rodney Gerard D'Cruz, *The Banking Regulation Review*, Seventh Edition, Law Business Research Ltd, 2016.

31 See Section 10 of the IFSA.

set up subsidiaries to handle some of its principal activities. As at 21 May 2018, 77 per cent of securities listed on Bursa are *shariah*-compliant.[32] Aside from conducting commercial activities, Bursa is also empowered to regulate and administer:

a the FTSE Bursa Malaysia Hijrah Shariah Index;
b the FTSE Bursa Malaysia EMAS Shariah Index;
c the FTSE Bursa Malaysia Small Cap Shariah Index;
d the Sukuk Index;
e Bursa Suq Al Sila' (an electronic Islamic commodity trading platform); and
f listed *shariah*-compliant instruments, such as Islamic exchange-traded funds, Islamic real estate trusts and Islamic unit trusts.

However, SC, and not Bursa, is responsible for the screening of companies to determine whether they are *shariah*-compliant for the purpose of being listed on the stock exchange.

Labuan FSA

The Labuan FSA was established under the Labuan Financial Services Authority Act 1996 and is solely responsible for the regulation, supervision and development of the Labuan IBFC under the LIFSSA. Aside from issuing licences for financial institutions operating within Labuan IBFC,[33] it is also empowered to make recommendations, investigate, collect and divulge information andnd conduct entry search and seizure, as well as to establish or participate in any body corporate for the purpose of promoting research and training.

Shariah advisory councils and shariah committees

Other than the establishment of *shariah* advisory councils (SACs) within BNM and the SC, individual financial institutions are also required to establish their own internal *shariah* committees to ensure the *shariah* compliance of their respective business operations.

BNM SAC

As mentioned earlier, the BNM SAC was established under the CBA as the authority for the ascertainment of Islamic law for the purposes of Islamic financial business.[34] In any Islamic financial business proceedings, the court or arbitrator must refer to the published rulings of the BNM SAC or refer any question concerning *shariah* matters to the BNM SAC for its ruling, which shall be binding on the court or arbitrator.[35]

SC SAC

The SC Shariah Advisory Council (SC SAC) was established in 1996 to advise the SC on *shariah* matters relating to Islamic capital market and is the authority for the ascertainment of the application of *shariah* principles in respect of Islamic capital markets businesses or transactions.[36]

The SC SAC has the following functions:

32 See www.sc.com.my/wp-content/uploads/eng/html/icm/sas/sc_syariahcompliant_180525a.pdf.
33 See Section 67 of the LIFSSA.
34 See Section 51 (1) of the CBA, and footnote 6.
35 See Sections 56 and 57 of the CBA.
36 See Section 31ZI(1) of the SCMA.

a to ascertain the application of *shariah* principles on any matter relating to Islamic capital market business or transactions;
b to issue rulings on any matters relating to Islamic capital market business or transactions;
c to advise the SC on any *shariah* issue relating to Islamic capital market business or transactions;
d to provide advice to any person on any *shariah* issue relating to Islamic capital market business or transactions; and
e such functions as may be prescribed by the Minister.[37]

In carrying out the above functions, the SC SAC adopts two significant approaches. First, by conducting research or studying the validity of conventional instruments from the *shariah* point of view, where focus is on the mechanism and use of the instruments to ensure their compliance with *shariah* principles. Second, by formulating and developing new financial instruments based on *shariah* principles. These approaches have formed the basis in developing several key *shariah* rulings on *sukuk* issuance.

Shariah committees of financial institutions

Every licensed holder under the IFSA must establish an internal *shariah* committee to ensure that its business, affairs and activities are *shariah*-compliant.[38] It is an independent body that reports directly to the board of directors. The appointment of the *shariah* committee members must be done with BNM's prior written approval.

All Islamic financial products or services offered by a licensed holder must be evaluated and approved by its *shariah* committee. The *shariah* committee may consult the BNM SAC for their ruling on any *shariah* matter and the latter's ruling prevails over the former's.[39]

Malaysia International Islamic Financial Centre Initiative

In 2006, the Malaysia International Islamic Financial Centre Initiative (the MIFC Initiative) was launched to position Malaysia as an international Islamic financial hub to, *inter alia*, facilitate Islamic finance business within the Asian region. Pursuant thereto, the MIFC was established as a network of the country's financial sector regulators, including BNM, the SC, the Labuan FSA, Bursa and government ministries and agencies, together with industry participation from the banking, *takaful*, capital markets, research and talent development institutions and service providers within Islamic finance. The MIFC network has greatly contributed to the development of Islamic finance in Malaysia by building strong ties among key stakeholders locally and abroad.

II COMMON STRUCTURES

The following discussion on common structures used by the financial institutions in offering Islamic financial products or financing facilities is based on the BNM SAC's rulings,

37 See Section 31ZJ of the SCMA.
38 See Section 30(1) of the IFSA.
39 See Section 58 of the CBA.

which were published in the second edition of Shariah Resolutions in Islamic Finance in October 2010. The rulings must be followed by all local or foreign financial institutions offering such products or services in Malaysia.[40]

i Consumer finance

Deposits typically involve contracts or arrangements under the *shariah* principle of *wadiah*, where property is deposited with a financial institution for safekeeping or protection, or *mudarabah*, which envisages the depositor as investor and the financial institution as entrepreneur, whereby the depositor contributes capital and the entrepreneur contributes expertise and operations. Profit earned is distributed according to agreement, but any losses suffered are borne by the investor.

As such it is permitted for (1) Islamic savings accounts to be established under the *shariah* principle of *mudarabah*;[41] and (2) Islamic current accounts to be established under the *shariah* principles of *mudarabah*, *wadiah* and *wadiah yad dhamanah*.[42]

Under the IFSA, there are two major classifications of products for the acceptance of money from customers, namely (a) Islamic deposits using *shariah* contracts with principal guaranteed features, applying the *shariah* principles of *wadiah yad dhamanah*, *qard* or *murabahah*; and (b) Islamic investment accounts using *shariah* contracts with non-principal guaranteed features, applying the *shariah* principles of *mudarabah*, *musharakah* or *wakalah*.

Given the above, investment accounts would not constitute debt obligations owed by the financial institution to its depositors, whereas in the case of Islamic deposits, whether the same constitute debt obligations owed by the financial institution to its depositors would depend on whether the financial institution's obligation to fully repay is based on a debt obligation, such as in the case of accounts opened under the *shariah* principles described at (a) above. This duality also enables customers with higher risk appetites to place their funds in investment accounts that will in turn receive higher returns depending on the performance of the underlying portfolio. This is also a new source of funding that may be utilised by financial institutions to fund more entrepreneurial business opportunities.

Islamic credit cards are offered using two *shariah* concepts, namely *bai al inah* and *wadiah*.[43] Two separate contracts must be entered into under the concept of *bai al inah* for sale and buy-back transactions of an asset. Financial institutions will sell an asset at a nominal value plus profit to the customer with an agreed deferred payment term and the customer will subsequently sell the same asset to the financial institution at a nominal value and payable on cash basis. The sale proceeds will be credited into the *wadiah* account to facilitate the purchases of goods or services by the customer.

The concept of *ijarah thumma al-bai* is applied in vehicle financing and involves two independent contracts: the *ijarah* contract and the *al-bai* contract.[44] Under the *ijarah* contract, the financial institution will appoint the customer as an agent to purchase the vehicle identified by the customer and the former will then lease the vehicle to the latter for

40 See Section 59 of the CBA.

41 See BNM, *Shariah Resolutions in Islamic Finance* (2nd edition, Kuala Lumpur: 2010), at p. 24 (ruling No. 15).

42 ibid., at pp. 26 and 155 (rulings Nos. 17 and 94).

43 ibid., at p. 148 (ruling No. 89).

44 ibid., at p. 3 (ruling No. 1).

a specified period. The customer has the option to purchase the vehicle from the financial institution upon the expiry of the lease period. An *al-bai* contract will be entered into should the customer opt to purchase the vehicle.

ii Home finance

The principle of *bai bithaman ajil* (BBA) is commonly used in Islamic home financing facilities. BBA contracts are contracts of sale and deferred payment where a home is sold on a deferred payment basis at an agreed selling price that consists of the actual cost of the home and the profit margin agreed between the financial institution lender and the customer borrower.[45]

Under BBA home financing, the agreed payment instalments remain fixed throughout the financing period as the selling price is fixed at the outset and the financing is not tagged to base lending rates. The latest Islamic home financing products allow customers to receive *ibra* (a rebate) on the monthly instalment amount if the home financing is linked to a *mudarabah* deposit account as long as the cost associated with the *ibra* is borne solely by the financial institution.[46]

In addition, the concepts of *ijarah mawsufah al-zimmah* and *musharakah mutanaqisah* are used to finance homes that are still under construction.[47] Based on the contract of *musharakah mutanaqisah*, both customer and financial institution share the rights over the home under construction. The financial institution will then lease its portion to the customer under the contract of *ijarah mawsufah al-zimmah*. The customer is required to pay advanced rent during the construction period of the home and will continue to pay full rent upon completion of the home.

iii Takaful (Islamic insurance)

In Malaysia, *takaful* involves contribution of money based on the *tabarru* concept (voluntary contribution) by all *takaful* participants who agree to relinquish all or part of their contribution as donation to aid other *takaful* participants who suffer losses or difficulties. This is originated from the concept of *ta'awun* (mutual assistance). A *takaful* company will then be appointed as their agent to manage the *takaful* fund and will in return receive commission of fixed service fee under the *wakalah* contract. A *retakaful* business model based on *tabarru* and *wakalah* or based on the *wakalah* model with the element of *wakaf* is permissible.[48]

iv Islamic private equity investments

The common structures used for *shariah*-compliant private equity or venture capital are *musharakah*, *mudarabah* and *wakalah*. The first Islamic venture capital fund established in Malaysia was based on the concept of *musharakah*, a risk-sharing partnership.[49] In this partnership, the ratio of distribution of profits need not coincide with the ratio of participation in the financing of the business activity but all parties bear the loss in proportion to their share in financing in the event of loss.

45 In this case, legal title to the home is with the customer or borrower.

46 ibid., at p. 128 (ruling No. 80).

47 ibid., at p. 16 (ruling No. 12).

48 ibid., at p. 62 (ruling No. 41).

49 See *Islamic Finance: An Ideal Model for Private Equity and Venture Capital* dated 30 September 2015, published by BNM.

The requirements for the registration of corporations undertaking Islamic venture capital and Islamic private equity activities are provided for in the Guidelines on the Registration of Venture Capital and Private Equity Corporations and Management Corporations dated 9 March 2015.[50] Under these Guidelines, an applicant who wishes to undertake Islamic venture capital or private equity activities must appoint a *shariah* adviser to provide *shariah* expertise and guidance on all matters pertaining to the Islamic venture capital or private equities activities and ensure that all aspects of the activities are in accordance with *shariah* requirements, including resolutions issued by the SC SAC.[51] In the case of investment in securities of any venture corporation by the registered corporations undertaking Islamic venture capital or private equity activities, the activities of the venture corporations must be *shariah*-compliant.[52]

v Islamic real estate investment trusts

Malaysian Islamic real estate investment trusts (REITs) are governed by the SC but will also fall under the purview of Bursa if they are listed on the stock exchange. The SC issued the Guidelines on Islamic Real Estate Investment Trusts in 2005 (Guidelines on I-REITs) to facilitate the establishment of Malaysian Islamic REITs. The number of listed Malaysian Islamic REITs remains at four as of 30 September 2017.[53]

These Islamic REITs specialise in different classes of assets and are as follows:

a Al-'Aqar' KPJ REIT (healthcare);

b Al-Salam Real Estate Investment Trust (*shariah*-compliant properties that include retail, office, food and beverage, which consists of restaurant and non-restaurant outlets);

c AXIS-REIT (office buildings and industrial properties); and

d Kuala Lumpur City Centre (KLCC) REIT (first *shariah*-compliant stapled REIT where the existing shares of KLCC Property Holdings Berhad are stapled together with the units of KLCC's three prime properties, namely Petronas Twin Towers, Petronas Tower 3 and ExxonMobil Tower).

It must be noted that the issuance of Islamic REITs must not only fulfil the requirements listed in the Guidelines on I-REITs but must also comply with the SCMA and the SC's Guidelines on Real Investment Trusts as the Guidelines on I-REITs only complement the latter by providing *shariah* guidance on the investment and business activities of I-REITs.[54]

For Islamic REITs, tangible assets will be acquired and rented out or leased to generate profits for the investors based on an *ijarah* contract. The owners of real estate sell assets to the Islamic REITs and a back-to-back asset lease arrangement will be entered into simultaneously. This helps to mitigate risks as an income stream is secured and the issue of securing a long-term tenant or buyer is solved.

50 For more details about the registration requirements, see Part B of the Guidelines.

51 See Chapter 5 of Part B of the Guidelines on the Registration of Venture Capital and Private Equity Corporations and Management Corporations.

52 See Part D of the Guidelines on the Registration of Venture Capital and Private Equity Corporations and Management Corporations.

53 See www.sc.com.my/wp-content/uploads/eng/html/resources/stats/REIT_approvedMgmntCompanies.pdf.

54 See *Exploring New Investment Opportunity through Real Estate* by the SC at www.fimm.com.my/shariah/3_sc_islamic%20Reit.pdf.

Under the said Guidelines, a *shariah* advisory committee must be established to oversee the *shariah* compliance of the REIT's operations. The rental of real estate by I-REITs is permissible provided that the property is not used for non-permissible activities.[55] *Takaful* schemes must be purchased to insure real estate and conventional insurance schemes can only be allowed if the former is unable to provide insurance coverage.

vi Investment funds

The *shariah* principle of *musharakah*, a joint venture profit and loss sharing arrangement, is commonly applied in investment and financing activities in Malaysia to provide working capital financing, trade financing and asset financing. There are two commonly used forms of *musharakah*-based financing:[56] (1) a joint venture partnership where the facility sums will be credited (in a lump sum or in stages) into a joint account that is registered under the customer's name but is managed by the financial institution in accordance with the *musharakah* principle; and (2) equity participation through establishment of a private limited joint venture company where the company's management will be appointed by both parties to represent their interests and will be responsible towards the development of a project. For the second form of *musharakah*-based financing, the financial institution will disburse the facility sums in one lump sum through additional paid up capital of the private limited company. These financing approaches are allowed provided that there is no element of capital or profit guarantee by any of the partners on the other partners.

Further to the above, the *shariah* principle of *istisna*, a type of sale contract where a subject matter is transacted before it comes into existence, is commonly used to finance construction and manufacturing activities in Malaysia. According to *istisna*, the financial institution enters into an agreement to purchase the project or asset to be developed from the customer (*istisna* – purchase by order) and will immediately sell it back to the customer at a marked-up price under the principle of *al-istisna* (sale by order). The purchase price will only be released by the financial institution upon the presentation of the requisite documents (such as a valid architect's certificate) whereas the customer is required to settle the selling price by way of instalments within the agreed period or by redemption exercise. The BNM SAC has previously ruled that a conventional bond can be used as a security for such financing as it is not made for the purpose of ownership, but merely as a security.[57]

vii Other areas – Islamic financial derivative instruments

Forward foreign currency exchange transactions

The concept of *wa'd* is widely used by the financial institutions to conduct forward foreign exchange transactions, whereby one of the parties to the contract promises to buy from or sell to the other counterparty a specific currency at an agreed exchange rate and settlement

55 Non-permissible activities include financial services based on *riba* (interest), gambling, conventional insurance, entertainment activities that are not permissible according to *shariah* principles, manufacturing or sale of tobacco-based products or related products, stockbroking or share trading in non-shariah-compliant securities, hotels and resorts and such other activities that the *shariah* committee can apply *ijtihad* (the process of making a legal decision by independent interpretation of the sources of the law, the Quran and the Sunnah) for other non-permissible activities to be included as a criteria in assessing whether the rental income for the I-REITs is *shariah*-compliant or not.

56 See footnote 35, at p. 40 (ruling No. 29).

57 ibid., at p. 21 (ruling No. 15).

date. Aside from *wa'd*, BBA is also allowed to be used as the underlying concept for forward foreign currency exchange transactions as all the deferred payment sale transactions are conducted independently and not related to each other. The unilateral *wa'd mulzim* (binding promise) is permissible to be applied in a forward foreign exchange transaction as it is treated as a promise.[58]

Islamic profit rate swap based on bai al inah

The *shariah* contract of *bai al inah* is used for Islamic profit rate swap (IPRS),[59] and depending on the duration of the swap contract, there are several stages involved in this contract.

First, the financial institutions (FIs) representing the swap counterparties jointly invest[60] in a *mudarabah* interbank investment (MII) whereupon the said investment will be used as the underlying asset in the swap transaction. The FIs will enter into an IPRS agreement with a third party (TP) to conduct a series of trade transactions at agreed dates[61] (e.g., semi-annually during the swap contract period, which in this instance shall be assumed at two years).

Second, the FI will sell the MII to the TP at a deferred sale price payable every six months (i.e., semi-annually) and the TP will thereafter sell it back to the FI at a sale price based on the fixed profit rate agreed in the swap contract. The settlement of the purchase price due from the TP will be offset against the payable amount due from the FI, which results in the FI being obliged to pay the fixed profit rate to the TP every six months during the two-year period. Third, the FI will sell the MII to the TP at the price agreed in the swap contract, which is based on the prevailing floating profit rate and the TP will thereafter sell it back to the FI at the said agreed price.

The settlement of the purchase price due from the TP will again be offset against the payable amount due from the FI and thus the FI will only be required to pay the floating profit rate for every six months for the two-year contract period.

The difference between payment obligations of both contracting parties resulting from the final step at the second stage and the final step at the third stage will be paid to the receiving party. Finally, the third stage will be repeated at the agreed reset date, which will be determined every six months until the swap contract matures. This arrangement is allowed and the issue of sale of debt with debt (which is prohibited by *shariah*) does not arise as the transfer of beneficial ownership takes place automatically given that the underlying asset used in the transaction is MII. The transfer will be reflected in the contract documentation and is *shariah*-compliant.

III TAXATION

Both conventional and Islamic financial products are governed under the same taxation regime. However, tax incentives are offered from time to time by the Malaysian government

58 ibid., at p. 137 (ruling No. 84).

59 ibid., at p. 139 (ruling No. 85).

60 As *mudarib* or managers for the swap counterparties (1) the FIs invest in the MII, but do not acquire it, to avoid the costs and implications of legal title; and (2) the amount invested by FIs is a notional swap amount contributed by the swap counterparties as prescribed in the swap contract.

61 The dates (described as 'reset dates' in the ruling) constitute determination points of the applicable floating profit rates to be swapped. These dates are set by swap counterparties, and may fall quarterly, semi-annually, annually or otherwise.

to encourage growth in the Islamic finance sector and facilitate Malaysia's aim towards becoming the regional Islamic finance hub. Some of the most significant and recent tax incentives are as follows:

i Malaysian Budget

The existing tax incentives announced under the Malaysian Budgets in 2016, 2017 and 2018 respectively comprise the following:

a companies enjoy single deduction on additional expenses[62] incurred for the issuance of *sukuk* under the principles of *ijarah* and *wakalah*[63] and enjoy double deduction on additional expenses incurred for the issuance of *sukuk* under the principles of *mudarabah*, *musharakah*, *istisna*, *murabahah* and BBA based on *tawarruq* until 2018;

b companies that issue sustainable and responsible *sukuk* will benefit from a tax deduction on their issuance costs until 2020;[64]

c companies that provide *shariah*-compliant fund management services and are certified by the SC will also enjoy a tax exemption on statutory income from the provision of such services until 2020;[65]

d recipients of green sustainable and responsible investment (SRI) *sukuk* grants enjoy income tax exemption for the purpose of financing the external review expenditure until 2020;[66]

e investors enjoy stamp duty exemptions on contract notes for trading of exchange-traded funds and structured warrants;[67]

f the fund manager managing an SRI fund approved by the SC will be given tax exemptions on management fee income from managing conventional and *shariah*-compliant SRI funds until 2020 in order to further promote fund management activities globally; and

g the following tax incentives that were provided pursuant to the MIFC Initiative from 2007 until 2016 have been further extended to 2020:

- full tax exemption on income earned from Islamic banking business or *takaful* business conducted through the International Currency Business Unit in foreign currencies by licensed financial institutions or licensed *takaful* companies and *takaful* units; and
- full stamp duty exemption on instruments executed pertaining to the above-mentioned activities.

Tax allowances and exemptions made under previous years' budgets are discussed in Section VI.

62 These are: (1) professional fees relating to due diligence, drafting and preparation of prospectus; (2) printing cost of prospectus; (3) advertisement cost of prospectus; (4) SC prospectus registration fee; (5) Bursa processing fee and initial listing fee; (6) Bursa new issue crediting fee; and (7) primary distribution fee. See Appendix 9 of the 2016 Malaysian Budget: www.bnm.gov.my/files/Budget_Speech_2016.pdf.

63 The Income Tax (Deduction for Expenditure on Issuance of Sukuk) Rules 2015 provide that a company shall be given a revenue deduction on an amount equal to the expenditure incurred on the issuance of *sukuk* under the *shariah* principles of *ijarah* or *wakalah* approved or authorised by, or lodged with, the SC or approved by the Labuan FSA. This is applicable from 2016 to 2018.

64 See Paragraph 72 and Appendix 8 of the 2016 Malaysian Budget.

65 ibid., Appendix 10.

66 See Appendix 4 of the 2018 Malaysian Budget.

67 See Appendix 8 of the 2018 Malaysian Budget.

ii Malaysian Income Tax Act 1967[68]

While Section 2(7) of the Malaysian Income Tax Act 1967 (ITA) provides that any reference in the ITA to interest shall apply to gains or profits received and expenses incurred, in lieu of interest, in transactions conducted in accordance with *shariah* principles, Section 2(8) of the ITA provides that any reference in the ITA to the disposal of an asset or a lease shall exclude enabling transactions under a scheme of financing approved by BNM, the SC, the Labuan FSA or the Malaysia Co-operative Societies Commission.

iii Malaysian Stamp Act 1949

Sukuk issuances currently enjoy stamp duty exemptions in Malaysia by way of orders issued under the Malaysian Stamp Act 1949, which include the following: (1) Stamp Duty (Exemption) (No. 23) Order 2000, which provides that all instruments relating to the issue of, offer for subscription or purchase of, or invitation to subscribe for or purchase, debentures approved by the SC under Section 32 of the Securities Commission Act 1993 and the transfer of such debentures are exempted from stamp duty; and (2) Stamp Duty (Exemption) (No. 4) Order 2013, which provides that an instrument relating to the sale and purchase of retail *sukuk* as approved by the SC under the CMSA are exempted from stamp duty.

IV INSOLVENCY

In Malaysia, corporate insolvency is currently governed by the Companies Act 2016 (CA), which repealed and replaced the Companies Act 1965.[69] The modes of winding-up proceedings provided thereunder still include compulsory and voluntary winding up and the appointment of receivers and managers over a corporation. However, the CA introduced two new corporate rescue mechanisms, namely corporate voluntary arrangement and judicial management in Division 8 of Part III of the CA, which came into force on 1 March 2018.[70] A voluntary winding up under the CA can either be a member's voluntary winding up or a creditor's winding up. A company may be wound up voluntarily if so provided under its constitution and the company has passed a resolution in a general meeting requiring itself to be wound up voluntarily or a special resolution for its winding up is passed.[71] In addition, the CA provides 12 situations[72] whereby a court may wind up a company, which include a company being unable to pay its debts, the most commonly occurring scenario.

Over and above the CA, however, a specialised framework addressing the failure of financial institutions licensed to undertake Islamic or international Islamic banking business under the IFSA to pay their debts as they fall due can be found in the IFSA and the MDICA.

i MDICA

The MDICA empowers the MDIC to assume control of a non-viable financial institution and to acquire and take control of non-performing loans that are outstanding between

68 For more tax incentives that are or were previously offered under the Income Tax Act for various Islamic capital market products or services, see www.sc.com.my/home/special-incentives-2/islamic-capital-market/.

69 See Part IV of the CA, which provides for voluntary and compulsory winding up of a company.

70 https://themalaysianlawyer.com/wp-content/uploads/2018/02/pub_20180228_p-u-b-106-2018-27-2-2018-crm.pdf.

71 Section 439 of the CA.

72 Section 465 of the CA.

the financial institutions, borrowers and security providers through the appointment of a conservator. The MDICA further provides that upon the appointment of the conservator, a moratorium shall take effect during which, *inter alia*, (1) no action, suit or proceeding may be commenced or continued against the MDIC, the conservator or the financial institution; (2) any petition for the winding up of the financial institution shall be dismissed; (3) no receiver, receiver manager or liquidator may be appointed over the financial institution; and (4) no steps may be taken to enforce any security over the assets of the financial institution.[73]

Under the MDICA, BNM may provide written notice to the MDIC where BNM is of the opinion that a financial institution has ceased to be viable or is likely to cease to be viable, whereupon the MDIC can exercise, *inter alia*, the following powers:

a the financial institution to take any step or action or refrain from any act or thing, in relation to itself, its businesses or its officers, to cease soliciting, taking or repaying deposits or carry on its business or such part of its business as the MDIC may direct or to restructure the whole or part of its business as may be specified by the MDIC;

b acquire or subscribe to the shares of the financial institution;

c assume control over the financial institution, carry on the whole or part of its businesses and manage the whole or part of its assets, liabilities and affairs, including disposal of its assets or businesses or any part thereof, or appoint any person to do so on behalf of the MDIC;

d apply for the appointment of a receiver or manager, or both, to manage the whole or part of the assets, liabilities, businesses and affairs of the financial institution;

e subject to the approval of the Minister, present a petition for the winding up of the financial institution;

f with the approval of the Minister, designate one of its subsidiaries as a 'bridge institution'; or

g transfer such assets and liabilities of the non-viable financial institution to the bridge institution on terms as determined by the MDIC.[74]

ii IFSA

The provisions of the IFSA include measures for addressing the insolvency of Islamic financial institutions (IFIs). Under the IFSA, BNM acts as a resolution authority that is, with the prior approval of the Minister, empowered to assume control of the whole or part of the business, affairs or property of an IFI, manage the same, or appoint any person to do so on behalf of BNM in the event that BNM is of the opinion that certain circumstances exist in relation to the IFI concerned, inclusive of the following:

a the assets of the institution are not sufficient to give adequate protection to its depositors, policy owners, participants, users or creditors, as the case may be;

b the capital of the institution has reached a level or is eroding in a manner that may detrimentally affect its depositors, policy owners, participants, users, creditors or the public generally; and

c the financial institution has become or is likely to become insolvent or is likely to become unable to meet all or any of its obligations.[75]

73 Sections 161 and 179 of the MDICA.

74 Section 98 of the MDICA.

75 Sections 177 and 179 of the IFSA.

Additionally, the IFSA provides BNM with further powers if it is found that an IFI is insolvent or is on the verge of insolvency, whereupon BNM may:

a make an application to appoint a receiver or manager, or both, over the whole or part of the business, affairs or property of the financial institution;[76]

b with the prior approval of the Minister, vest in a bridge institution or any other person, the whole or part of the business, assets or liabilities of the financial institution;[77]

c with the prior approval of the Minister, provide financial assistance to another institution or any other person to purchase any shares, or the whole or any part of the business, assets or liabilities, of the financial institution;[78] or

d recommend to the Minister and the Minister may, on that recommendation, authorise BNM to file an application for the winding up of the financial institution.[79]

Lastly, the IFSA further provides that:

a the provisions of the CA shall apply to the winding up of an institution, unless specifically provided otherwise. However, no application for the winding up of a financial institution may be presented by any person without the prior written approval of BNM;[80] and

b in the winding up of the licensed Islamic bank or the licensed *takaful* operator, the assets of the said financial institution shall be available to meet all their liabilities to depositors or *takaful* participants in priority over all other unsecured liabilities, other than preferential debts set out in the CA and debts due and claims owing to the government under the Government Proceedings Act 1956.[81]

V JUDICIAL FRAMEWORK

i Courts

Although Malaysia has a dual judicial system consisting of secular laws (criminal and civil) and religious laws (*shariah*), each with its own court system, cases involving Islamic finance business disputes fall within the jurisdiction of the civil courts and not the *shariah* courts.

Article 121 of the Federal Constitution of Malaysia 1957 (FC) sets out the jurisdictions of the Malaysian civil courts whereas Article 74(1) of the FC prescribes that Parliament may make laws with regard to the matters contained in the Federal List, inclusive of List I under the Ninth Schedule of the FC (List I), which, *inter alia*, includes civil and criminal procedure, the administration of justice and contracts[82] but specifically excludes the constitution and organisation of the *shariah* courts. As such, Articles 121 and 74(1) read together indicate that the jurisdiction of the civil court is specifically set out in List I.

Article 121(1 A) of the FC states that the civil court has no jurisdiction over matters within the jurisdiction of the *shariah* court, whereas Article 74(2) of the FC provides that a state legislature may make laws contained in the State List, inclusive of List II of the

76 Section 184 of the IFSA.
77 Section 188 of the IFSA.
78 Section 200(b) of the IFSA.
79 Section 205 of the IFSA.
80 Sections 204, 206 and 207 of the IFSA.
81 Sections 217 and 218 of the IFSA.
82 See Paragraphs 4(a) and 4(b) of List I of the Ninth Schedule of the FC.

Ninth Schedule of the FC (List II), which, *inter alia*, includes Islamic law and personal and family law of persons professing the religion of Islam and the constitution and organisation of the *shariah* courts.[83]

Based on the above provisions, jurisdiction over Islamic banking and finance laws lies with the civil court for the following reasons:

a while the term 'Islamic law' in List II is wide,[84] its application is only limited to persons professing the religion of Islam and would not be applicable to banks and financial institutions, which cannot be said to profess the religion of Islam;

b laws relating to Islamic banking and finance fall within the category of contract and mercantile law under List I, which is under the purview of the Malaysian federal legislative body. As such, these are subject to the jurisdiction of the civil courts as civil court judges are bound by laws and regulations that are exclusively federal;[85] and

c the judgment of the Malaysian Supreme Court in the case of *Mohamed Habibullah bin Mahmood v. Faridah Dato' Talib*[86] held that the *shariah* court may only decide matters falling under its jurisdiction, and as such Article 121(1 A) does detract from the jurisdiction of the High Court in respect of the matters in List I.

ii Cases

As stated above, disputes relating to Islamic finance in Malaysia are decided by the civil courts rather than the *shariah* courts, notwithstanding the application of *shariah* principles. Bearing this in mind, together with the popular usage of the BNM SAC approved BBA principle in Malaysian home financing transactions, the following cases are noteworthy in illustrating how the Malaysian courts have progressively dealt with disputes involving Islamic finance transactions.

Initially, the civil courts dealt with disputes through the application of common law principles applicable to conventional banking without discussing or reference to applicable underlying *shariah* principles.[87] In *Bank Islam Malaysia Bhd v. Adnan Omar*,[88] the court applied common law doctrine that parties were bound by the four corners of their agreement. The defendant was therefore obliged to pay the entire selling price as he had knowingly entered into the contract and was fully aware of its terms. The decision did not examine whether the BBA facility involved non-*shariah*-compliant elements, expressly referred to the facility as a loan and held that defendants had no right to a rebate, which was at the discretion of the lender. Understandably, this operated to the disadvantage of the defendants, who in defending claims against them, were deprived of an analysis of *shariah* principles by the court.

83 ibid., Paragraph 1 of List II.

84 ibid.

85 This refers to the Malaysian Civil Law Act 1956, the Malaysian Courts of Judicature Act 1964 and the Rules of the High Court 1980.

86 [1993] 1 CLJ 264. See also the Malaysian High Court judgment in *Bank Islam Malaysia Berhad v. Adnan Omar* [1994] 3 CLJ 735, in which the High Court held that, *inter alia*, *shariah* courts can only decide cases that fall under the State List of the Malaysian Federal Constitution, which excludes commercial law matters such as Islamic banking and finance.

87 See *Bank Kerjasama Rakyat Malaysia Bhd v. Emcee Corporation* [2003] 1 CLJ 625, CA, which held that the law applicable to Islamic banking disputes was the same as that applicable to conventional banking disputes. This was followed in *Tahan Steel Corporation v. Bank Islam Malaysia Bhd* [2004] 6 CLJ 25.

88 [1994] 3 CLJ 735.

Subsequently, the courts took a more interventionist approach in *Affin Bank v. Zulkifli Abdullah*,[89] which concerned a BBA facility wherein the customer had defaulted in instalment payments for the asset sale price, and the lender had claimed the outstanding balance of the asset sale price (i.e., less the payments previously made). In coming to a decision, the courts decided that a critical examination of the underlying *shariah* principles in the financing was required to ensure justice and equality between the parties.

This approach was subsequently followed in *Malayan Banking Berhad v. Marilyn Ho Siok Lin*,[90] in which the court specifically analysed whether the transaction was contrary to Islam, and ruled that the Islamic banks could not claim unearned profits on BBA contracts because the contract was similar to a conventional loan and unearned profits were equal to interest calculation. The resulting judgment disallowed the lenders claims for unearned profits notwithstanding that the predecessor to the CBA, the Central Bank of Malaysia Act 1958 was amended in 2003[91] to allow for a referral by the court to BNM SAC for *shariah*-related issues. However, the court was not bound to make such a referral, and the judge in *Affin Bank* declined to do so, and decided the matter based on a review of the transaction documents.

The *Affin Bank* judgment was not well received in the Islamic finance industry as lenders became uncertain as to what they could claim in default situations. In addition, *shariah* scholars were dissatisfied with the decision and viewed it to be defective from a *shariah* law perspective. Some three years later, the presiding judge in *Affin Bank* further developed this approach in *Arab-Malaysian Finance Bhd v. Taman Ihsan Jaya Sdn Bhd & 11 Ors*,[92] where *Affin Bank* was affirmed and the court ruled that a *bona fide* sale was required in BBA financing for the profit or selling price to be *shariah*-compliant. If not, then deferred payment of the sale price would be nothing more than a credit or loan extended, and any profit therefrom would be prohibited as *riba*. The judge rejected the approach in *Adnan Omar* and held that the parties' agreement alone did not prevent the court from examining and determining the exact nature of a transaction.

The other judges presiding over disputed BBA financing transactions began to adopt differing views by seeking the advice of *shariah* scholars and the BNM SAC, in contrast to *Affin Bank*. In *Malayan Banking Bhd v. Ya'kup Oje & Anor*[93] the court opined that there would be great uncertainty if customers entering into financing contracts approved by both the Islamic financial institution lenders *shariah* committee and by the BNM SAC were allowed to challenge the *shariah* compliance of the contract in court, and that this was morally unacceptable from a *shariah* perspective.

The Malaysian Court of Appeal considered *Taman Ihsan Jaya* on appeal in *Bank Islam Malaysia Berhad v. Lim Kok Hoe & Anor* and other appeals[94] and held that the High Court judgment in *Taman Ihsan Jaya* was manifestly wrong and must be set aside for the following reasons:

89 [2006] 3 MLJ67.

90 [2006] 3 CLJ 796.

91 See Section 16B of the CBA 1958.

92 [2008] 5 MLJ 631.

93 [2007] 5 CLJ 311.

94 [2009] 6 MLJ 839.

a the judge in *Taman Ihsan Jaya* was plainly wrong to equate profit earned as being similar to *riba* or interest. The two cannot be similar as a BBA contract is in fact a trade transaction between the customer and the bank and the element of profit is therefore completely distinct from interest in conventional loans;

b judges in civil court should not take it upon themselves to declare whether banking business is in accordance with the religion of Islam; this requires consideration by eminent jurists properly qualified in the field of Islamic jurisprudence; and

c the judge in *Taman Ihsan Jaya* failed to follow the judicial precedent of superior courts, which clearly favoured the common law approach in *Adnan Omar*.

In the recent appellate case of *Maybank Islamic Berhad v. M-IO Builders Sdn Bhd & Anor*,[95] the appellate court opined that the validity of the disputed Murabahah Overdraft Facility agreements should be governed by the law that generally governs the contract between parties in Malaysia, namely the Contracts Act 1950. Therefore, the said agreements were held to be valid notwithstanding their failure to comply with *shariah* principles. It is interesting to note that most of the claims were filed as an attempt by customers to escape liability as a whole or to reduce the quantum of their liability. If courts were to declare these facilities, which are monitored and approved by BNM, as invalid, the development of the local Islamic banking industry would be adversely affected as Islamic financial institutions would face uncertainty and increased risk in their ability to recover the principal and profit in relation to the granting of these facilities.

Subsequently, BNM and Parliament conclusively laid much uncertainty to rest with the coming into force of the CBA, which provides, *inter alia*, that:

a the BNM SAC would be the authority for determining Islamic law for the purposes of Islamic finance business;[96]

b the BNM SAC would be a consultative body to the Malaysian judiciary, and that consequently judges and arbitrators were required to take into consideration published rulings of the BNM SAC or refer to the BNM SAC for its ruling on any *shariah* issues arising from disputes being adjudicated;[97] and

c once a ruling is issued by the BNM SAC in response to a reference, that ruling was binding on the referring financial institution, court or arbitrator.[98]

In addition to this, the issuance of BNM's Guidelines on Ibra' (Rebate) for Sale-Based Financing 2012 obliged Islamic banks to grant *ibra* to customers of sale-based financing facilities, thus resolving earlier questions of unfairness or injustice. With these developments, the above-mentioned cases remain purely of academic interest.

95 [2016] MLJU 1415.

96 See Section 51 of the CBA.

97 See Section 52(1) (a) of the CBA.

98 See Sections 56 and 57 of the CBA.

VI OUTLOOK

The following recent developments illustrate Malaysia's continuing commitment to its financial services objectives under the ETP, the FSB and the Blueprint. Collectively, they underscore a promising outlook for Malaysia's dynamic and innovative Islamic finance sector and its continuing efforts to lead in the growth and development of Islamic finance globally.

i Islamic indices

To ensure that *shariah*-based investments continue to grow, the SC and Bursa acknowledged that Islamic indices serve an essential role in Islamic finance as they identify securities available for investment within Islamic financial markets and facilitate the valuation of *shariah*-compliant products. These indices also broaden the base of investors and increase *shariah*-compliant product diversity.

In line with the above, Bursa launched Bursa Malaysia-i, the world's first end-to-end integrated Islamic securities exchange platform in September 2016.[99] The platform's basic function is to enable investors to invest in and trade *shariah*-compliant products via a *shariah*-compliant trading platform incorporating the full range of *shariah*-compliant exchange-related services, including listing, trading, clearing, settlement and depository facilities. Bursa Malaysia-i forms an important part of Bursa Malaysia's plan to position Malaysia as the pre-eminent marketplace for Islamic-based financial offerings and *shariah* investing.

ii Islamic pension fund

In August 2016, Malaysia's state pension fund, the Employees Provident Fund (EPF) made available to its members the option of converting their current conventional savings into an Islamic pension scheme option, simply called 'EPF Simpanan Shariah', which took effect on 1 January 2017, whereby dividend rates would not be guaranteed, but based on the performance of *shariah*-compliant investments. EPF Simpanan Shariah is open to all members regardless of race, religion and nationality. However, members who have chosen Simpanan Shariah would not be allowed to revert to the conventional scheme after the effective date. According to EPF sources, a total of 59.03 billion ringgit of the initial 100 billion ringgit fund allocated for Simpanan Shariah 2017 have been taken up and 635,037 members have switched to Simpanan Shariah as at 23 December 2016. As at 31 December 2017, EPF has about 700,000 contributors with a total size of 67.76 billion ringgit for Simpanan Shariah, from 100 billion ringgit allocated for the savings as at 31 December 2017.[100] EPF has allocated 50 billion ringgit as further injection for Simpanan Shariah 2018.[101]

The EPF also announced that it had allocated an initial fund size of 100 billion ringgit, equivalent to about 15 per cent of the EPF's total investment assets of 681.71 billion ringgit (as at end March 2016), and that its investment in *shariah* assets was expected to grow by at least 25 billion ringgit per annum on average, or in tandem with its total asset growth, to

99 See www.thesundaily.my/news/1961269.

100 See www.theedgemarkets.com/article/syariah-account-will-offer-similar-returns-long-term%C2%A0.

101 See www.thestar.com.my/business/business-news/2017/01/18/epf-more-than-half-of-simpanan-shariah-fund-taken-up/.

maintain a minimum of 45 per cent *shariah* assets.[102] As at 31 December 2017, the *shariah* assets stood at 47.5 per cent of the fund's total asset exposure and contributed 42.9 per cent of total income in 2017.

iii Islamic fund and wealth management

The SC unveiled the Blueprint on 12 January 2017 with the aim of, among other things, establishing Malaysia as a leading international centre for Islamic fund and wealth management.

According to the Blueprint, one of the strategic thrusts to achieve the aim is to develop Malaysia as an international provider of Islamic wealth management services. In this regard, focus will be concentrated on efforts to deepen and broaden the suite of *shariah*-compliant wealth management solutions while enhancing the supporting market infrastructure and creating a more conducive and enabling environment. Efforts will also be directed towards promoting and differentiating aspects of Islamic wealth management across the value chain of wealth generation, accumulation, preservation and distribution by aligning products and services to the tenets of the *maqasid al-shariah* and by utilising *waqf* assets and structures. This will enable the Islamic fund and wealth management service provider to tap into a target market of affluent investors, especially Muslim investors.

iv Sustainable and responsible investments

With a clear shift in global trends towards business strategies that incorporate sustainable practices, stronger governance and ethics, together with environmental and social concerns, this enabled Islamic finance, based on the principles of fairness, social and environmental responsibility, to feature prominently in the rise of sustainable development projects. With this in mind, the SC introduced the SRI *sukuk* framework in 2014 to facilitate the creation of an ecosystem conducive for SRI investors and issuers.

The framework further enhances Malaysia's position and reputation as a hub for Islamic finance and sustainable investments. In June 2015, Malaysia's sovereign wealth fund, Khazanah Nasional Bhd issued the first tranche of the 1 billion ringgit SRI *ihsan sukuk*, the proceeds of which were to be utilised for the Yayasan Amir trust schools programme, a not-for-profit foundation that is party to a public private partnership with the Malaysian Ministry of Education.[103]

According to the Global Sustainable Investment Review 2016, Malaysia is the largest SRI market in the region, with a 3 per cent share in Asia (excluding Japan), as Malaysia recognises *shariah*-compliant funds as part of the SRI universe.[104] The SC has developed a framework for SRI funds by issuing the Guidelines on Sustainable and Responsible Investment (SRI) Funds in December 2017 to facilitate and encourage growth of SRI funds in Malaysia. This will build on Malaysia's position as a regional *shariah*-compliant SRI centre; a strategic thrust that was identified under the Blueprint. These Guidelines are applicable

102 See www.thestar.com.my/business/business-news/2016/06/20/epf-shariah-savings-scheme-open-for-registration-on-aug-8/ and www.freemalaysiatoday.com/category/nation/2018/02/10/epf-declares-6-9-dividend-6-4-for-simpanan-shariah/.

103 Part 1 of the SC Annual Report 2015 and www.yayasanamir.org.my.

104 See www.theedgemarkets.com/article/trends-global-sustainable-investments-25.

for both conventional and *shariah*-compliant funds.[105] Malaysia achieved further success in the SRI space in July 2017 with the establishment of the world's first green SRI *sukuk* by Tadau Energy (a joint venture between Kagayaki Energy, a Malaysian renewable energy and sustainable technology investment firm, and Edra Solar, owned by the China General Nuclear Power Corporation). This was a significant development in the green financing and global *sukuk* arena, and the result of a collaboration between the SC, BNM and the World Bank Group, aimed at developing an ecosystem to facilitate the growth of green *sukuk* and to introduce innovative financial instruments to accommodate global infrastructure needs and green financing.[106]

In November 2017, the Association of Southeast Asian Nations (ASEAN) Green Bond Standards (GBS) were launched at the inaugural ASEAN Capital Market Conference. The ASEAN GBS aim to provide more specific guidance on how the Green Bond Principles are to be applied across the ASEAN, in order to promote transparency and consistency in the ASEAN green bond market framework. Quantum Solar Park (Semenanjung) Sdn Bhd issued the largest green *sukuk* in the world of 1 billion ringgit, which coincides with the ASEAN GBS. The proceeds are to fund the construction of three large solar power plants with total capacity of 150MW (megawatt), which are the largest solar power projects in South-East Asia. This transaction would assist Malaysia in achieving its renewable energy generation target of 7,200MW by 2020 and propel the nation's objective to be a key driver in the green Islamic financial space. The green SRI *sukuk* paves the way for more sustainable and responsible financing in Malaysia and ASEAN and coincides with ASEAN GBS, which further supports and assists the establishment of climate-friendly investments.

In December 2017, Permodalan Nasional Bhd issued the first tranche of 690 million ringgit under its 2 billion ringgit and 15-year Merdeka ASEAN green SRI *sukuk* programme. This was the first green *sukuk* recognised under both the SC's SRI *sukuk* framework and the ASEAN GBS.[107] In addition, tax incentives were announced in July 2017 to attract green issuers, which included tax deduction until year of assessment of 2020 on issuance costs of SRI *sukuk* approved, authorised by or lodged with SC,[108] over and above the measures previously introduced in the 2014 Budget.[109] In the 2018 Malaysian Budget, the former prime minister unveiled a series of tax incentives, including an income tax exemption on green SRI *sukuk* grants, aimed at encouraging the issuance of green SRI *sukuk* in Malaysia. The SC, through the Capital Market Development Fund, will provide a green SRI *sukuk* grant of 6 million ringgit to finance the external review expenditure incurred by a green SRI *sukuk* issuer.[110]

105 See www.sc.com.my/post_archive/the-sc-continues-to-drive-sustainable-and-responsible-investment-sri-issues-new-guidelines-on-sri-funds/.

106 See https://www.nst.com.my/opinion/columnists/2017/09/283670/malaysias-green-sukuk-going-places; and www.mifc.com/index.php?ch=28&pg=72&ac=184&bb=uploadpdf.

107 See footnote 6.

108 See https://www.sc.com.my/post_archive/malaysias-first-green-sukuk-under-scs-sustainable-responsible-investment-sukuk-framework/.

109 See www.mida.gov.my/home/tax-incentives-for-green-industry/posts/.

110 See Appendix 4 of the 2018 Malaysian Budget.

v Financial technology

The role of fintech in Islamic finance as a key enabler for future business and facilitator for an automated end-to-end Islamic banking system for *shariah*-compliant banking operations. To this end, six Islamic banking institutions in Malaysia collaborated in February 2016 to launch the Investment Account Platform,[111] the first bank-intermediated fintech platform combining Islamic banking services and technology to channel funds from investors to *shariah*-compliant economic ventures.[112] In this regard, BNM and the SC have taken initiatives to boost the development of fintech in Malaysia as elaborated below.

BNM has approved seven firms to operate within its 'regulatory sandbox' in accordance with the Guidelines on Financial Technology Regulatory Sandbox Framework dated 18 October 2016.[113] This will enable innovation of fintech to be deployed and tested in a live environment within specified parameters and time frames. The Islamic financial institutions are encouraged to embrace the movement by coming up with their own fintech innovations or by working with fintech start-ups, especially those in the digital payments space.

In addition, the SC and the Australian Securities and Investments Commission entered into an innovation cooperation agreement on 27 June 2017 to further promote innovation in financial services in their respective markets. This enables both regulators to explore potential joint innovation projects relating to the application of new technologies and to facilitate referrals of innovative businesses seeking to operate in each other's jurisdictions. This marks an important milestone for Malaysia's digital finance sector.[114] In September 2017, the SC signed a series of innovation cooperation agreements with several other regulators in major financial centres: the Hong Kong Securities and Futures Commission, the Dubai Financial Services Authority and the Monetary Authority of Singapore.[115] In February 2018, the Global University of Islamic Finance inked a memorandum of understanding with MIMOS Bhd, Malaysia's national information and communications technology research and development centre, to collaborate in the development of a blueprint for an Islamic finance-based investment technology platform.[116]

vi Securities Industry Dispute Resolution Centre

Securities Industry Dispute Resolution Centre (SIDREC) is an independent body established by the SC in 2011 for the settlement of disputes between investors and capital market intermediaries. SIDREC offers a free service and aims to ensure that investors have access to an independent and impartial and expert dispute resolution avenue. Commercial and Islamic banks offering capital market services and products have become members of SIDREC in September 2017 following the SC's amendment to the Capital Markets and Services (Dispute Resolution) Regulations 2010. With these developments, investors can initiate dispute resolution claims for amounts of up to 250,000 ringgit. SIDREC may also

111 See www.iaplatform.com.
112 See www.bnm.gov.my/index.php?ch=en_announcement&pg=en_announcement&ac=356&lang=en.
113 See www.myfteg.com/approved-participants-in-sandbox.
114 See https://www.sc.com.my/post_archive/sc-and-asic-sign-innovation-cooperation-agreement-to-establish-fintech-bridge/.
115 See www.sc.com.my/post_archive/sc-establishes-fintech-cooperation-agreements-with-major-financial-centres/.
116 www.inceif.org/2018/03/02/inceif-collaborates-with-mimos-to-embark-on-islamic-fintech/.

provide mediation for claims exceeding 250,000 ringgit with the consent of both parties.[117] In 2018, SIDREC expanded its purview, allowing it to offer its services to investors and capital markets services providers with disputes relating to claims exceeding 250,000 ringgit. The new service, being a voluntary scheme, requires both parties to a dispute to agree to use SIDREC's alternative dispute resolution services.[118]

vii Conclusion

Malaysia is recognised by the Islamic Finance Services Board and International Monetary Fund as a systemically important jurisdiction in which 15 per cent or more of its financial sector assets are Islamic,[119] and has maintained its leading position as the most developed Islamic finance market globally, as recognised by the Thomson Reuters's Islamic Finance Development Indicator 2017.[120] It is recognised that Malaysia's achievements are attributable to the development of effective market structure, diverse players, a deep Islamic finance talent pool and robust legal, regulatory and *shariah* frameworks conducive to the sector's growth and development.[121] The BNM SAC has also played an important role in developing Islamic finance in Malaysia through its *shariah* rulings, which have not only instilled customer and market confidence, but also catalysed a number of industry innovations (e.g., the BNM SAC's approval to use hybrid contracts, such as *musharakah mutanaqisah* (diminishing partnership), which enabled the introduction of innovative products).[122] Moody's has recognised Malaysia as the largest Islamic issuer in terms of volume, both in the long and short-term market, at 34 per cent of total global issuances. While Moody's estimated that the total sovereign *sukuk* volume would experience a marginal decline in overall value in 2018 compared with 2017, as some of the large issuances may not be repeated in 2018, the total sovereign *sukuk* volume is expected to remain stable.[123] With the new government's determination to focus on the country's finances and economic management,[124] there is optimism that Malaysia will consolidate and continue its leadership and innovation in Islamic finance, to play its part in forging a more sustainable, equitable, socially responsible and environmentally beneficial world.

117 See www.bnm.gov.my/index.php?ch=en_press&pg=en_press&ac=4246&lang=en.

118 See https://sidrec.com.my/sidrec-expands-purview-can-handle-claims-above-rm250000/.

119 www.reuters.com/article/us-islamic-finance-imf/imf-to-add-islamic-finance-to-market-surveillance-in-2019-idUSKCN1IQ081.

120 www.zawya.com/islamic-finance-development-indicator.

121 See BNM Financial Stability and Payment Systems Report 2017, www.bnm.gov.my/files/publication/fsps/en/2017/fs2017_book.pdf.

122 ibid.

123 www.theedgemarkets.com/article/moodys-malaysia-global-leader-islamic-finance-topped-sukuk-issuance-volume-2017.

124 www.thesundaily.my/news/2018/05/11/govt-will-focus-finances-economic-management-mahathir.

Chapter 8

NETHERLANDS

Omar Salah[1]

I INTRODUCTION

Dutch banks were among the first banks to become active in the field of Islamic finance: at the beginning of the twentieth century, the Netherlands Trading Society was established in Jeddah, Saudi Arabia, to provide interest-free money exchange services to pilgrims from Indonesia.[2] Since the emergence of modern-day Islamic finance in the 1990s, however, there has been limited Islamic finance activity in the Netherlands. In 2004, the first European *sukuk* was issued by the German state of Saxony-Anhalt using a Dutch vehicle (a *stichting*) as the issuing entity, but the entire structure was initiated by the German state so this was in essence a German Islamic finance transaction. ABN AMRO and the Liechtensteinische Landesbank launched a structured investment product called LLB Top 20 Middle East Total Return Index Certificate in 2007 and Barclays launched three Amsterdam-listed Islamic investment products in 2008. Further, Rabobank studied the potential demand for Islamic banking among households in the Netherlands. In 2007, Minister Wouter Bos (former Minister of Finance) also announced that the possibilities for Islamic finance in the Netherlands should be studied. Despite several studies that showed there is a potential demand for Islamic finance in the Netherlands,[3] the Islamic finance market did not pick up. Hence, there have not been many Islamic finance transactions in the Netherlands and, in general, Islamic finance remains a novel and exotic form of financing for most Dutch financiers and borrowers.

II LEGISLATIVE AND REGULATORY FRAMEWORK

i Legislative and regulatory regime

In 2008, the Dutch central bank (DCB) and the Dutch financial services regulatory authority (AFM) conducted a study on Islamic finance in the Netherlands. One of their conclusions was that the existing regulatory framework in the Netherlands can be applied to Islamic finance, but with respect to certain financial supervision-related matters (e.g., market entry, conduct-of-business, capital adequacy and provision of information) the Dutch regulatory framework may need amendments to specifically address Islamic finance products.[4]

1 Omar Salah is a senior associate at De Brauw Blackstone Westbroek.

2 O Salah, *Sukuk Structures: Legal Engineering Under Dutch Law*, Eleven International Publishing 2014, pp. 5–6.

3 See, among others, B Verhoef, S Azahaf and W Bijkerk, 'Islamic finance and supervision: An exploratory analysis', DNB Occasional Studies 2008-6/3, pp. 21–24.

4 B Verhoef, S Azahaf and W Bijkerk, 'Islamic finance and supervision: An exploratory analysis', DNB Occasional Studies 2008-6/3, pp. 35–36.

However, no such legal amendments were introduced. Consequently, there is no legislative and regulatory regime that focuses exclusively on Islamic finance, but instead the existing legislative and regulatory regime for conventional finance also applies to Islamic finance.

The regulatory regime for banks and other financial undertakings (including Islamic banks and other Islamic financial undertakings) is based on both European regulations and Dutch national (financial supervision) laws. These laws are primarily codified in the Dutch Financial Markets Supervision Act (FMSA), which came into force on 1 January 2007. Banks (both conventional and Islamic) established in the Netherlands are required to obtain a banking licence from the European Central Bank (ECB), while the DCB processes licence applications. Further, if (Islamic) banks intend to provide investment services or perform investment activities in the Netherlands, they need to apply for a wider banking and investment firm licence. In general, Dutch branches of foreign (Islamic) banks with activities in the Netherlands are subject to the same licence requirements as banks with registered offices in the Netherlands. However, if the foreign (Islamic) banks have their registered offices in another eurozone country, they may conduct banking activities through their Dutch branches or on a cross-border basis in the Netherlands using their 'European passport': they may conduct banking activities under their ECB banking licence, provided that the ECB has been notified thereof. A comparable regulatory regime applies to insurance companies (whether conventional or the Islamic *takaful*), which also need to obtain a licence in the Netherlands.

The FMSA establishes the rules for the offering of securities in the Netherlands, prospectus approval, public bids and the operation of regulated markets. These rules apply on both the issuance of conventional bonds and shares, and the issuance of *sukuk*. The FMSA also contains extensive rules on the relationship between (Islamic) banks and their customers; (Islamic) banks must comply with certain conduct-of-business rules if they offer loans to customers. In addition, the Dutch Civil Code (DCC) and the Act on Consumer Credit govern the civil law relationship between (Islamic) banks and their customers: according to these laws, (Islamic) banks need to provide detailed information to their customers, there are specific requirements for the contents of loan contracts, and customers have additional consumer protection rights to rescind loan contracts under certain circumstances.[5] Furthermore, the Mortgage Credit Directive (2014/17/EU) was implemented in the Netherlands on 14 July 2016, resulting in the introduction of a new Chapter 2b to Book 7 DCC and amendments to the FMSA. These amendments relate to new rules on credit worthiness assessments, obligations to provide information to consumers, and customers having certain consumer protection rights in cases of early repayments, arrears and foreclosures. As of 1 January 2017, Chapters 2a and 2b of Book 7 DCC were further amended and a new Chapter 2c was introduced, with rules on consumer credit, asset financing and loans. These amendments mainly relate to the abolishment of Chapter 5a of Book 7A DCC and the Interim Hire Purchase Immovable Property Act (IHPIPA), and the transfer of a large part of their articles to the aforementioned parts of Book 7 DCC. Chapter 5a of Book 7A DCC and IHPIPA used to contain mandatory rules for leasing contracts such as the *ijarah* and the *ijarah wa iqtina*, but also for a purchase and sale of property in instalments such as the *murabahah* (as is further discussed below). The

5 As a result of the implementation of the Consumer Credit Directive (2008/48/EC) in the Netherlands, a new Chapter 2a was introduced to Book 7 DCC and the Act on Consumer Credit was amended (whereby a large number of articles were abolished and transferred to Chapter 2a of Book 7 DCC).

most important change of their abolishment and the amendments to Book 7 DCC is that the provisions are no longer mandatory for professional parties, but they are only mandatory if the borrower or lessee is a consumer.

While the conclusion of the DCB/AFM study in 2008 was that legal amendments to the FMSA would have been preferred to further facilitate the supervision of Islamic finance products in the Netherlands, no such amendments are required for the structuring of Islamic finance products under Dutch commercial (civil, contract and property) and corporate laws. Dutch commercial and corporate laws are compatible with the structuring of Islamic finance transactions. Partnership contracts, such as the *musharakah* and *mudarabah*, can be structured through a limited partnership contract or a general partnership contract, but also by incorporating stock companies, such as a private company with limited liability (BV)[6] or a public limited liability company.[7,8] The contract of *murabahah* qualifies as a purchase and sale of property in instalments pursuant to Article 7:84 (3) DCC. Also, leasing contracts such as the *ijarah* can be structured under Dutch law. The *ijarah* qualifies as a rental agreement under Article 7:201 DCC. Depending on how the *ijarah wa iqtina* is structured in practice, it may qualify as a rental agreement or as a hire purchase agreement under Articles 7:101 and 7:84 (3) DCC. As mentioned above, as of 1 January 2017, no mandatory rules under Book 7 DCC that may conflict with Islamic law apply to the *murabahah*, *ijarah* and *ijarah wa iqtina* if these contracts are concluded between professional parties, as will be the case in most Islamic finance transactions (e.g., corporate lending, real estate transactions and debt capital market transactions such as *sukuk* issuances). If, however, an Islamic bank contemplates offering these Islamic finance products to consumers, certain mandatory rules in Book 7 DCC (e.g., rules on rebate in case of early repayment) need to be assessed carefully to ensure *shariah* compliance while structuring these products under Dutch law.

One of the main challenges for *sukuk* under Dutch law is the lack of trust laws in the Netherlands. In practice, often English law trusts are used in *sukuk* structures to accommodate the Islamic law requirement that *sukuk* holders must hold some form of ownership in the underlying asset of the *sukuk* structure. For example, in the case of a *sukuk al-ijarah*, whereby a tangible asset is sold and leased back by the originator to a special purpose vehicle (SPV) that issues *sukuk*, the SPV holds the underlying asset (which is leased back to the originator) in trust for the *sukuk* holders. As a result, the SPV holds the legal ownership of the underlying asset, while the *sukuk* holders hold its beneficial ownership. This is market practice in most *sukuk* structures and the main rationale for the use of English law trusts is, as stated, to meet the Islamic law requirement that *sukuk* holders must hold some form of ownership. However, the concept of a trust is not accepted under Dutch law. As a matter of fact, Article 3:84 (3) DCC contains a 'fiducia prohibition', which prohibits the use of fiduciary security and holding fiduciary title to an asset.

In practice, this may be solved by creating an English law trust that will be recognised in the Netherlands on the basis of the Hague Trust Convention on the Law Applicable to Trusts and their Recognition (the Hague Trust Convention). The Netherlands is a party to the Hague Trust Convention. Consequently, it is obliged to recognise certain elements of a trust created under English law. However, if the significant elements thereof are more closely

6 *Besloten vennootschap met beperkte aansprakelijkheid.*

7 *Naamloze vennootschap.*

8 For a discussion of the *musharakah* as a BV, see O Salah, *Sukuk Structures: Legal Engineering Under Dutch Law*, Eleven International Publishing 2014, pp. 73–82.

connected to the Netherlands, then, under Article 13 of the Hague Trust Convention, the Netherlands is not bound to recognise an English law trust. In such cases, there are alternative ways under Dutch law to deal with the Islamic requirement that *sukuk* holders must hold some form of ownership of the underlying asset. This may require further explanation to a *shariah* supervisory board who may be dealing with a *sukuk* issuance in the Netherlands for the first time (which will be the case, given that so far there have been no *sukuk* issuances in the Netherlands). If one looks very closely at the Islamic requirements for *sukuk*, one will notice that the Islamic *shariah* requires *sukuk* holders to hold some form of ownership in the underlying asset so that the *sukuk* holders trade in that asset instead of trading in debt claims while trading their *sukuk* in secondary markets (which would, otherwise, lead to a violation of the Islamic *shariah* prohibition on the *bay al-dayn*). However, under Islamic *shariah*, the use of trusts or the division of the right of ownership (*milkiyyah*) into legal and beneficial ownership is not prescribed as a prerequisite for *sukuk* structures.[9] As stated, the use of English law trusts emerged – and has been accepted – in Islamic finance practice.

In the Netherlands, the Islamic *shariah* requirement of ownership of *sukuk* holders can be met – in the case of unsecured *sukuk* (which are predominantly issued globally) – by transferring the economic ownership of the underlying asset to the *sukuk* holders. As a result, the *sukuk* holders do not acquire any *in rem* rights in the underlying asset, but will contractually be entitled to the economic benefits of the underlying asset.[10] In the case of secured *sukuk*, the aforesaid may be accompanied by the creation of a collective security arrangement that provides the *sukuk* holders with security over the underlying asset.[11]

ii Regulatory and supervisory authorities

There is no regulatory or supervisory authority that deals exclusively with Islamic finance in the Netherlands. The regulatory and supervisory authorities dealing with conventional products also cover Islamic finance products. The supervision model in the Netherlands focuses on (1) system and prudential supervision, and (2) conduct-of-business supervision.[12] The ECB and DCB are responsible for system and prudential supervision, while the AFM is responsible for conduct-of-business supervision.

System supervision mainly boils down to ensuring the stability of the financial system as a whole. As regards prudential supervision, this covers the granting of licences and being responsible for prudential and integrity supervision of banks, insurers, investment firms, clearing institutions, payment services providers and trust companies. Under the Single Supervisory Mechanism, the ECB is the central prudential supervisor of financial institutions in the eurozone. The ECB is responsible for the prudential supervision of the most significant banks in the Netherlands, while the DCB is responsible for less significant banks.

The AFM is responsible for conduct-of-business supervision. It supervises the operation of the financial markets and strives for efficiency therein. It covers the entire financial market

9 O Salah, *Sukuk Structures: Legal Engineering Under Dutch Law*, Eleven International Publishing 2014, pp. 24–25 and 56–60.

10 ibid., pp. 122–128.

11 ibid., pp. 128–142.

12 M Van Loopik and M Ter Haar, Ic 21 on Netherlands, in: J Putnis (ed), *The Banking Regulation Review*, Law Business Research 2018, pp. 312–328.

sector (both retail and wholesale). Further, it is responsible for prospectus supervision, listing matters and the trading infrastructure. For example, the AFM would need to approve a prospectus for the issuance of *sukuk* in the Netherlands.

III COMMON STRUCTURES

As mentioned above, Islamic finance has not picked up in the Netherlands (yet). Consequently, there are no commonly used structures. There have been only a handful of real estate *shariah*-compliant transactions. The funding for these transactions was often provided by (the Islamic windows of) foreign financial institutions. The structures that were used were based either on *murabahah* or *ijarah* contracts.

One of the structures used is based on *murabahah*. The *murabahah* contract used in Islamic finance transactions in the Netherlands is the commodity *murabahah* (also known as *tawarruq*). *Shariah*-compliant investors interested in real estate located in the Netherlands will incorporate a BV, which will acquire the real estate (PropCo). The PropCo will purchase and acquire the real estate from a potential seller. The purchase price will be funded partially through an equity investment from the *shariah*-compliant investors and partially through external funding (often, this is the largest part of the funding). The PropCo will approach a financier and enter into a *murabahah* facility with it. Under the *murabahah* facility, the financier purchases commodities for X price from a commodities broker, and the financier sells those commodities to the PropCo for X + profit margin. The sale from the financier to the PropCo is an instalment sale: the purchase price of X + profit margin is deferred and will be paid in instalments. If the financier is providing secured funding, the PropCo will also create a right of mortgage on the real estate. Next, the PropCo sells (under the documentation it is, in fact, the financier acting as agent for the PropCo to sell) the commodities for X price to another commodities broker (which can then on-sell it to the initial commodities broker). As a result, the PropCo obtains immediate funding equal to X and has an obligation to pay X + profit margin to the financier in instalments.

The financier can be a bank, but it can also be an SPV (incorporated as a separate BV). In the latter case, the SPV will enter into a back-to-back facility agreement with a bank to obtain funding equal to X and the interest paid under the facility agreement will be equal to the profit margin under the *murabahah* facility between the SPV and the PropCo. If the funding is secured, the SPV will create a right of pledge over its secured rights under the *murabahah* facility (including a right of mortgage) in favour of the bank.

The other structure used for *shariah*-compliant real estate transactions in the Netherlands is based on the contract of *ijarah*. In this structure, there will be one BV that will acquire the real estate (PropCo) and another BV through which *shariah*-compliant investors will invest (InvestCo). The PropCo will purchase and acquire the real estate from a third-party seller. The PropCo will be the legal owner of the real estate. The acquisition of the real estate will be partially funded by the *shariah*-compliant investors and partially through external funding. The PropCo will enter into a (conventional) facility agreement with a bank to attract external funding and, if it is a secured funding, create a right of mortgage in favour of the bank. Further, the PropCo will enter into an *ijarah* contract with the InvestCo pursuant to which the real estate will be leased to the InvestCo. This can be structured either in the form of a rental agreement under Dutch law, or by creating a right of long lease in favour of the InvestCo. The *ijarah* is a back-to-back lease to the conventional facility agreement, so that the lease payments are equal to the interest paid by the PropCo to the bank under the facility agreement. The InvestCo then, in turn, subleases the real estate to lessees and makes a return on it. The difference between what is received by the InvestCo from subleases and its obligations under the *ijarah* lease is distributed to the *shariah*-compliant investors.

IV TAXATION

There is no separate taxation regime for Islamic finance products in the Netherlands and such products are not afforded special treatment under Dutch tax law. Dutch tax law has an economic approach towards financial transactions (whereby the economic substance of a transaction prevails over its formal legal structure). Since most Islamic finance products mirror the economic effects of conventional finance products, Dutch tax law does not seem to raise major issues while structuring Islamic finance transactions.[13] This especially holds true for wholesale and investment banking. In the case of retail banking, however, tax law has been flagged as an obstacle for the introduction of Islamic retail banking products in the Netherlands. Despite much debate on the matter, the Dutch tax authorities are of the opinion that the profit paid in Islamic mortgage transactions (e.g., the profit margin in the *murabahah*) does not qualify as interest. Therefore, it is not eligible for mortgage interest relief. This puts Islamic retail banking products at a disadvantage compared to their conventional counterparts, resulting in the lack of a level playing field for Islamic finance from a tax perspective. Despite this, the Dutch legislature has not introduced any legislative amendments in relation to Dutch tax law, in contrast to other European countries, such as the United Kingdom, Ireland, France and Luxembourg.

V INSOLVENCY

There is no separate insolvency regime for Islamic finance products in the Netherlands and such products are not afforded special treatment under Dutch insolvency law. In general, the treatment of an Islamic finance product under Dutch insolvency law will depend on the type of Islamic finance contract and its qualification under Dutch law.

It is, however, important to bear in mind that where the concept of economic ownership is used under Dutch law (e.g., for *sukuk* structures) as a Dutch alternative to the English law trust, the economic owners do not hold any *in rem* rights under Dutch law. For example, if the issuer of an unsecured *sukuk* provides the economic ownership of an underlying asset to the *sukuk* holders under Dutch law, the *sukuk* holders only have a bundle of contractual rights that entitle them to the economic benefits of the underlying asset. If the issuer of the *sukuk* is declared bankrupt by a Dutch court, the relevant asset will fall into its bankruptcy estate (contrary to trust assets, which are separated from the insolvency estate of a trustee under English law). The *sukuk* holders as the economic owners of the underlying asset only have a contractual claim to the benefits of the underlying asset, which they can file with the bankruptcy trustee.

13 See A Rozendal and A Westhoff, 'Een alternatief voor de financiering van Nederlands beleggingsvastgoed?', in O Salah (ed), *Islamitisch bankieren: Van religieuze principes naar financiële transactiestructuren*, Wolf Legal Publishers 2011, pp. 89–98.

VI JUDICIAL FRAMEWORK

i Courts

Dutch courts have jurisdiction to decide on disputes involving *shariah*-compliant products, assuming there is no clause on submission to jurisdiction of another court and no arbitration clause in the relevant Islamic finance contract. In the Netherlands, there are no separate *shariah* courts with jurisdiction over Islamic finance products.

ii Cases

There have been no (significant) cases that have been decided by the Dutch courts on or in respect of Islamic finance products and structures.

VII OUTLOOK

Within the Netherlands, the major Dutch banks, such as Rabobank, ABN AMRO, ING and de Volksbank (formerly SNS Bank), have not yet taken initiatives to enter, or develop, the Islamic finance market, but have been looking at it with some interest. Moreover, the major Dutch banks are, or have been, active in the Islamic finance market outside the Netherlands; for example, in South East Asia and the Middle East.

Certain banks, in particular foreign Islamic banks, have been looking with interest to the Dutch Islamic finance market for retail banking. The entrance of these banks will be a game changer for the development of Islamic finance in the Netherlands. In addition, various small organisations are currently assessing the possibility of offering the first *shariah*-compliant mortgage loans in the Netherlands, possibly with the cooperation of larger institutions. At the same time, discussions on abolishing mortgage interest relief have been ongoing for a while now. If mortgage interest relief is completely abolished, this will undoubtedly be regarded as a positive development for Islamic retail banking from a tax law perspective, as it will place Islamic retail banking products on a level playing field with their conventional counterparts. It will give the smaller Dutch organisations an incentive to continue their efforts to provide the first *shariah*-compliant mortgage loans in the Netherlands.

Another interesting development is that various Dutch multinational companies are expanding globally and encountering Islamic finance as a form of financing for their activities in South East Asia and the Middle East. Given the continuing growth of these multinational companies, one would expect their exposure to Islamic finance to increase. By contrast, inbound investments from Islamic countries into the Netherlands may be preferred on a *shariah*-compliant basis (i.e., *shariah*-compliant investors looking to invest and finance themselves on a *shariah*-compliant basis). Given that the Dutch legislative framework perfectly assists Islamic wholesale banking, there are no impediments to facilitating such transactions.

In conclusion, the outlook for the development of an Islamic finance market in the Netherlands remains challenging. Although the legislative framework is there and there are certain developments that may contribute to the Islamic finance market in the Netherlands, in general there are no major incentives to structure financial products in a *shariah*-compliant manner (instead of on a conventional basis). The entrance of more parties with a clear preference for *shariah*-compliant funding may change these prospects. If and when that happens, it is good to know that the Dutch legislative and regulatory framework will not impose any impediments on those parties wishing to conduct business and attract funding on a *shariah*-compliant basis.

Chapter 9

PHILIPPINES

Rafael A Morales[1]

I LEGISLATIVE AND REGULATORY FRAMEWORK

The Philippines officially recognised Islamic banking and finance some 40 years ago, when a legislative charter was granted to Al-Amanah Bank,[2] the first Islamic bank established in the country to cater to the banking requirements of the Muslim population. In 1990, that bank was reorganised and replaced with the Al-Amanah Islamic Investment Bank of the Philippines (AIIBP).[3]

Although Islamic banks are recognised as a distinct category of banking institutions under the General Banking Law of 2000,[4] the AIIBP remains to date the only bank of its kind in the country. Also, within conventional banks, there are no Islamic windows or units. However, under the General Banking Law of 2000, the Bangko Sentral ng Pilipinas (BSP), if minded to act accordingly, can already authorise the establishment of Islamic banks other than the AIIBP, as well as Islamic units within conventional banks. This is so because Subsection 3.2 of that Law empowers the BSP to make 'other classifications of banks', specifically mentioning 'Islamic banks as defined in Republic Act No. 6848, otherwise known as the Charter of AIIBP'. As the reference in Subsection 3.2 is to 'Islamic banks' in the plural (not singular), there is a legislative intent for the BSP to enable the formation of more Islamic banks (and, for that matter, Islamic units within conventional banks), in addition to the AIIBP. In fact, the BSP is well aware of this, considering that Section X101(b)(6) of the BSP's Manual of Regulations for Banks contains an enumeration of the services that Islamic banks can provide to their customers.

Nevertheless, the recent passage of Republic Act No. 11054, the Organic Law for the Bangsamoro Autonomous Region in Muslim Mindanao (Bangsamoro Organic Law), should boost Islamic banking and finance, considering that the BSP, the Department of Finance and the National Commission on Muslim Filipinos are mandated therein to 'jointly promote the development of an Islamic banking and finance system, to include, among others, the establishment of a Shariah Supervisory Board and the promotion and development of *shariah*-compliant financial institutions'.[5] Further, there will be a review of 'existing market

1 Rafael A Morales is the managing partner at Morales & Justiniano.

2 Republic Act No. 6848 is the Charter of the AIIBP.

3 See the chapter on the Philippines in *Getting the Deal Through – Islamic Finance & Markets 2016* (Rafael A Morales and Bishr Shiblaq, contributing editors), at 38.

4 Republic Act No. 8791; see Subsection 3.2(f) thereof.

5 Bangsamoro Organic Law, Section 32; see also Rafael A Morales, 'Philippines continues to foster Islamic finance development', *Islamic Finance News* (4 May 2016).

environment policies' and the adoption of 'measures to enhance the competitiveness of Islamic finance products', so that 'Islamic financial players are not inhibited from introducing Islamic finance products'.[6]

i Legislative and regulatory regime

At present, there is no general legislative framework for Islamic banking and finance in the Philippines. However, the Bangsamoro Organic Law authorises 'the crafting of the Bangsamoro Islamic banking and finance framework by the Bangsamoro Parliament applicable within the Bangsamoro Autonomous Region'.[7] Moreover, in the Philippine Senate, there is a pending bill[8] that seeks to 'provide for the regulation and organisation of an expanded Islamic banking system in the Philippines'. If this bill is enacted, it will be known as the Philippine Islamic Financing Act. As the operation of Islamic banks and financial institutions within the Bangsamoro Autonomous Region is also to be supervised by the BSP, the uniformity of regulations on Islamic banking and finance outside of, as well as within, the Bangsamoro Autonomous Region is expected.

The BSP had already issued the regulations implementing the Charter of the AIIBP.[9] Under the proposed Philippine Islamic Financing Act, the BSP is also mandated to promulgate the necessary rules for the effective implementation of the law.[10] This new set of implementing rules will govern the operations of entities that will be authorised by the BSP to perform banking, financing and investment operations designed to promote and accelerate the socio-economic development of the country, based on *shariah* principles.[11] The BSP is expressly empowered under the proposed law to authorise the establishment of Islamic banks other than the AIIBP, as well as Islamic units within conventional banks.[12] This empowerment is more direct and explicit than Subsection 3.2 of the General Banking Law of 2000 grants to the BSP.

In the absence of a special legislative framework for Islamic banking and finance, existing laws applicable to conventional banking, capital market and insurance would have to be considered. Central to this is Article 1306 of the Civil Code of the Philippines,[13] which allows contracting parties to 'establish such stipulations, clauses, terms and conditions as they may deem convenient, provided they are not contrary to law, morals, good customs, public order or public policy'. This freedom in contract-making would allow the adoption

6 Bangsamoro Organic Law, Section 32.

7 Bangsamoro Organic Law, Section 34.

8 Senate Bill No. 668 (Seventeenth Congress of the Philippines, First Regular Session) introduced by Senator Paolo Benigno A Aquino IV.

9 The implementing rules are contained in Appendix 44 to the Manual of Regulations for Banks.

10 Senate Bill No. 668, Section 35.

11 ibid., Section 7.

12 ibid., Section 5. Under Section 31 of the Bangsamoro Organic Law, the Bangsamoro government 'shall encourage the establishment of: (1) banks and financial institutions and their branches including an Islamic window in domestic and foreign conventional banks; and (2) offshore banking units of foreign banks within the Bangsamoro Autonomous Region, and in accordance with the principles of the Islamic banking system'.

13 Republic Act No. 386, as amended.

of terms and conditions suitable to Islamic banking, capital market and insurance, with the approval of pertinent regulators, namely the BSP for banking, the Securities and Exchange Commission (SEC) for capital market, and the Insurance Commission for insurance.[14]

Interestingly, the absence of legislation or regulation on Islamic capital markets has not prevented the Philippine Stock Exchange (PSE) from releasing its list of *shariah*-compliant shares of stock, with a view to diversifying its investment base. The list is updated, from time to time, and published by the PSE on its website (www.pse.com.ph) by the fifth trading day of the month following every quarter.[15]

ii Regulatory and supervisory authorities

The BSP has sole supervision over the operations of banking institutions in the Philippines, including Islamic banks and financial institutions.[16] On the other hand, the Insurance Commission is expected to regulate and supervise entities that will issue Islamic insurance in due time in the country.

It is reasonable to assume, too, that the SEC will be the regulator and supervisor of the Islamic capital market in the Philippines, once the rules for this have been promulgated. In fact, the SEC has already asserted its supervisory authority in this regard, by not interdicting the periodic issuance by the PSE (a stock exchange under the supervision of the SEC) of the list of *shariah*-compliant shares of stock. It is also expected that the SEC will regulate the issuance of *sukuk* in the domestic market, pursuant to its authority under the Securities Regulation Code[17] to register securities issued and offered to the public in the Philippines.[18]

To date, there is no central authority in the Philippines responsible for ensuring that transactions or products are *shariah*-compliant. However, within the AIIBP, there is a five-member advisory council whose function is 'to offer advice and undertake reviews pertaining to the application of the principles and rulings of the Islamic *shariah* to the Islamic

14 See footnote 3.

15 The latest list was circulated through the PSE's Memorandum to the 'Investing Public and All Trading Participants' dated 6 July 2018. The PSE has engaged the services of IdealRatings, Inc in screening PSE-listed companies in accordance with the standards set by the Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI). To be included in the list, a company must meet the following PSE criteria: (1) the nature of the company's primary business must not involve any of the prohibited activities in AAOIFI's Shariah Standard No. 21 – Rules for Dealing of Shares (i.e., conventional interest-based lending, financial institutions, conventional insurance, mortgage and lease, derivatives, pork, alcohol, tobacco, arms and weapons, embryonic stem-cell research, hotel, gambling, casinos, music, cinema and adult entertainment) or, if the company derives income from these prohibited activities, the income, on an aggregated basis, must not exceed 5 per cent of its gross revenues; (2) the company's interest-bearing debt, as well as its interest-bearing deposits or investments, must not exceed 30 per cent of its 12-month trailing average market capitalisation; and (3) the company's accounts receivable must not exceed 67 per cent of its 12-month trailing average market capitalisation.

16 General Banking Law of 2000, Section 4; Bangsamoro Organic Law, Section 32.

17 Republic Act No. 8799.

18 It was reported that the National Home Mortgage Finance Corporation was planning to issue *sukuk*. See Rafael A Morales, 'Philippines continues to foster Islamic finance development', *Islamic Finance News* (4 May 2016).

bank's transactions'.[19] Under the proposed Philippine Islamic Financing Act, each Islamic bank is required to constitute its *shariah* advisory council.[20] The challenge here is the current scarcity in the Philippines of experts or scholars on Islamic banking and finance.

II COMMON STRUCTURES

Islamic banks (including the AIIBP) have flexibility in structuring their *shariah*-compliant products and services, considering that they can 'undertake various investments in all transactions allowed by the Islamic *shariah* in such a way that shall not permit the *haram* (forbidden), nor forbid the *halal* (permissible)'.[21]

i Consumer finance

In consumer finance, for instance, the AIIBP is authorised to 'provide financing with or without collateral by way of *al-ijarah* (leasing), *al-bai ul takjiri* (sale and leaseback) or *al-murabahah* (cost-plus-profit sales arrangement)'.[22] Other Islamic banks[23] can provide similar consumer finance.

In *al-ijarah*, the fund owner (such as a bank) purchases the asset required by the fund user (the consumer), who then acquires the right to use the asset through a lease for a fixed period, subject to the payment of rentals to the fund owner.[24] *Al-bai ul takjiri* is similar to *al-ijarah* except that the fund user will, at a point in time, purchase the leased asset at an agreed price with all the previously paid lease rentals considered as part of the purchase price.[25] In *al-murabahah*, the fund owner purchases the asset required by the fund user and then sells the same at an agreed mark-up to the fund user. In this arrangement, the fund user may be required to place a margin deposit, which will be used to pay part of the purchase price.[26]

Even under existing law, the prohibition against charging or collection of interest (*riba*)[27] from consumers is not a problem, because Article 1956 of the Civil Code of the Philippines provides that: 'No interest shall be due unless it has been expressly stipulated in writing.' Thus, to comply with *shariah* principles, all that the contracting parties must do is not to stipulate any interest in their agreement.[28]

ii Home finance

Al-murabahah can be used in home finance. Here, a bank can buy a house and resell the same in instalments to a buyer for profit. Given the strict avoidance of interest in *shariah*, the bank

19 Charter of the AIIBP, Section 5.
20 Senate Bill No. 668, Section 22.
21 Section X101(b)(6)(k) of the Manual of Regulations for Banks; Section 6(7)(l) of the Charter of the AIIBP.
22 Section 7(i) of Appendix 44 to the Manual of Regulations for Banks.
23 General Banking Law of 2000, Subsection 3.2(f).
24 Section 44(3) of Appendix 44 to the Manual of Regulations for Banks.
25 Section 44(2) of Appendix 44 to the Manual of Regulations for Banks.
26 Section 44(6) of Appendix 44 to the Manual of Regulations for Banks.
27 As defined in Section 43(3) of Appendix 44 to the Manual of Regulations for Banks, the term '*riba*' includes 'the receipt and payment of interest in the various types of lending and borrowing and in the exchange of currencies on forward basis'.
28 Footnote 3, at 39.

must take at least constructive possession of the house before reselling it to the buyer that the transaction can be characterised as an authentic asset-based trade rather than a conventional financing arrangement.[29]

iii Insurance

There is as yet no *takaful* market in the Philippines. Further, there are no conventional insurance companies that can be adapted to be *shariah*-compliant.[30] It remains to be seen how the Insurance Commission will address or react to the introduction of the *takaful* concept in the local insurance market.

iv Private equity investments

Islamic banks can invest in equities of warehousing companies, leasing companies, storage companies, and companies engaged in the management of mutual funds but not in mutual funds themselves.[31] Moreover, they can accept placements from a customer for investment, together with their own funds, in *shariah*-permissible transactions on a participation basis.[32] Here, participation means 'any agreement or arrangement under which the mode of joint investments of specific transactions shall not involve the element of interest charge other than as percentage share in profits and losses of business'.[33]

v Real estate investments

Financing fixed-asset acquisitions (such as buying real estate) may be effected through *al-bai bithaman ajil* (deferred payment sale), pursuant to which the ownership of the asset is immediately transferred to the buyer but the purchase price is collected later, usually in instalments.[34]

Real estate investment trusts (REIT), designed to promote the development of the capital market by broadening the participation of Filipinos in the ownership of real estate in the Philippines, have yet to take off in the Philippines because of problems in implementation, although the REIT Act was passed as early as 2009.[35]

29 ibid.

30 ibid.

31 Section X101(b)(6)(o) of the Manual of Regulations for Banks.

32 Section X101(b)(6)(b) of the Manual of Regulations for Banks.

33 Section 43(10) of Appendix 44 to the Manual of Regulations for Banks.

34 Section 44(1) of Appendix 44 to the Manual of Regulations for Banks.

35 Republic Act No. 98501. The problems lie in the requirement for a REIT to have a minimum public ownership initially of 40 per cent and eventually 67 per cent, as well as the imposition of value added tax on the initial asset transfer.

vi Investment funds

Under BSP rules, Islamic banks can issue investment participation certificates, *muquaradah* bonds[36] and debentures to fund projects that will promote the economic development primarily of the autonomous region in southern Philippines.[37] Broadly, they can undertake various investments in all transactions that are *halal* (permissible) and not *haram* (forbidden).[38]

One other arrangement is *al-mudarabah* (trust financing), wherein the fund owner provides full financing to the fund user, who contributes only his or her entrepreneurship and labour. The profit is shared by them at a pre-agreed rate or ratio, but if the venture fails, the fund owner bears all the losses even if the fund owner is not involved at all in the management of the venture.

vii Other areas

Islamic banks can open savings accounts for safekeeping or custody with no participation in profits or losses, unless the funds are otherwise authorised by the account holders to be invested.[39]

An Islamic bank can also act as an agent for another for a fee, under an *al-wakalah* arrangement. Here, the bank may issue a letter of credit for an importing customer, who is required to place a 100 per cent margin deposit on an *al-wadiah* (safe custody) basis wherein the bank has full discretion to use the deposit to meet its obligations under the letter of credit.[40]

On the other hand, in an *al-kafalah* (guarantee) arrangement, an Islamic bank can issue a standby letter of credit in respect of the performance of a task or the settlement of an obligation. Where a security deposit is required, it will be taken on an *al-wadiah* basis.[41]

Furthermore, an Islamic bank can take security for an outstanding obligation, based on the *al-rahan* principle. Although Islamic banks extend financing through partnership and trading assets, security may be taken as a precaution under that principle.[42]

III TAXATION

Under the proposed Philippine Islamic Financing Act, the government is mandated to provide 'neutral tax treatment between Islamic banking transactions and equivalent conventional banking transactions'.[43] This is aimed at providing a level playing field in terms of taxation between Islamic banking and conventional banking, so that Islamic banking transactions will not be disadvantaged tax-wise compared with their conventional counterparts.

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36 As defined in Section 43(12) of Appendix 44 to the Manual of Regulations for Banks, *muquaradah* bonds are 'long-term non-interest-bearing bonds of definite denomination issued and floated by the bank on the basis of participation under the *mudarabah* principle to be used in financing projects for economic development'.

37 Section X101(b)(6)(m) of the Manual of Regulations for Banks.

38 Section X101(b)(6)(k) of the Manual of Regulations for Banks.

39 Section X101(b)(6)(a) of the Manual of Regulations for Banks.

40 Section 44(11) of Appendix 44 to the Manual of Regulations for Banks.

41 Section 44(4) of Appendix 44 to the Manual of Regulations for Banks.

42 Section 44(9) of Appendix 44 to the Manual of Regulations for Banks.

43 Senate Bill No. 668, Section 31; under Section 32 of the Bangsamoro Organic Law, the Bangsamoro parliament 'shall enact laws that promote the growth of Islamic finance such as those that promote tax incentives and ensure tax neutrality of Islamic finance transactions in the Bangsamoro Autonomous Region'.

It is noteworthy that, during its first eight years of operation, the AIIBP was exempted from all taxes under the National Internal Revenue Code.[44] This tax exemption has lapsed. There appears to be no plan to have this exemption restored.

IV INSOLVENCY

There is no separate insolvency regime for Islamic finance participants in the Philippines, and Islamic finance products are not afforded special treatment under local insolvency rules.

The insolvency rules governing conventional banks under the New Central Bank Act[45] and the General Banking Law of 2000 are also applicable to Islamic banks. Initially, a conservator will be appointed by the BSP to take charge of the assets, liabilities and management of an Islamic bank that is in a state of continuing inability or unwillingness to maintain a condition of liquidity deemed adequate to protect the interest of bank depositors and creditors.[46] If the BSP determines that the bank cannot continue to operate on its own without involving probable loss to its depositors and creditors, then the conservatorship will be terminated and the BSP will appoint a receiver, who will determine whether the bank can still be rehabilitated or otherwise liquidated.[47]

Similarly, the insolvency rules for conventional insurance companies under the Insurance Code[48] could be applied to *takaful* companies. The rules here also involve conservatorship and receivership prior to liquidation. In a nutshell, if the Insurance Commissioner determines that a company is in a state of continuing inability or unwillingness to maintain a condition of solvency or liquidity deemed adequate to protect the interests of its policyholders and creditors, he or she will appoint a conservator to take charge of the company's assets, liabilities and management.[49] If it is determined that the condition of the company is one of insolvency, the Insurance Commissioner will order the company to cease and desist from transacting business and designate a receiver and then a liquidator if the company cannot resume business with safety to its policyholders and creditors.[50]

For other Islamic finance participants, the Financial Rehabilitation and Insolvency Act of 2010 applies.[51] As the name of this law indicates, corporate rehabilitation may be sought in court by or for a debtor company but the rehabilitation proceedings will be converted by the court into one for liquidation if there is no substantial likelihood of the company being successfully rehabilitated.[52]

44 Charter of the AIIBP, Section 37. The National Internal Revenue Code is set out in Republic Act No. 8424, as amended.
45 Republic Act No. 7653.
46 Section 29 of the New Central Bank Act; Section 67 of the General Banking Law of 2000. As defined in Section 43(5) of Appendix 44 to the Manual of Regulations for Banks, the term 'depositor' refers to 'a person or entity who has an account at an Islamic bank, whether the account is a current account, a savings account or any other deposit account; unless the context requires another meaning, a depositor corresponds to an investor in joint investment of the Islamic bank'.
47 Section 30 of the New Central Bank Act; Section 69 of the General Banking Law of 2000.
48 Presidential Decree No. 612, as amended by Republic Act No. 10607.
49 Section 255 of the Insurance Code.
50 Section 256 of the Insurance Code.
51 Republic Act No. 10142.
52 Section 12 et seq. of the Financial Rehabilitation and Insolvency Act of 2010.

V JUDICIAL FRAMEWORK

i Courts

No special court has exclusive jurisdiction over disputes involving *shariah*-compliant products and structures. Conventional or regular courts still have jurisdiction over these disputes.

There are *shariah* courts but they have jurisdiction only over cases relating to Muslim personal law (defined as 'laws on personal status, marriage and divorce, matrimonial and family relations, succession and inheritance, and property relations between spouses').[53] These courts are under the administrative supervision of the Supreme Court of the Philippines, which has appellate jurisdiction over cases decided by them.[54]

ii Cases

In the Philippines, judicial power is vested in the Supreme Court and the lower courts (such as metropolitan or municipal trial courts, regional trial courts, and the Court of Appeals).[55] However, only the decisions of the Supreme Court form part of the legal system.[56] To date, there are no cases decided by the Supreme Court that affect or interpret Islamic finance products and structures in the Philippines. In fact, there is, as yet, no corpus of jurisprudence on Islamic banking and finance.

Shariah law generally applies only to Muslims in the Philippines and only in respect of Muslim personal law, as defined above. Commercial transactions are governed by the general law on contracts and commerce. This explains why existing Supreme Court decisions on *shariah* law relate only to Muslim family issues.

Within the AIIBP, disputes between and among shareholders, as well as those between shareholders and the bank itself, are settled by the board of directors, acting as arbitrators. The arbitral award is final and executory.[57]

VI OUTLOOK

The prospects for Islamic banking and finance look promising, with the passage of the Bangsamoro Organic Law. The BSP can already authorise, at the very least, the opening of Islamic units within conventional banks. Indeed, it is high time for the BSP to take bold steps to promote the growth of Islamic banking and finance in the Philippines. In line with the progress of economic integration within the Association of Southeast Asian Nations (ASEAN), the member nations have established the framework for the integration of their financial and banking markets, including the formation of the qualified ASEAN banks (QABs). With the anticipated entry into the Philippine banking system of QABs from the other ASEAN members and with expertise in Islamic banking and finance, the BSP is expected to encourage and enable local banks and financial institutions to enhance their capabilities in Islamic banking and finance to be more competitive with their regional counterparts.

53 Presidential Decree No. 1083, Section 7(i).

54 ibid., Section 145.

55 Section 1, Article VIII, 1987 Constitution of the Philippines.

56 Article 8, Civil Code of the Philippines.

57 Charter of the AIIBP, Section 9.

Chapter 10

TURKEY

Sera Somay and Gözde Kayacık[1]

I LEGISLATIVE AND REGULATORY FRAMEWORK

i Legislative and regulatory regime

Products

In Turkey, Islamic finance products are regulated under the legislation that applies to conventional transactions. Nonetheless, issuance of *sukuk* certificates is specifically regulated under Lease Certificates Communiqué No. III-6.1 (Official Gazette dated 7 June 2013) and the issuance process has been detailed thereunder.

The Islamic banking industry, which is known in Turkey as 'participation banking' (*katılım bankacılığı*) and its various Islamic banking products, such as *murabahah*, *mudarabah* and *musharakah*, are regulated under:

a the Banking Law No. 5411;

b the Financial Lease, Factoring and Financing Companies Law No. 6361;

c the Regulation on Banks' Transactions Subject to Permission and Indirect Shareholding; and

d other secondary legislation published by the Banking Regulation and Supervision Authority of Turkey, more specifically the Regulation on the Principles and Procedures Related to the Determination of Qualifications of the Loans and other Receivables by Banks and the Provisions to be Set Aside In Relation Thereto (Official Gazette dated 1 November 2006), the Regulation on Equities of Banks (Official Gazette dated 5 September 2013) and the Regulation on Procedures and Principles of Preparation and Publication of Annual Activity Reports by the Banks (Official Gazette dated 1 November 2006), among others.

The applicable legislation for issuance of lease certificates (*sukuk*) as an Islamic capital markets product, are (1) Article 61 of the Capital Market Law No. 6362 and the Lease Certificates Communiqué covering the procedure to be followed by corporates and public authorities as to issuance of lease certificates (*sukuk*); and (2) Article 7/A of the Public Finance Law No. 4749 covering the issuance of lease certificates (*sukuk*) by public authorities, including the Turkish Treasury.

1 Sera Somay is a partner and Gözde Kayacık is a senior associate at Paksoy.

Insurance

There are a number of *takaful* companies operating in Turkey. While their establishment and existence are based on the Insurance Law No. 5684, the Turkish Treasury[2] has introduced a new regulation, the Regulation on Working Procedures and Principles of Participation Insurance, which came into force on 20 December 2017 (the Takaful Regulation), and which aims to set out the procedures and principles regarding participation insurance or *takaful*. In addition to elaborating on management models (i.e., *mudarabah*, *wakalah* or hybrid management models) for participation insurance companies, the Takaful Regulation has imposed on participation insurance companies the obligation either to establish an advisory committee or to outsource the monitoring of their activities to ensure compliance with the applicable participation insurance and Islamic (participation) finance principles.

Following the entry into force of the Takaful Regulation, the General Directorate of Insurance of the Turkish Treasury issued the Decree Regarding Implementation of Participation Insurance on 21 December 2017, to further detail the implementation of the Takaful Regulation.

Funds

In terms of funds, the Communiqué on Principles of Investment Funds No. III-52.1 (published by the Capital Markets Board of Turkey in the Official Gazette dated 9 July 2013) allows Islamic funds to be composed of Islamic finance products, including Islamic pension funds, and allows conventional funds to invest in lease certificates (*sukuk*).

ii Regulatory and supervisory authorities

There is no particular authority that has been established for the purposes of implementing Islamic finance legislation or that has a supervisory role over Islamic finance practice in Turkey.

As in conventional financing, the Banking Regulation and Supervision Authority of Turkey has the authority to supervise and enact secondary legislation applicable to Turkish banks, including participation banks.

The Capital Markets Board of Turkey also has the authority to supervise and enact secondary legislation applicable to a certain Islamic finance product (lease certificates (*sukuk*)), which are issued in accordance with Article 61 of the Capital Market Law and the Lease Certificates Communiqué.

Pursuant to Article 80 of the Banking Law, Turkish participation banks are obliged to become a member of the Participation Banks Association of Turkey, the responsibilities of which include, among others:

a improving the participation banking sector;
b determining professional ethics for participation banks;
c taking any measure to prevent unfair competition among participation banks; and
d filing lawsuits where necessary in the interests of participation banks.

2 Prime Ministry Undersecretariat of Treasury of the Republic of Turkey (i.e., the Ministry of Treasury and Economy).

II COMMON STRUCTURES

The common Islamic structures that are used in the Turkish market are *murabahah*, *ijarah*, *musharakah* and *mudarabah*. The Banking Law refers to *salam*, *istisnah*, *mudarabah*, *murabahah*, *ijarah* and *musharakah*.

Islamic banks in Turkey collect their deposits based on the *mudarabah* structure. *Murabahah* is the one of the most commonly used structures and is used by Islamic banks in Turkey for corporate, consumer and credit card loans. Furthermore, Islamic banks in Turkey obtain their own funding from international markets in the form of *murabahah* syndications. The same applies to Turkish corporates for their syndicated financings to the extent that they make use of Islamic products. *Ijarah* is used for the financing of machinery, equipment and other investment tools by companies. Islamic banks in Turkey can sell leasing products directly whereas conventional banks can only perform financial leasing through their financial leasing arm. *Musharakah* in Turkey is used to finance construction contracts. *Istisnah*, on the other hand, is used to finance housing projects and *qard hasan* for cash withdrawals under credit card contracts.

The initial introduction of *sukuk* in the Turkish market was in 2010 through lease certificates, which are asset-based instruments. The lease certificates followed the *sukuk al-ijarah* structure whereby the special-purpose vehicle purchases the underlying assets and then leases those assets to the obligor. The sale of the lease certificates is possible via private placement where no prospectus is required, as well as via public sale. The market has since been enhanced by new regulations that permit not only *sukuk al-ijarah* but other *sukuk* structures such as commodity *murabahah*, *wakalah*, etc. as well as certain tax incentives that are analysed in detail in Section III. All privately owned Islamic banks in Turkey have issued *sukuk* in international and domestic markets.

Sovereign *sukuk* were first introduced to the Turkish market through a change in legislation in June 2012, following which the Turkish Treasury issued domestic and international *sukuk*.

Furthermore, there are Islamic indexes in Turkey – the Participation 50 Index, Participation 30 Index and Model Portfolio Index – which are comprised of shares of *shariah*-compliant companies with different conditions based on the index. There are also participation funds in Turkey sold by Islamic and conventional banks, and investment institutions consisting of equity and debt products as well as gold. Equity products are mostly the Participation Indexes referred to above, whereas the debt products are mostly *sukuk* issued by the Republic of Turkey and other Islamic banks in Turkey.

Takaful (Islamic insurance) is also available in Turkey and there are a number of *takaful* companies (i.e., participation insurance companies) active in the market. The Insurance Association of Turkey reports on data related to *takaful* and participation insurance, showing total contributions generated.

III TAXATION

There is no specific regime to encourage or promote utilisation of Islamic financial products and structures in Turkey. Rather, the local tax administration intends to 'equalise tax treatment for equivalent financial activities of commercial and Islamic finance institutions', as noted in its statements given in relation to recent legislative amendments. Pursuant to these amendments to the tax regulations, which have brought welcome clarifications (through exemptions and allowances) to a number of long-standing uncertainties in the tax laws, there has been solid improvement in the practicability of a specific type of product (namely *sukuk al-ijarah*).

Pursuant to exemptions and allowances introduced in 2016, corporate taxpayers could enjoy corporate income tax and value added tax exemptions in sale and leaseback structures (i.e., *sukuk al-ijarah*) not only for immovable properties but also for movable assets. Moreover, the transfer of underlying immovable assets under the lease certificates will not reset the holding period (e.g., in the event that the sale and leaseback are followed by a potentially taxable disposal in the future), and the documents executed for the transfer of any underlying asset under the lease certificates will be exempt from stamp tax.

IV INSOLVENCY

There is no separate insolvency regime for Islamic finance participants.

The only special treatment is applicable to the assets of an asset leasing company (ALC), which acts as the issuing entity of lease certificates. Turkish law ring-fences the assets of an ALC to protect the rights of the holders of the lease certificates. Pursuant to Article 61 of the Capital Market Law and Article 3 of the Lease Certificates Communiqué, *sukuk* assets pertaining to an issuance cannot be disposed of, pledged, posted as collateral, attached (including for the purpose of collecting public claims) or added to a bankruptcy estate, and cannot be subject to a precautionary injunction until the payment of all the obligations to the certificate holders relating to the issuance is made in full. If an issuer cannot fulfil its obligations under lease certificates in a timely manner, its management or audit may be transferred to public institutions and its activity licence may be cancelled. Likewise, if it becomes bankrupt, (1) the income generated from the *sukuk* assets shall first be used in the payments to be made to lease certificate holders; and (2) the Capital Market Board will be authorised to take any measures to protect the rights of certificate holders, among other things, to initiate a bankruptcy or liquidation proceeding of the ALC and to ultimately have recourse to shareholders of the ALC holding at least 10 per cent of the share capital and to the board members of the ALC (subject to a number of conditions) if any shareholder or board member can be held responsible for the non-payment.

V JUDICIAL FRAMEWORK

i Courts

There are no courts specialised in disputes involving *shariah*-compliant products and structures. Commercial courts would have jurisdiction over such matters.

ii Cases

A lawsuit was filed in April 2013 before the Constitutional Court of Turkey,[3] the high court overseeing constitutional jurisdiction, on the partial cancellation of Article 7/A of the Public Finance Law, which is a specific article for issuance of lease certificates (*sukuk*) by public authorities only, including the Turkish Treasury.

3 Constitutional Court decision; case No: 2013/72, decision No: 2013/126, dated 31 October 2013, published in the Official Gazette dated 24 January 2014, No. 28892.

Article 7/A authorises the relevant minister to sell, lease, transfer, etc. the assets of non-listed entities covered by this legislation. The second part of the Article, which was requested to be cancelled, sets forth that the minister may also carry out similar transactions, which, in each case, would be exempt from certain formal requirements.

The cancellation request was made on the basis that the Article had been drafted in a broad manner by shifting the legislative power to the executive branch of the government. The Constitutional Court rejected the lawsuit on November 2013 on the grounds that the legislature submits the technical and administrative aspects of the transactions to the executive branch and the legislation aims to develop local capital market and financial instruments.

It should also be noted that the Turkish Treasury has undertaken a number of international and local *sukuk* issuances based on this legislation.

VI OUTLOOK

Following the opening of two state-owned Islamic banks – Ziraat Katılım Bank and Vakıf Katılım Bank – on 12 May 2015 and 11 February 2016 respectively, and the establishment of the public wealth fund of Turkey with the mission to develop the Islamic finance practice in Turkey, the number of *sukuk* issuances has increased. The two *sukuk* issuances made in international markets in 2017 and 2018 by Ziraat Katılım Varlık Kiralama and Aktif Bank Sukuk Varlık Kiralama total US$618.4 million. Moreover, following amendments to the applicable legislation, the Turkish Treasury, which can now issue *sukuk*, started issuing gold bond and gold indexed *ijara sukuk*, in October 2017, in order to bring idle gold into the economy, to broaden investor base and to diversify borrowing instruments. The number of issuances has reached a total of 2.47 tonnes; consisting of 1.15 tonnes of gold bond and 1.32 tonnes of gold indexed *ijara sukuk*.[4] Another recent development in the *sukuk* market is the issuance of Turkey's first real estate investment trust (REIT) *sukuk* with a nominal value of 100 million Turkish lira in February 2018 by Halk REIT. These developments in the market indicate the market's and the government's continuing goals for the growth of Islamic finance products.

4 Treasury Financing Programme: 2017 Developments and 2018 Projections – press release by the Prime Ministry Undersecretariat of Treasury of the Republic of Turkey, dated 31 October 2017.

Chapter 11

UNITED ARAB EMIRATES

Amjad Ali Khan and Rahat Dar[1]

I LEGISLATIVE AND REGULATORY FRAMEWORK

i Legislative and regulatory regime

The United Arab Emirates (UAE) has always provided an attractive environment from which to provide Islamic finance services and products into the Gulf Cooperation Council (GCC) and beyond. In addition to being an established and vibrant global financial centre and its geographical location in the centre of the Asian and Western financial markets, the UAE also provides a legal system and a judiciary that is familiar with the principles of *shariah*. The UAE's Constitution identifies *shariah* as a principle source of law and UAE Federal Law No. 5 of 1985 Concerning Civil Transactions (the UAE Civil Code), which is deeply anchored in *shariah*, recognises the basic Islamic financing contracts, including:

a *Murabahah* (cost-plus financing): Article 506 of the UAE Civil Code defines a *murabahah* sale as:

> *1. A sale may be by way of resale with a profit, a loss or at cost price if the capital value of the thing sold is known at the time of the contract, and the amount of the profit or loss is specified.*
>
> *2. If it appears that the seller has exaggerated in declaring the amount of the capital value, the purchaser may reduce (the amount) by the amount of the excess.*
>
> *3. If the capital value of the thing sold is not known when the contract is made, the purchaser may rescind the contract when he learns of it, and the same shall apply if the seller conceals a matter affecting the thing sold or the capital value, and he shall lose his right to elect if the goods are sold or consumed or pass out of his ownership after delivery.*

b *Mudarabah* (trust financing): Article 693 of the UAE Civil Code states that a *mudarabah* is 'a contract whereby the person owning property puts in the capital, and the *mudarib* puts in effort or work, with a view to making a profit'.

c *Musharakah* (partnership financing): Article 654 of the UAE Civil Code identifies *musharakah* generally in the following statement: 'A company is a contract whereby two or more persons are bound each to participate in a financial project by providing a share of property or work for the exploitation of that project and the division of any profit or loss which may arise thereout.'

1 Amjad Ali Khan is a senior consultant and Rahat Dar is a senior associate at Afridi & Angell.

d *Ijarah* (leasing): Article 742 of the UAE Civil Code defines *ijarah* as 'the conferring by the lessor on the lessee of the right of use intended for the thing hired for a specified period in consideration of an ascertained rent'.

e While there is no specific article in UAE law that expressly refers to and deals with *istisnah*, the official commentary to the UAE Civil Code stipulates that the *shariah* principles of *istisnah* are applicable in the case of construction contracts (*muqawala*), which are defined in Article 872 as 'a contact whereby one of the parties thereto undertakes to make a thing or to perform work in consideration which the other undertakes to provide'.

While the emirate of Dubai has established itself as a major centre for business and commerce, the UAE is a relatively young country and the laws and regulations applicable to financial products and services (including Islamic finance) are rudimentary – often just providing a mandate for the formation of regulatory authorities to govern the provision of the relevant financial products and services in the UAE. Consequently, the detailed rules, regulation and policies relating to financial products and services are left to the discretion of the relevant regulatory authorities. The internal rules, policies and guidelines implemented by the authorities relating to the relevant financial products are not always made public. The laws relevant to Islamic financial services are in many cases diffused in multiple pieces of legislation and the coverage of issues (including consumer protection) is general rather than comprehensive.

Islamic banking

The UAE is one of the largest Islamic banking markets in the world, after Saudi Arabia and Malaysia. According to the UAE Central Bank, as at December 2017, 22.4 per cent (550 billion UAE dirhams or US$149.73 billion) of all banking assets in the UAE are *shariah*-compliant, which represents a far steeper growth rate for Islamic finance, in comparison to that of conventional bank loans.

The principal governmental and regulatory policies that govern the UAE banking sector, including Islamic banks (except in the Dubai International Financial Centre (DIFC), where the regulatory authority is the Dubai Financial Services Authority), are UAE Federal Law No. 10 of 1980 concerning the UAE Central Bank, the Monetary System and the Organisation of Banking (the Banking Law), UAE Federal Law No. 18 of 1993 as amended (the Commercial Code), UAE Federal Law No. 6 of 1985 concerning Islamic Banks, Financial Establishments and Investment Companies (the Islamic Banking Law), and the various circulars, notices and resolutions issued by the board of governors of the UAE Central Bank, from time to time (which deal with various aspects of banking, including bank accounts, maintaining of certain reserve ratios, capital adequacy norms and reporting requirements to the UAE Central Bank).

The Banking Law is the primary legislation giving the UAE Central Bank the authority to regulate financial services (including Islamic financial services) in the UAE. According to the Banking Law, the UAE Central Bank has the power to license and regulate a wide variety of financial institutions, including those seeking to provide financing in the UAE. In particular, the following institutions are regulated:

a commercial banks, which includes institutions that customarily receive funds from the public for granting loans and that issue and collect cheques, place bonds, trade in foreign exchange and precious metals, and carry on other operations allowed by law or by customary banking practice;

b investment banks, which includes institutions conducting similar activities to commercial banks, with the notable exception that they do not accept deposits with a maturity of less than two years;

c investment companies, which manage portfolios on behalf of individuals or companies, subscribe to equity and debt instruments, prepare feasibility studies for projects, market shares and debt instruments, and establish and manage funds;

d finance companies, which provide corporate and consumer credit facilities, but may not accept deposits from individuals;

e Islamic banks, which undertake all the activities of a commercial bank and additionally can own assets financed by them;

f Islamic finance companies, which may provide personal, consumer, property, vehicle and trade financing, issue guarantees, enter into foreign exchange contracts with corporate entities, subscribe to shares, bonds and certificates of deposits, accept deposits from corporate entities, and manage investment vehicles; and

g real estate finance companies, which are finance companies that specialise in funding real estate projects on a conventional or *shariah*-compliant basis.

With respect to Islamic banks, permissible activities are not specified in the Islamic Banking Law, which provides that Islamic banks means 'those whose memorandum of association includes a commitment to abide by the provisions of *shariah* and conduct their activities in accordance therewith'. The Islamic Banking Law contains specific provisions relating to the establishment and operation of Islamic banks, and provides that Islamic banks have the right to:

a carry on all or part of banking, commercial, financial and investment services and operations;

b engage in all types of services and operations practised by banks and referred to in the Banking Law, whether those operations and services are conducted for the Islamic bank's own account or for or in partnership with a third party; and

c establish companies and participate in enterprises provided that the activities of the latter are in conformity with *shariah*.

The Islamic Banking Law provides that Islamic financial institutions and investment companies shall have the right to carry out lending, credit and other financial operations. They may also participate in enterprises, invest their funds in movable assets and receive deposits for investment thereof in accordance with the provisions of *shariah*. Each Islamic bank, financial institution and investment company must appoint a *shariah* supervisory board (SSB) consisting of at least three *shariah* scholars specialised in *shariah* law and finance, to ensure that its operations and products comply with the rules and principles of *shariah*. The SSB will review all proposed financial products and related documents, and issue a *fatwa* (opinion) on the *shariah* compliance of the same. Once the financial product has received the approval of the SSB, it can be offered by the Islamic bank or financial institution to the public in the UAE.

In addition to the Islamic Banking Law, Islamic banks are also subject to the provisions of the Banking Law.

The concept of a higher *shariah* authority was first contemplated under Article 5 of the Islamic Banking Law, which provides that this authority shall incorporate 'legal and banking personnel to undertake higher supervision over Islamic banks, financial institutions and investment companies to ensure legitimacy of their transactions accordingly to the provisions of Islamic *shariah* law, and also to offer opinion on matters that these agencies may come across while conducting their activities. The opinion of the said Higher Authority shall be binding on the said agencies'.

In 2017, the UAE cabinet approved the formation of the board of the Higher Shariah Authority (the Higher Authority) to strengthen consistency of the Islamic finance industry across the UAE. At the first meeting of the board of the Higher Authority, they identified a number of core objectives for the Higher Authority, in particular (1) issuing of *fatwas* and ensuring the legitimacy of the products, services and activities of institutions providing Islamic services; (2) introducing and approving new and existing *shariah* standards and uniform documents relating to best practices for global Islamic financial services; (3) notifying the UAE Central Bank of *sharia* matters concerning preventive systems related to global Islamic financial services, as well the *sharia*-compliant instruments and ways for developing the same; (4) conducting *shariah* research regarding Islamic financing and ways of supporting it; and (5) communicating and cooperating with other international organisations that currently set *shariah* regulations and standards for the Islamic financial industry. As the Higher Authority is a recent development it still remains to be seen how it will interact with, and impact on, the role of other key stakeholders, in particular the SSBs currently overseeing *shariah* compliance at financial institutions.

Capital markets

The capital markets in the UAE are still in their infancy and there are very few Islamic products listed on the local exchanges. While the UAE Central Bank is the principal financial services regulator for banks and financial institutions in the UAE, such entities are also subject to additional registration and licensing requirements at the federal and emirate levels. The Emirates Securities and Commodities Authority (ESCA) is the regulator in relation to listed securities (including *sukuk*). As with other jurisdictions in the GCC, the laws and regulation relating to the provision of financial products on the local capital markets are supplemented to a large extent by the regulatory regime implemented on the individual exchanges. In the UAE, while the regulators will provide the broad requirements for issuing securities, it is the individual regulators of the exchanges (such as in the Abu Dhabi Stock Exchange and the Dubai Financial Market) that will provide the detailed framework for the listing of the relevant financial products on these exchanges. A detailed review of the rules and regulations of the individual stock exchanges in the UAE and the DIFC is beyond the scope of this chapter.

While the UAE equity capital markets have been near inactive in the past few years, with only a handful of primary listings on the local exchanges, *sukuk* (or Islamic bonds) have bucked the trend and emerged as the fastest-growing segment of the UAE Islamic capital markets. The UAE is also a popular destination for listing *sukuk*. At the end of 2017, the total value of *sukuk* listed on NASDAQ Dubai stood at US$50.8 billion, with 11 new *sukuk* listings with an aggregate value of US$10.25 billion in 2017.

Decision No. 16 of ESCA's Board of Directors of 2014 Concerning the Regulation of Sukuk (the Sukuk Regulations) provides specific guidelines for the issuance of *sukuk* in the UAE and the listing of *sukuk* on the local capital markets. In particular, the Sukuk Regulations provide that:

a all retail *sukuk* (i.e., *sukuk* where the maximum value of each *sukuk* certificate is 100,000 UAE dirhams and is offered to the public through a public subscription) shall only be issued in the UAE through public subscription and shall be listed on a local market;
b the obligor (i.e., the company that will receive the funds from the issuance of the *sukuk* certificates) must obtain ESCA's approval before issuing or listing *sukuk* on a regulated market;
c for a primary listing of a *sukuk*, the obligor must ensure that the *sukuk* has been approved by its SSB. If the obligor does not have an SSB, the *sukuk* must be approved by a *shariah* committee approved by ESCA;
d unless ESCA provides otherwise, the nominal value of a listed *sukuk* must be above 10 million UAE dirhams or its equivalent in any foreign currency accepted by ESCA and the relevant capital market;
e the issuer must appoint a UAE licensed bank to act as the paying agent in the UAE;
f the obligor must provide a prospectus (prepared in accordance with the guidelines in the Sukuk Regulations) for a primary listing of a *sukuk*;
g the obligor must comply with detailed continuing obligations in connection with a listed *sukuk*, including notifying ESCA and the relevant market of any information that may be expected to materially affect market activity, the price of the listed *sukuk*, or the ability of the obligor or issuer to meet its commitments under the *sukuk*; and
h ESCA shall respond to any application for the listing of a *sukuk* within five business days. If no response is received in this time frame, the application shall be considered as rejected. ESCA shall have the right to attach any conditions, to any listing approval, that it deems necessary to protect the public interest.

Takaful insurance

The growth in *takaful* is far outstripping that of conventional insurance. In the wider Middle East, the *takaful* market segment is growing by 20 per cent a year. Currently, there are more than 60 *takaful* companies operating in 23 countries worldwide, generating *takaful* premiums estimated to be in excess of US$2 billion.

Under Federal Law No. 6 of 2007 regarding the Establishment of the Insurance Authority and Organisation of its Operations (the Insurance Law), the UAE Insurance Authority (the Insurance Authority) was appointed as the regulator for the insurance industry in the UAE (outside the free zones), including *takaful* insurance, and tasked with promoting the role of the insurance industry to indemnify persons, property and liabilities against risks to ultimately protect the national economy; to accumulate and grow national savings and invest them to support economic development in the UAE; to encourage fair and effective competition; to provide the best insurance services with appropriate coverage at a affordable rates; and to achieve job emiratisation (i.e., job creation for Emiratis) in the UAE insurance market.

Takaful insurance companies are required to comply with the provisions of the Insurance Law, and the *takaful* regulations below must be read in conjunction with the Insurance Law.

The Insurance Authority issued the Board of Directors Resolution No. 4 of 2010 Concerning the Takaful Insurance Regulations, which outlined rules designed to regulate the work of *takaful* insurance companies and can be summarised as follows:

a All insurance and investment transactions by the *takaful* insurance company must be compliant with the provisions of *shariah*. As per the 2010 Regulations, all premiums should be invested in accordance with *shariah*. We are not aware of any instance where this is not the case. We are not aware of *takaful* companies investing *takaful* funds with conventional insurers or using conventional insurers for reinsurance purposes.

b *Takaful* products may not be offered through an 'Islamic window' of a conventional insurance company.

c Risk management operations and investment business shall be conducted by the company on *wakalah* or *wakalah* and *mudarabah* together.

d Family *takaful* insurance and general insurance may not be combined in one *takaful* insurance company. The existing *takaful* insurance companies currently engaged in both types were given a specific deadline to adjust their positions.

e The insurance company is committed to provide a *qard hasan* to the participants' fund in case of a deficit in the assets of this fund.

f The maximum amount of *qard hasan* is the sum of shareholders' equity.

g The amount of *wakalah* fees and how it is calculated, as well as the *takaful* insurance company's share of *mudarabah*, must be stated in advance.

h An SSB must be formed in each *takaful* insurance company.

i The Supreme Committee for Fatwa and Sharia Oversight was formed within the Insurance Authority.

j It is necessary to appoint a *shariah* controller within each *takaful* insurance company.

The Insurance Authority's Board of Directors' Decision No. 26 of 2014 Pertinent to Financial Regulations for Takaful Insurance Companies (the 2014 Regulations), which was largely inspired by the EU's Solvency II standards, outlined various financial standards required for *takaful* insurance companies, including:

a the introduction of solvency margins and a guarantee fund. The previous minimum capital requirements (MCR) of 100 million and 250 million UAE dirhams, required for insurers and reinsurers respectively, have been supplemented with the following capital requirements:
- a minimum guarantee fund (MGF), which comprises an amount that is the higher of (1) not less than one-third of the solvency capital requirement (SCR); or (2) the higher of a minimum amount to be specified by the Insurance Authority for each type of business and a specified percentage of the net earned premium for each type of business; and
- SCR being a risk-based capital calculation that utilises the solvency template published by the Insurance Authority. The SCR introduces, for the first time in the UAE, a risk-based capital component for insurers.

Takaful operators are required to maintain the higher of the MCR, the MGF and the SCR. In practice, it is likely that the MCR will remain the key requirement for much of the *takaful* industry given the relative youth and lack of scale of the *takaful* operators in the UAE;

b the basis for calculating the financial provisions to meet its obligations towards participants and their beneficiaries, including unearned contribution reserves, outstanding loss reserves and unexpired risk reserves (all as defined in the 2014 Regulations);

c determining the *takaful* operator's assets that meet the accrued insurance policies. The *takaful* operator must develop investment and risk management policies, including strict limitations on each class of asset that may be held by a single counterparty, to address concentration risk. For example, maximum limits set by law include (1) a 30 per cent limit on real estate assets; (2) a 30 per cent limit on equities – only one-third of this may be invested in a particular class of assets; and (3) a 20 per cent limit on mutual fund investment – only half of this may be invested in a particular asset class;

d the accounting standards adopted by the *takaful* operator; and

e the records and documents to be maintained by the *takaful* operator, which shall be made available to the Insurance Authority upon request.

While the above developments will enhance consumer protection, they will also cause some hardship for *takaful* operators, particularly for the smaller operators who may find it difficult to meet the extensive reporting requirements and limitations on the types of assets in which they may invest. It is expected that these requirements will encourage smaller *takaful* operators to merge and consolidate their business, to manage the new solvency and reporting requirements.

Investment funds

The vast majority of funds (including Islamic investment funds) marketed in the UAE (whether to retail customers, high net worth individuals or institutional investors) are organised offshore, and the number of onshore funds is extremely low.

There are no laws in the UAE that deal specifically with Islamic investment funds. Therefore, the legal and regulatory regime applicable to investments in general will also apply to Islamic investment funds.

The principal financial services regulator in the UAE is the UAE Central Bank. Important UAE legislation applicable to investment funds includes:

a the Banking Law;

b the Islamic Banking Law;

c UAE Central Bank Resolution 164/A/94 (regarding the regulation of the financial companies and banking, and financial and investment consultation establishment of companies);

d UAE Central Bank Resolution 89/3/2000 (regarding amendment to regulation of investment companies and banking and financial investment consultation establishment of companies);

e UAE Central Bank Resolution 58/3/96 (regarding the regulation of finance companies);

f UAE Central Bank Resolution 21/2/88 (regarding the system of investment banks in the state);

g ESCA Resolution 3 of 2000 (concerning regulations on disclosure and transparency);

h ESCA Resolution 4 of 2000 (concerning the Emirates securities and commodities authority and market);

i ESCA Resolution 48 of 2008 (concerning financial advice and analysis); and

j the ESCA Board of Directors Decision No. 9 of 2016 (concerning the regulation of mutual funds) (the Investment Funds Regulation).

The Investment Funds Regulation further confirmed the transfer of responsibility for the licensing and marketing of mutual funds (including any Islamic investment funds), which are defined as financial pools engaged in the activity of accumulating investors' assets for the purpose of investment against the issue of fund units of equal value, and a number of related activities from the UAE Central Bank to ESCA. ESCA approval is required for the sale, marketing and promotion of foreign securities and funds in the UAE, and the establishment of domestic funds. In particular, the Investment Funds Regulation provides that:

a all foreign mutual funds (which are the most common type of investment fund in the UAE) must be approved by ESCA to be marketed in the UAE. The fact that a foreign fund may only be offered to institutional investors does not provide an exemption from the requirement to obtain ESCA approval;

b a foreign mutual fund may not be marketed to the public in the UAE unless the foreign fund is (1) subject to the supervision of an authority equivalent to ESCA in its jurisdiction of incorporation and (2) authorised to make offers to the public in its jurisdiction of incorporation;

c all approved foreign mutual funds, whether public or private, must be promoted by a local promoter, which includes (1) banks and investment companies licensed by the UAE Central Bank and (2) companies licensed to be local promoters by ESCA. The local promoter will act as an intermediary between the foreign fund and the persons to whom units in the fund are promoted in the UAE. The local promoter will also be responsible for a broad range of issues, including:
- continuous monitoring of the operations of funds to safeguard the investment of the unitholders;
- keeping records of the units distributed by the fund;
- providing subscribers with copies of the foreign fund's offering document;
- ensuring timely disclosure of material information and financial statements relating to the foreign fund to investors in the UAE; and
- distributing dividends and redemption proceeds to the unit holders in accordance with the foreign fund's documents; and

d an entity establishing a local fund must be a UAE joint-stock company or a UAE branch of a foreign company. The company or branch must have a minimum capital of 5 million UAE dirhams.

The investment policy of the investment fund must specify, among other things, proposed investment instruments, investment risks relevant to the proposed investment instruments, restrictions on types of investments and borrowing controls. The Investment Funds Regulation also prescribes certain restrictions on investment of the fund's assets, in line with the investment nature of the fund, covering:

a investment in tradable securities (stocks, bonds and cash instruments) or high liquid non-tradable securities;

b financial derivatives on tradable securities to control the level of risks set forth in the fund's prospectus or for hedging in an amount not greater than the total net asset value subject to disclosure thereof;

c declared indexes or bank deposits to ensure liquidity with a maximum maturity of 12 months with licensed banks;

d open-ended mutual funds subject to determining the investment ratio (such funds must be licensed by an entity similar to ESCA); and

e immovable assets of high liquidity.

Any application for a licence from ESCA for either the establishment of a fund or the establishment of a local promoter company requires the submission of a letter of application, various constitutional documents of the applicant and a business plan of some sort. The exact documents are not prescribed by the relevant authority; rather, the normal practice is for ESCA to notify the applicant of such additional documents as it might require on an *ad hoc* basis. ESCA requires an applicant seeking approval for promotion of a foreign mutual fund to submit the fund's key information, an undertaking from the local promoter, a signed promotion agreement, the fund offering document, and the constitutional documents and the previous two years' audited financial statements of the applicant (although additional documents may be requested).

ii Regulatory and supervisory authorities

While the authorities identified in Section I.i have the power to regulate the provision of financial services in and from the UAE, in practice *shariah* supervision and compliance is still left to the individual financial institution. Currently, in the UAE *shariah* compliance is achieved in various ways, including by way of adopting national regulation, voluntary *shariah*-compliant standards and *fatwas*, and directives and resolutions of the Islamic financial institution's internal SSB. However, it is anticipated that the decisions and regulations issued by the Higher Authority will soon be added to the above list.

Previously, the adherence to the voluntary standards issued by standard setting bodies such as the Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI) and the Islamic Financial Services Board varied among individual Islamic banks and financial institutions in the UAE. However, this may soon change following the Higher Authority's recommendation that all banks and financial institutions offering *shariah*-compliant products in the UAE comply with the requirements of the AAOIFI's standards with effect from 1 September 2018. It remains to be seen how this recommendation will be implemented in practice, particularly in the context of cross-border syndicated financing where one or more of the syndicated banks are located in jurisdictions that do not have mandatory implementation of AAOIFI standards. Islamic banks and financial institutions must continue to maintain an internal SSB (generally consisting of three to five *shariah* scholars) to ensure that their practices are in line with the requirements of *shariah*. There is no specific regulatory oversight or fit and proper person test. However, the Central Bank may request to see details of the academic and professional qualifications of the *shariah* scholars. The role of the SSB is to review the practices and financial products offered by an Islamic financial institution and issue *fatwas*, confirming that the Islamic financial institution's products and services are in compliance with the principles of *shariah*. Currently, it is not clear how the Higher Authority's core objectives of issuing *fatwas* on financial products will impact any *fatwas* issued by SSBs and how any inconsistency between the *fatwas* would be resolved. For now, Islamic financial institutions continue to seek guidance from their internal SSB; this can be problematic when arranging syndicates of Islamic banks or financial institutions, as there may be differences of opinion between the different SSBs on the application of *shariah* principles to the financing structure.

In determining whether a financial instrument is compliant, the *shariah* scholars generally adhere to the following process:

a review the product concept description created by the product development team;
b review the market conditions identified by the product development team;
c review the product development team's views on the Islamic principles on which the transactions will be based; and
d review the product development team's proposals and issuing *fatwas*.

The resulting *fatwa* of the scholars is then reviewed by the product development team and can be followed by a discussion between the scholars and the product development team to finalise the product. The need for a constant dialogue between the product development team and the scholars throughout this process should be stressed. In line with the majority of countries where *shariah*-compliant financial services are offered, each financial institution in the UAE has its own SSB, making individual decisions for the institution. It remains to be seen whether the adoption of the Higher Authority will result in the UAE becoming the latest country to adopt the centralised *shariah* compliance regime in place in other jurisdictions, such as Malaysia and Sudan, where *shariah* compliance is centralised within the central bank.

Originally pioneered by the Malaysian Central Bank (Bank Negara Malaysia), other central banks (e.g., in Oman, Nigeria and Pakistan) have more recently established a centralised SSB within their central bank or financial regulator. The central SSB is responsible for the approval of all *shariah*-compliant financial transaction structures in the country. The responsibility of the SSB of the individual financial institutions is to ensure the transactions undertaken by the institution are compliant with these rules. Any amendments requested by individual institutions will have to be presented to the central SSB for ratification. The centralised SSB and Bank Negara Malaysia maintain a register of approved scholars. Scholars cannot be a member of more than one board per type of financial institution. As a result, a scholar could, for example, be a member of the SSB of a retail bank and an investment bank, but not of two retail banks.

II COMMON STRUCTURES

i Consumer finance

Islamic banks provide a comprehensive range of core consumer banking services similar to those offered by their conventional counterparts, in particular:

a Islamic banks accept deposits into current accounts for safe custody of their funds, as well as convenience and use. The bank may levy a charge for providing this service. These deposits are not subject to any conditions on drawing or depositing. The bank may use such deposits at its own risk and responsibility in respect of profit or loss.

b Savings accounts are operated similarly to current accounts. However, customers may be restricted in the frequency in which they can withdraw their funds or may be required to give a notice period to the bank prior to doing so. The bank, at its discretion, may reward its customers with a profit-share generated from their deposits at the end of its financial year.

c Islamic banks open investment accounts into which they accept deposits from customers seeking investment opportunities for their funds using the *mudarabah* contract. Deposits are held for a specified period. While the profits generated by the bank from the investment of the funds are shared between both the bank and the customer, according to a predetermined ratio, any losses must be borne by the customer, unless the loss was attributed to any fault by the bank.

d Islamic banks are unlikely to give an overdraft facility to their customers since they will not charge interest for such a service. Instead, the bank may give a *qard hasan* to customers in case of hardship to enable them to meet certain obligations.

e To provide trade finance facilities, the Islamic bank uses either the conventional letter of credit or the *murabahah* contract. In practice, Islamic banks tend to open a letter of credit only for customers who have an equivalent credit balance with the bank and in return for a fee. The Islamic bank is likely to use the *murabahah* contract for trade financing where the customer does not have adequate credit with the bank. As mentioned, under a *murabahah* contract, the bank earns its return from the markup profit.

ii Home finance

For the acquisition of completed properties an Islamic bank will generally provide funding by using the *murabahah* structure. However, for properties under construction, banks generally use the *istisnah* and forward *ijarah* structure.

For a *murabahah* financing the bank will (1) acquire title to the asset from a third party and (2) transfer title to the customer (subject to a mortgage over the land or flat, etc.).

Under an *ijarah* financing, once the asset is completed the title will first pass to the customer and then (following entry into the *ijarah* financing) pass to the bank. Once the lease term is completed, the title should revert to the customer (assuming that the customer has complied with its obligations under the *ijarah*).

iii Insurance

The participants jointly donate funds (on a *tabarru'* basis) to a pool for the purpose of providing mutual indemnity and protection to the participants exposed to defined risks under the *takaful* policy. The *takaful* contract is a combination of *tabarru'* (donation) and *dhaman* (indemnity) contracts between the individual insured and the pool of insured (policyholders) as represented by the *takaful*, and agency (*wakalah*) or profit sharing (*mudarabah*) contracts between the insured and the *takaful* operator.

iv Project finance

Many investors get together to become shareholders in large financial projects through the mechanism of the *mudarabah*. The Islamic bank's role in these funds is to act as the *mudarib* and to use these funds to finance a large project. This *mudarabah* fund can be utilised by the bank in conducting its business using any of the Islamic contracts, such as *murabahah*, *ijarah*, *salam* or *istisnah*.

v Asset finance

Islamic banks finance acquisition of assets by using the *ijarah* contract, and the *ijarah wa iqtina* for longer-term assets. This technique is particularly popular for vessel financing by Islamic banks. The title to the asset will pass from the customer to the bank. The asset will be leased back to the customer for the term of the lease. At the end of the lease period, the title to the asset will revert to the customer.

vi Investment funds

The Islamic structure used for a fund will depend on the underlying objectives of the fund. Fixed-income funds usually invest in *murabahah* (commonly commodity *murabahah*), *sukuk* and *ijarah*, with the investors investing their funds with *mudarib* using a *mudarabah* or *wakalah* contract (which governs the relationship between the investors and the *mudarib*). The *ijarah* fund structure is favoured as it can generate higher returns.

III TAXATION

Legislation establishing a general corporate income tax regime is currently in force in the UAE. The regime is, however, only applicable to companies active in the hydrocarbon industry and branches of foreign banks operating in the wider UAE. Under current legislation, there is no requirement for withholding or deducting for or on account of UAE taxation in respect of payments of accrued return or principal on investments.

The Constitution of the UAE specifically reserves the right to raise taxes (such as VAT) on a federal basis, for the purposes of funding its budget, to the federal government of the UAE. It is not clear how or if such taxes will affect Islamic finance agreements or institutions. This will only become clear once the relevant laws are passed.

IV INSOLVENCY

There is no separate insolvency regime for Islamic finance participants in the UAE.

V JUDICIAL FRAMEWORK

i Courts

Although the UAE has *shariah* courts, these courts only deal with family law-related issues, including marriage, divorce and intestacy. Any commercial disputes in the UAE (including Islamic finance disputes) are resolved through litigation in the UAE civil courts or arbitration. Consequently, should a commercial dispute be brought before a UAE court, the court is unlikely to apply a different treatment to the dispute solely on account of the transaction being *shariah*-compliant. The dispute will be subject to the same processes and procedures as a conventional financing counterpart. The courts will also apply the laws of the UAE in determining the case. Furthermore, if a document purports to be governed by *shariah* law, courts will likely disregard this choice of law, and will instead apply the applicable UAE laws.

The UAE is a federation of seven emirates. All member emirates, except Dubai and Ras al-Khaimah, are part of a federal judicial system; Dubai and Ras al-Khaimah have independent judicial systems. In every emirate, the court system consists of the Court of First Instance, the Court of Appeal and the Court of Cassation (Ras al-Khaimah, however, does not have a Court of Cassation).

Commercial disputes in the UAE (including Islamic finance disputes) are generally resolved through litigation in the UAE civil courts or arbitration. It is common for UAE banks and financial institutions to choose UAE law (or the law of a particular emirate) as the governing law of the transaction documents and the UAE courts as having exclusive jurisdiction over all related disputes.

The UAE operates under a civil law system. The civil court (or Court of First Instance) hears all claims ranging from commercial matters (including debt recovery cases) to maritime disputes. After judgment has been delivered, the parties have the right to appeal to the Civil Court of Appeal on factual or legal grounds, or both, within 30 days of the date of judgment. It is possible to introduce additional evidence to the Court of Appeal and request that additional witnesses be called to testify. Thereafter, parties may appeal on points of law alone to the Court of Cassation (the highest court in Dubai), which is usually composed of five judges. The appeal must be filed within 30 days of the date the parties were notified of the judgment of the Court of Appeal. All decisions of the Court of Cassation are final and are not subject to appeal.

Each case is decided on its own merits and facts. All court proceedings are in Arabic. All non-Arabic documents filed in court by the litigants must be translated into Arabic by a translator licensed by the Ministry of Justice. The judicial system in the UAE is essentially inquisitorial in nature. In each case, the judge will investigate the facts and apply the law to the facts in reaching his or her judgment. There is no concept of a jury trial.

All proceedings in UAE civil matters are based on the written pleadings of the parties, supported by documentary evidence. In general, there is no oral hearing in civil cases. There is a widespread practice for both the federal and the Dubai courts to refer matters to court-appointed experts for findings of fact in a variety of areas, including finance, accounting and other technical matters. Experts' reports (including reports from *shariah* scholars) are not binding and can be challenged by the parties, but they are usually considered persuasive by the courts. Oral evidence can only be given to establish a fact in a civil case with the permission of the court and the right to cross-examine witnesses is severely restricted.

The UAE courts do not adhere to the traditional common law standard of proof such as the balance of probability test in civil claims or the beyond all reasonable doubt test in criminal matters. The final decision in any case is at the discretion of the judge or judges hearing the case.

All commercial cases are heard by the civil courts, usually consisting of three judges in the Court of First Instance, three judges in the Court of Appeal and five judges in the Court of Cassation.

These judges may not have specialist knowledge of commercial matters. However, commercial disputes must first be referred to a Reconciliation and Settlement Committee (the Committee), appointed by the Ministry of Justice (Federal Law No. 26 of 1999 regarding establishing reconciliation committees in the Federal Courts (the Reconciliation Committee Law)). The Committee facilitates settlement and usually hears parties in person. If a claim cannot be settled, the claimant can file a claim in the Court of First Instance. If the parties reach a settlement, they record and sign its terms. This agreement is binding and enforceable. This procedure does not apply in Dubai or Ras al-Khaimah. Dubai recently passed a law creating the Centre for Amicable Settlement of Disputes, to which certain cases must be referred before initiating court action.

To maintain the legal enforceability of an agreement, it is advisable for all the elements necessary for *shariah* compliance purposes to be incorporated into the agreement itself. Under the UAE Civil Code, where the intention of the parties is clear from the language of the contract, the courts will not imply any further meaning or additional terms to the contrary. Save in the cases where the contract was unclear and the provisions of the law and customary practice are silent on an issue, the UAE courts are unlikely to examine the *shariah* aspects of a document.

In addition to the civil courts, the parties may choose to resolve a dispute through the International Islamic Centre for Reconciliation and Commercial Arbitration (IICRCA). The IICRCA is a dispute resolution forum for the Islamic finance industry, based in Dubai. The IICRCA was established for the purpose of assisting in resolving financial and commercial disputes that may arise between financial and commercial institutions or between such institutions and their clients or third parties through reconciliation or arbitration in accordance with the principles and rules of the Islamic *shariah*. The IICRCA handles commercial disputes in the Islamic financial industry from across the GCC as well as Malaysia. The agreement of the parties is required for the IICRCA to have jurisdiction. The IICRCA is not commonly used.

There are other regional arbitration centres, in Sharjah and Ras al-Khaimah, such as Sharjah International Commercial Arbitration Centre and Ras al-Khaimah Centre of Reconciliation and Commercial Arbitration. These arbitration centres are not commonly used.

ii Cases

We are not aware of any significant case law regarding the interpretation of Islamic financial products. Furthermore, note that the UAE does not follow the principle of *stare decisis* and judgments of the UAE courts are not always published.

VI OUTLOOK

i Higher Authority

While it is clear that the Higher Authority shall regulate and set standards for the Islamic finance industry in the UAE, few details have been released as to how such an authority will affect interaction with existing SSBs (i.e., will the UAE adopt something along the lines of Malaysia's centralised *shariah* supervisory regime (see Section I.ii) or will financial institutions still manage *shariah* supervision through their SSBs?).

The Higher Authority has taken major steps in developing the Islamic finance industry in the UAE, such as recommending that all banks and financial institutions offering *shariah*-compliant products in the UAE comply with the requirements of the AAOIFI standards with effect from 1 September 2018. Existing products and services will also need to be revised to comply with the AAOIFI standards. This is a key development and provides consistency and uniformity in the cross-border approach to offering *shariah*-compliant products and services, and will bring the UAE in line with other countries in the region, such as Bahrain and Jordan, where financial products and services also adhere to the AAOIFI standards. The board of the Higher Authority discussed draft standards regarding the governance of *sukuk* issuances at a meeting in July 2018.

It is also hoped that establishing a centralised *shariah* regulator such as the Higher Authority will help to address the ongoing controversy surrounding '*fatwa* shopping' in the UAE (i.e., the practice by financial institutions of approaching multiple *shariah* scholars, to review their proposed financial products, to choose the *shariah* scholar who offers the most favourable *fatwa*).

ii Investment regulations

In 2015, ESCA's research department circulated draft regulations for (1) private equity funds, (2) real estate investment funds, and (3) investment funds. These draft regulations detailed rules and procedures on a variety of issues relating to the particular types of fund, including the offering, operating and management of such funds in and from the UAE. However, following the issuing of the less detailed Investment Funds Regulation, it is no longer clear whether ESCA still intends to proceed with the above draft regulations.

Chapter 12

UNITED KINGDOM

John Dewar and Munib Hussain[1]

I LEGISLATIVE AND REGULATORY FRAMEWORK

i Legislative and regulatory regime

Islamic finance has been developing rapidly in the UK for over a decade and the government has taken a leading role in legislating for its development and promotion. The UK hosted the first stand-alone Islamic financial institution in the EU and, according to the latest ICD-Thomson Reuters Islamic Finance Development Report (2016), the UK is ranked 22nd out of 124 countries in terms of its overall Islamic finance offering. This puts it in first place in Europe, and in fourth place among non-Muslim-majority nations. The UK has a strong and proud tradition of openness and flexibility, which, combined with London's position as a leading international financial centre and the UK's significant Muslim population (just under 5 per cent of the UK population according to the 2011 census), provides a strong foundation for growth. As a result of its standing, London has long been perceived as the Western hub for Islamic finance.

Rather than regulating Islamic finance products with separate legislation, the UK's approach has been to adapt pre-existing legislation and regulations governing conventional financial instruments to cater for the structures commonly used in Islamic finance. In so doing, the UK's approach has been to ensure a level playing field for Islamic finance products and conventional instruments, and so the UK has proactively monitored and responded to any unequal treatment between the two by introducing remedial legislation and regulations. For example, as early as 2003, the government introduced special exemptions to stamp duty land tax to relieve the unintended double taxation charge that arose as a result of structures used by Islamic mortgages and was also quick to remedy the adverse tax treatment of *sukuk* to place them on a level playing field with conventional debt instruments. This approach leaves the application of Islamic principles as a matter of conscience for the parties concerned, reflecting both the lack of a single codified body of Islamic law and the fact that there are differences of opinion among scholars as to how Islamic principles should be applied to modern-day financial instruments. As discussed in more detail below, the English courts have taken an approach consistent with this in considering only English law (to the extent that this is the governing law of the relevant contracts) when ruling on disputes involving Islamic finance transactions.

The primary legislation that governs Islamic finance in the UK is set out in the Finance Act 2005 as amended by the Finance Act 2007. The Finance Act 2005 characterises Islamic

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finance transactions as 'alternative finance arrangements' and takes a relatively straightforward approach to folding Islamic finance instruments into the conventional legislative environment. For example, anything described in an Islamic finance instrument as 'profit' will be treated in the same manner as the provisions of previous Finance Acts that deal with 'interest'; this is particularly important when considering the tax treatment of Islamic finance instruments. Further, given that the Finance Act 2005 was generally aimed at bank financing with a specific focus on consumer financing, particularly Islamic mortgages, the Finance Act 2007 expanded the scope of the Finance Act 2005 to include *sukuk* (defined as alternative finance investment bonds (Section 53, Finance Act 2007)) with the intention to pave the way for the inaugural *sukuk* issuance by the UK government (discussed in more detail below) by responding to the anomaly created by previously not providing for tax deductibility of profit distributions under a *sukuk*, making it a more expensive way to raise finance when compared to a conventional bond with tax-deductible interest payments.

Prior to the introduction of the Finance Act 2007, an issue that arose in connection with a potential *sukuk* issuance by a UK issuer was whether, for the purposes of the Financial Services and Markets Act 2000 (FSMA), a *sukuk* would be considered to be the equivalent of a conventional bond or of a collective investment scheme (CIS). The issue arose because *sukuk* contemplate the investment by the issuer of the issue proceeds received from *sukuk* holders in certain assets – these are all features of a CIS. Market practitioners had long taken the view that a *sukuk* should be treated in the same manner as a conventional bond (with the investment in the assets being in satisfaction of *shariah* (not investor) requirements), but for such treatment to be given in the UK, an assessment would need to be made by the regulator in respect of each individual case – this was clearly not a practical solution. The Financial Services and Markets Act 2000 (Regulated Activities) (Amendment) Order 2010 (the 2010 Order) introduced a number of amendments to clear up this issue and to confirm that *sukuk* should be regulated in the same manner as conventional bonds. The 2010 Order amended the Financial Services and Markets Act 2000 (Regulated Activities) Order 2001 to specifically state that alternative finance investment bonds are to be categorised as 'specified investments' in the same manner as financial instruments that create or acknowledge indebtedness. The 2010 Order also amended the Schedule to the Financial Services and Markets Act 2000 (Collective Investment Schemes) Order 2001 to specifically exclude alternative finance investment bonds from the definition of CIS, and introduced a new Section 77A, which created a definition of alternative finance investment bonds. This definition is consistent with that set out in the Finance Act 2007.

Notably, the 2010 Order made a number of consequential amendments to other legislation and regulations, including the Financial Services and Markets Act 2000 (Regulated Activities) Order 2001, the Financial Services and Markets Act 2000 (Carrying on Regulated Activities by Way of Business) Order 2001 and the Financial Services and Markets Act 2000 (Financial Promotion) Order 2005. These amendments extend the scope of those regulations to include alternative finance investment bonds. The amendments illustrate a consistent approach taken by successive UK governments in treating Islamic finance as a subset of the universe of conventional financial instruments. This approach indicates that the Islamic finance industry will be held to the same standards as the conventional finance industry in the UK, and contracting parties should expect to be subject to the same levels of scrutiny from the English regulators and courts as their conventional peers.

ii Regulatory and supervisory authorities

The two principal authorities charged with the oversight of Islamic finance institutions (to the extent that such institutions perform 'regulated activities') are the Financial Conduct Authority (FCA) and the Prudential Regulatory Authority (PRA). The FCA is the conduct regulator with supervisory responsibility for Islamic finance in the UK, and all Islamic banks in the UK are required to be authorised and licensed by the FCA. The PRA holds responsibility for the prudential regulation of banks, building societies, credit unions, insurers and major investment firms – including Islamic banks in the UK. The FCA and the PRA each hold Islamic banks and financial institutions to the same standards of regulation as conventional banks, and Islamic banks in the UK are considered to be 'financial institutions' for the purposes of the FSMA. Islamic banks are subject to sanctions and fines in the same manner as conventional banks. The FCA's and the PRA's approach to regulation can be summed up as 'no obstacles, but no special favours'.

Unlike certain other regulatory authorities, such as Malaysia's, the FCA does not have *shariah* scholars who review the *shariah* compliance of a product offered by an Islamic finance institution. Consistent with the UK approach of treating Islamic finance institutions in the same way as conventional firms, the Islamic finance institution would require authorisation to carry on regulated activities and obtain the necessary permissions from the FCA in the ordinary way. However, an Islamic finance institution may need to provide additional information to the FCA in certain circumstances, such as the role, if any, that its *shariah* board performs in relation to operational and financial matters. In addition, UK regulatory bodies have stated that they intend to work with international industry bodies, such as the International Organization of Securities Commissions, which have their own Islamic finance initiatives. The UK's Financial Services Authority (which was the sole UK regulator prior to its split into the FCA and the PRA) also supported moves to develop common *shariah* standards by organisations such as the Islamic Financial Services Board and the Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI). While neither of these standards have been formally adopted in the UK (and therefore do not have any binding legal effect), they are certainly useful in identifying best practice.

Finally, it is worth noting that financial transactions entered into with an individual and not otherwise subject to regulation under FSMA may be subject to regulation under the Consumer Credit Act (CCA) 1974, unless that agreement is entered into wholly or predominantly for business purposes, or one of the other exemptions under the CCA 2006 applies.

II COMMON STRUCTURES

i Consumer finance

Shariah-compliant consumer finance providers in the UK currently occupy a niche space advancing funds to customers in the form of simple *murabahah* financing and offering deposit investments in the form of profit-sharing investment accounts based on the principle of *wakalah*. Prominent consumer finance banks in the UK include Gatehouse Bank, the Bank of London and the Middle East as well as branches of some well-known Middle Eastern banks, such as Abu Dhabi Islamic Bank, Al Rayan Bank and QIB UK.

One of the most interesting recent developments in Islamic consumer financing has been the establishment in the UK of Beehive, a peer-to-peer financing platform that includes a *shariah*-compliant window. Beehive's *shariah*-compliant window uses commodity *murabahah* financing backed by the Dubai Multi Commodities Centre's Tradeflow commodities trading platform, based in the Dubai International Financial Centre (DIFC). If an investor wishes to invest in *shariah*-compliant transactions only, it can indicate that preference in its profile.

Beehive uses the Shariyah Review Bureau, which is licensed by the Central Bank of Bahrain, as its *shariah* board to review potential opportunities for investment. Any investments that are not approved as *shariah*-compliant by Beehive's *shariah* board are not made available to the Islamic investor – these are made available only to conventional investors. Assuming an investment is *shariah*-compliant, Islamic investors may place bids on the Beehive platform to enter into a financing with the end user in much the same manner as a conventional peer-to-peer lending platform. If successful in its bid, the Islamic investor then enters into a *murabahah* contract with that counterparty.

ii Home finance

The primary structures used in home finance in the UK are *ijarah* and an *ijarah* with diminishing *musharakah* structure, which contain many of the features of a conventional repayment mortgage. Under the terms of an *ijarah* mortgage, the bank purchases the property (with title in and to the property registered in the name of the bank) and leases it to the homeowner for a specified period. The homeowner gives an undertaking that, at the end of the specified period, it will purchase the property from the bank using the final lease payment, following which legal title is transferred to the homeowner and title in and to the property is registered in the name of the homeowner. Under the terms of an *ijarah* with diminishing *musharakah* structure, the bank and the homeowner together purchase the property in proportion to the capital put forward by each of them. However, title in and to the property is registered solely in the name of the bank. The homeowner pays the bank rent for the use of that part of the property that is owned by the bank under the terms of the *musharakah*. The homeowner also makes periodic payments to the bank to purchase its remaining interests in the *musharakah* such that the bank's interest diminishes until the homeowner is the sole owner of the property. Once the homeowner has purchased all the bank's interests in the *musharakah* (and thus is the sole owner of the property), title in and to the property is registered in the name of the homeowner and the mortgage terminates.

Islamic banks in the UK also offer rent-only *ijarah* mortgage packages that contain features similar to a conventional 'interest-only' mortgage. In this scenario, the homeowner pays the bank rent for that portion of the property owned by the Islamic bank through the *musharakah* term. At the end of the *musharakah* term, the homeowner is obliged to purchase all the bank's interests in the *musharakah* in one go.

Much of the growth in the *shariah*-compliant home finance market was facilitated by an amendment to the tax laws in the UK in 2003 that removed what had previously been a double charge to stamp duty land tax: once at the date of the joint purchase of the property by the bank and the homeowner (and registration of title in the name of the bank), and a second at the date of the purchase by the homeowner of all the bank's interest in the *musharakah* (and registration of title in the name of the homeowner). This change in tax law is discussed in Section III, below.

iii Insurance

Insurance companies in the UK offer *takaful* products to Muslim customers using structures typical to the *takaful* market. As with many other facets of Islamic finance, London is seeking to become a hub of *takaful* and the Islamic Insurance Association of London (IIAL) was launched in July 2015 with the aim of promoting that goal. Lloyd's of London is a founding member of the IIAL and launched an office in the DIFC in March 2015.

Friendly societies and other mutual insurance companies are potential vehicles that could be adapted to provide *takaful*. Friendly societies in particular have an affinity with *shariah* principles because all contributions to a friendly society are made voluntarily. Friendly societies have evolved in different ways over the years. Since 1992, most have taken advantage of the ability to incorporate, which allows them to undertake a defined range of activities. There would be significant challenges in establishing a new *shariah*-compliant friendly society since, to be authorised by the Financial Services Authority to carry on regulated activities in the UK, the friendly society would need significant amounts of regulatory capital. As a mutual institution, a friendly society does not have shareholders that might provide that capital. On the contrary, Section 5(2)(b)(i) of the Friendly Societies Act 1992 provides, in effect, that only members (or persons connected with members) can receive benefits from the society and the converse of this is also generally held to be true, namely that a person cannot be a member of a friendly society unless he or she (or a person connected) receives insurance or similar benefits from the society.

iv Private equity investments

The leverage that private equity funds obtain in connection with investments normally presents an insurmountable barrier to entry for Islamic investors who, as a result, are unable to invest in conventional private equity funds. Fully *shariah*-compliant funds require tight restrictions on debt and the appointment of a full-time *shariah* supervisory board to approve individual investments, and are expensive to establish. The demand does not appear to have been sufficiently high to make overcoming these obstacles economically viable and, as a result, the Islamic private equity space has not grown with any conviction. Opportunities exist in the synthetic feeder fund space in relation to specific identifiable investments, but this is yet to become a significant tool in the UK private equity market.

v Real estate investments

UK real estate is one of the most popular asset classes for both international and domestic Islamic investors. Local players, Gatehouse Bank and 90 North Square, have offered *shariah*-compliant real estate investment products to Islamic investors for a number of years. Real estate investments typically apply a *wakalah*, *mudarabah* or *musharakah* structure to invest in an underlying portfolio of real estate assets, as well as *shariah*-compliant real estate investment trusts. However, care must be taken around certain *shariah* red flags, including any terms of any underlying leases that may include late payment interest charges. For new assets that are yet to be rented, late payment interest can generally be restructured as a late payment administrative charge – an approach that is common in *shariah* structures. However, with established assets (especially those held by conventional landlords), late payment interest may be embedded in the contracts, and amending such contracts is both impractical and undesirable. In this situation, the documents governing the Islamic investment typically provide that if any *haram* income exceeds a *de minimis* threshold (typically 5 per cent of the total income from the real estate assets) then those amounts should either be directed solely to a conventional co-investor (if there is one) or otherwise to charity.

vi Investment funds

As noted above, the specific requirements of *shariah*-compliant investment funds (such as the requirement for a *shariah* supervisory board), the restrictions on any leverage that may be applied to investments in assets and the need for an annual *shariah* audit have meant that the UK has not seen a high number of *shariah*-compliant investment funds established.

vii Other areas

The UK government became the first sovereign national government outside the Islamic world to issue a *sukuk* with Her Majesty's Treasury's £200 million *sukuk* issuance in June 2014. The *sukuk* was structured as a *sukuk al-ijarah* (being the simplest and most widely accepted Islamic finance structure) and pays out profits based on the rental income from three government-owned properties in lieu of interest. The £200 million sale was more than 10 times oversubscribed by investors in the UK, the Middle East and Asia, attracting orders of £2.3 billion. The interesting aspect of the structure is that it did not adopt the delegate model (the Islamic equivalent of a conventional bond trustee) but opted instead to replicate the structure used for UK government gilts. While a comparatively small issuance by the standards of the UK government, the *sukuk* was intended to act more as a marketing tool for the UK government in its push to promote the UK and London as a centre for Islamic finance.

Following on from that, UK Export Finance participated as guarantor of Emirates Airline's issuance of US$913,026,000 *sukuk* in March 2015. The proceeds of the *sukuk* issuance were to be used to purchase four new Airbus A380-800 aircraft, which would become the *ijarah* assets. In addition to being the world's first *sukuk* supported by an export credit agency, what was particularly interesting about this transaction was that there was a lead time between the issuance of the *sukuk* and the Airbus aircraft being available for delivery. As a result, for the period between the issue date and the relevant aircraft delivery dates, the proceeds of issuance were invested in what were known as 'rights to travel' on Emirates aircraft. This was an example of the UK government seeking to promote Islamic finance in tandem with the interests of British industry (the wings for the Airbus A380 are manufactured in Filton, near Bristol, and Broughton, in North Wales). It is also another example of alternative assets – the rights to travel – being used to underpin *sukuk* and builds on the success of issuances by Axiata Telecom (which utilised airtime vouchers) and FWU Group (which utilised the intellectual property in computer program source code) of *sukuk* backed by alternative assets.

III TAXATION

Reforms to tax law and regulation have led the way in terms of the accommodation of Islamic finance within the laws of the UK. In 2003, Parliament passed the Finance Act 2003, which introduced the concept of alternative property finance to cure the double charge to stamp duty land tax that had affected the Islamic mortgage market up to that point. Under *ijarah* and diminishing *musharakah* structures there are effectively two sales of the property being financed: the first when the bank buys the property from the vendor and the second when the homeowner completes repayment of the financing and buys the property back from the bank. Each of these purchase transactions previously gave rise to a charge to stamp duty land tax, which made the Islamic mortgage market prohibitively expensive. The Finance Act 2003 introduced specific exemptions for Islamic mortgages to ensure that they incurred only one charge to stamp duty in the same manner as a conventional mortgage.

The introduction of the various regulations to facilitate *sukuk* issuance in the UK between 2007 and 2010 also gave rise to a need to include changes to tax law on the basis that the most common structure used for *sukuk* (and the one used for the UK government's *sukuk*) is *ijarah* based on property. The Stamp Duty Land Tax (Alternative Finance Investment Bonds) Regulations 2010 fixed a point of confusion by clarifying that the exemption from stamp duty land tax that applies to a transfer of leases as part of an alternative finance income bond structure will not be denied on the basis of other provisions of those regulations that would otherwise deem such a transfer to be a grant for stamp duty land tax purposes (i.e., the exemption is extended to ensure that an *ijarah*-based Islamic finance instrument is treated in the same manner as its conventional equivalent). These regulations are further supplemented by the Alternative Finance Investment Bonds (Stamp Duty Land Tax) (Prescribed Evidence) Regulations 2009, which prescribe the evidence that needs to be provided to Her Majesty's Revenue and Customs in relation to claims for relief from stamp duty land tax in these circumstances.

The common purpose of this legislation has been to allow Islamic instruments the same treatment as conventional ones by making a distinction between the transfer of ownership of land for the purposes of occupancy or other use and the transfer of a form of ownership of land that is intended purely to facilitate a *shariah*-compliant transaction.

IV INSOLVENCY

There are various structures that can be adopted for a *sukuk* that may affect how it is classified for insolvency, tax and regulatory purposes. *Sukuk*, are, however, typically structured to have the same economic effect as a conventional bond and are treated as such for International Financial Reporting Standards purposes. To date, the treatment of Islamic finance instruments in insolvency remains untested in the UK. Further, no Islamic institution has filed for insolvency or any insolvency-related procedure in the UK, meaning that it is not clear how the English courts would treat any such situation. Whether a *sukuk* is treated as an equity or a debt instrument depends on the structure and the risks and rewards of the *sukuk*. In particular, whether the *sukuk* is asset-based or asset-backed could affect this analysis. Often, it is the case that, from the originator's perspective, the *sukuk* are shown as a financial liability on its balance sheet because it retains control over the issuer entity. From the *sukuk* holders' perspective, the holding would need to be classified into certain categories, such as an instrument held to maturity or a loan and receivable. Legislation now provides that, where certain conditions are satisfied, the return paid to *sukuk* holders is tax-deductible by the issuer, consistent with the treatment afforded to conventional bondholders.

However, it is worth noting that the Financial Services and Markets Act 2000 (Regulated Activities) Order 2010 made certain consequential amendments to legislation necessitated by the inclusion of a new definition of alternative finance investment bonds. These included amendments to the Insolvency Act 1986 to broaden the scope of the definition of 'bond' to include alternative finance investment bonds. This appears to indicate clearly that the intention of lawmakers in the UK is for *sukuk* to be treated in the same manner as conventional bonds and from that we may extrapolate that in the event of insolvency under English law, *shariah*-compliant instruments would be treated in the same manner as their conventional counterparts. Much of this is based on the economic effect of those instruments as well as their legal form, but it is clear that there is no current intention for a separate insolvency regime to be introduced for *shariah*-compliant instruments.

V JUDICIAL FRAMEWORK

i Courts

As a general comment, *shariah* is not applied in the UK and English law does not recognise *shariah* as a system of law capable of governing a contract, on the basis that English law does not provide for the choice or application of a system of law other than a system of national law. This is based on the Convention on the Law Applicable to Contractual Obligations 1980 (the Rome Convention), which requires that a governing law of an agreement must belong to a country (see below on the *Shamil Bank* case). The English courts have, however, taken the (uncontroversial) view that they have jurisdiction to decide cases involving *shariah*-compliant products and structures that are documented under contracts governed by English law. The main question that arises is how English courts – being courts in a non-Muslim jurisdiction – will address matters that concern *shariah* compliance. In particular, will English courts consider matters of *shariah* law in reaching a judgment?

The *Shamil Bank* case[2] looked at the question of conflict of laws between English law and *shariah* law. The full facts of the case are not relevant to the discussion on this topic; what is important is the wording of the governing law clause in the agreements that were in dispute. That clause read as follows: 'Subject to the principles of the Glorious Sharia'a, this Agreement shall be governed by and construed in accordance with the laws of England.'

The defendants advanced a defence that, for the agreements in dispute to be enforceable, the above governing law clause required that they be valid and enforceable both in accordance with the principles of *shariah* and in accordance with English law.

The judge considered whether this gave rise to a conflict of laws point, noting that it is not possible for a contract to be governed by two systems of law. In rejecting the defendants' claim and deciding that the relevant agreements were not governed by *shariah* law, the judge focused on the Rome Convention, which states at Article 3.1 that a contact 'shall be governed by *the* law chosen by the parties' [emphasis added] and which makes clear at Article 1.1 that the reference to the parties' choice of law to govern a contract is a reference to 'the law of *a country*' [emphasis added].

In his ruling, Lord Justice Potter stated that *shariah* is a non-national system of law and agreed with the view of Mr Justice Morison in the original trial that the principles of *shariah* are 'not simply principles of law but principles which apply to other aspects of life and behaviour'. As is noted in many articles and texts on Islamic finance, *shariah* is not a codified body of law; rather it is a collection of strands of jurisprudence developed by separate schools of Islamic thought, based on each school's interpretation of the cornerstones of Islam: the Quran, the Sunnah and the Hadith. These interpretations are often not consistent and sometimes openly contradictory. As such, it is not clear how the reference to 'Subject to the principles of the Glorious Sharia'a' should be interpreted by a judge. As noted by Morison J in his original judgment in this case, 'the application of [*shariah*] principles in relation to matters of commerce and banking were plainly matters of controversy'.

Potter LJ went on to consider whether, instead, the principles of *shariah* had been included in the disputed agreements as a matter of contract. In considering this point, the judge noted that:

2 *Shamil Bank of Bahrain EC v. Beximco Pharmaceuticals Limited and others* [2004] EWCA Civ 19.

> *The doctrine of incorporation can only sensibly operate where the parties have by the terms of their contract sufficiently identified specific 'black letter' provisions of a foreign law or an international code or set of rules apt to be incorporated as terms of the relevant contract such as a particular article or articles of the French Civil Code or the Hague Rules.*

Potter LJ again cited the differences of opinion that are such a particular feature of Islamic finance and noted the lack of any specificity as to which aspects of *shariah* were intended to apply to the agreements in dispute. He therefore held that the principles of *shariah* were not ones to be considered by the court and that 'the validity of the contract and the defendants' obligations thereunder fall to be decided according to English law'.

The *Shamil Bank* case has therefore set the standard under English law that the English courts will consider disputes under English law-governed *shariah*-compliant contracts as matters of English law to the exclusion of questions of *shariah*.

While speculative, it is worth considering whether the judge may have taken a different view as to the application of *shariah* to the contracts had the parties, as an example, specified that the *shariah* principles codified by the AAOIFI in its Shari'ah Standards should apply. AAOIFI's Shari'ah Standards represent one of the few attempts to codify *shariah* and is a standard set of principles to which most Islamic financial institutions elect to adhere.

The position in *Shamil Bank* is supported by the earlier *Symphony Gems* case,[3] in which Mr Justice Tomlinson stated that 'it is important to note – indeed, in my judgment, it is absolutely critical to note – that the contract with which I am concerned is governed not by *Shariah* law but by English law'. This case involved some dispute as to whether an agreement that had been labelled a *murabahah* contract was, in fact, a *murabahah* contract and therefore whether or not the agreement was *shariah*-compliant. That question had wider implications for the case but as to the question of how an English court will review an English law agreement (whether or not it is expressed to comply with *shariah*), the judge continued: 'it seems to me that it is not of any relevance to the issues which I have to decide what are the essential features of a Morabaha [sic] contract . . . it is a contract governed by English law. I must simply construe it according to its terms as an English contract'.

While by no means a weighty corpus of precedent, the fact that there is case law available from the English courts provides comfort to international market participants as to the treatment of Islamic finance contracts that are, for the most part, governed by English law.

ii Cases

As well as the governing law issues considered above, another issue that has been considered by the English courts is whether a claim for *ultra vires* can be made on the basis that a contracting party (who is only permitted to enter into contracts that comply with *shariah*) entered into a contract that purported to be a *shariah*-compliant contract but that may, on its facts, be non-compliant with *shariah*.

The best-known case on this is *Blom Bank*.[4] The facts of the case are, briefly, that Blom Development Bank SAL (Blom Bank) entered into a *wakalah* contract with The Investment Dar (TID), a Kuwaiti investment company. Under the terms of the *wakalah* agreement, Blom Bank was to be paid a return on its *wakalah* investment that purported to be linked to

3 *Islamic Investment Company of the Gulf (Bahamas) Ltd v. Symphony Gems NV & Others* Unreported, 13 February 2002.

4 *The Investment Dar Company KSCC v. Blom Development Bank SAL* [2009] EWHC 3545 (CH).

the profits of the underlying investment (i.e., profit amounts may be lower than anticipated (including zero) and are not guaranteed), but that, according to the terms of the agreement, provided for a fixed return. This meant that rather than taking investment risk, Blom Bank took only insolvency risk on TID. TID is a *shariah*-compliant investment company that is required by its articles to contract only in a manner that is *shariah*-compliant, with those articles stating: 'None of the objectives shall be construed and interpreted as permitting the company to practice directly or indirectly in any usury or non-*shariah* compliant activities.' Blom Bank brought a case for summary judgment, seeking the return of the principle amount invested plus all profit accrued. TID argued that the *wakalah* arrangement was not a true *wakalah* arrangement but rather disguised lending at what amounted to an interest rate. Since this was specifically prohibited by TID's objects, the transaction was *ultra vires* TID.

What is important to note about this case is that no ruling was made on the question of *ultra vires*. Instead, the issue was declared to be unsuitable for summary judgment and referred as a matter for trial. What is equally interesting is that the judgment declared that if the contractual claim that Blom Bank had made against TID for payments due to it under the *wakalah* contract failed as a result of the *ultra vires* defence, a claim in restitution (which Blom Bank added to its appeal in response to the *ultra vires* argument) was likely to succeed. Blom Bank was awarded summary judgment for the principal amount it invested with the question of *ultra vires* and whether or not Blom Bank had a claim for its profit left as questions for trial. This was because the question of *ultra vires* was one for expert determination at trial involving consideration of Kuwaiti law, being the jurisdiction of incorporation of TID. At the time of this case, TID was in considerable financial distress and, having been placed under the protection of the Kuwaiti Financial Stability Law, the case went no further.

What distinguishes the *Blom Bank* case from both the *Shamil Bank* case and the *Symphony Gems* case is the willingness of the court to consider issues of *shariah* compliance in front of an English court, albeit on the limited basis of the consideration of an *ultra vires* defence. As the *Blom Bank* case went no further, it does not provide a conclusive or even compelling guide as to how the English courts will consider issues of *ultra vires* and *shariah* compliance. However, one should also bear in mind that the judge was clear that, in his view, were an *ultra vires* defence to succeed, a claim for restitution would be successful. This may be read to confirm the view that English courts will consider English law-governed Islamic finance contracts as questions of English law only.

This approach was reaffirmed in a recent English High Court case.[5] Dana Gas (an issuer based in the UAE) attempted to render its *mudarabah sukuk* unenforceable on a number of grounds, one of which was that the *sukuk* were not *shariah*-compliant. Although Dana Gas had sought to bring proceedings to adjudicate on this matter in the Sharjah Federal Court of First Instance, a number of the *sukuk* documents were governed by English law, and so Dana Gas also sought and obtained an interim injunction in the English High Court preventing the *sukuk* holders from declaring an event of default or dissolution event in relation to the *sukuk*. In its injunction claim, Dana Gas has referred to the Ralli Bros principle, which provides that an English law contract that requires performance of an act that is unlawful in the place of its performance will not be enforced by an English court. On 17 November 2017, the English High Court ruled against Dana Gas on all grounds.

5 *Dana Gas PJSC v. Dana Gas Sukuk Ltd & Ors* [2017] EWHC 2928.

VI OUTLOOK

The UK has been the most prominent non-Muslim jurisdiction that has sought to promote Islamic finance and has taken concrete steps both through legislation and government-led transactions to promote Islamic finance. On its website, the London Stock Exchange (LSE) boasts that over US$48 billion has been raised through 65 *sukuk* issuances that have been listed on the LSE and such securities can be admitted on either the Main Market, which is a regulated market under the EU Markets in Financial Instruments Directive (2004/39/EC), or the Professional Securities Market, which is a platform reserved for professional investors and is not a regulated market. Further, several *shariah*-compliant institutions are listed on the Alternative Investment Market, enabling the purchase of *shariah*-compliant shares and there are numerous *shariah*-compliant exchange-traded funds based on Islamic indices.

London remains, and is expected to remain as such in a post-Brexit environment, one of the world's premier financial capitals and its expertise in creating complex structured finance products puts it in a strong position to be at the forefront of the development of Islamic finance globally. While no new Islamic finance-specific legislation is expected in the near-term, the UK government has a track record in reacting to the demands of the market as they arise.

In terms of commercial and transactional development, fintech is one of the main focus areas in finance at present and Islamic finance is not immune to this trend. Peer-to-peer financing and crowdfunding would appear to capture the very essence of Islamic finance and the introduction of a *shariah*-compliant platform on Beehive should be the first of a number of similar initiatives. The UK government has done its part to encourage Islamic finance through the issuance of *sukuk*, which has paved the way for UK corporate issuers to follow suit. There can be no question that the legal system in the UK has been suitably adapted to facilitate the growth of Islamic finance and so its future development in the UK looks very positive.

Chapter 13

UNITED STATES

Mona E Dajani and Dong Whi (Tony) Noh[1]

I OVERVIEW

Islamic finance in the United States dates from the 1980s, when two institutions opened on the West Coast. Their services were limited to investment and home finance, and were available only regionally. From the late 1990s, the market size grew significantly, paralleling the growth of the Muslim population in the US: from 50 per cent in the 1990s to 66 per cent in the 2000s.

There are currently 25 Islamic financial institutions in operation in the US, the top three of which, according to asset size, are the American Islamic Finance House, University Bank (through its subsidiary University Islamic Financial) and Harvard Islamic Finance Program. In 2013, JP Morgan started to offer Islamic banking services. Investment banks such as Standard Chartered Bank followed and now offer Islamic banking products in Asia, Europe, the Middle East and the US. Recently, in the US commercial real estate sector, banks such as Malaysia-based Maybank, Kuwait-based Warba Bank and National Bank of Kuwait, Italian bank Intesa Sanpaolo and MASIC, a Saudi private equity investment firm controlled by the Al Subeaei family, have participated in commercial Islamic finance transactions in the US in connection with commercial real estate.

Retail banks operate in several states: University Islamic Financial (a subsidiary of University Bank), based in Ann Arbor, Michigan, is the first and only exclusively *shariah*-compliant bank in the US; Devon Bank in Chicago regularly offers Islamic finance services; Guidance Residential, in Reston, Virginia, is the biggest non-bank financial institution that offers Islamic finance services; and another large Islamic mortgage lender is LARIBA, in California, which also provides business financing.

Shariah requirements have made further proliferation of Islamic finance difficult. Possibly because US investors are still unfamiliar with *shariah*-compliant products, the secondary market for Islamic financial products is smaller in general. The result has been that Islamic mortgage lenders have had difficulty in remaining liquid, stemming further growth of the market. Starting in 2001 and 2003 respectively, Freddie Mac and Fannie Mae, the US housing agencies, had bought Islamic mortgage products to provide extra liquidity in the US Islamic finance market. They have now grown to become the main investors in Islamic mortgages – by 2007, Guidance Residential had been relying on Freddie Mac for more than US$1 billion in financing.

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II LEGISLATIVE AND REGULATORY FRAMEWORK

i Legislative and regulatory regime

Unlike the United Kingdom, where there is a plethora of Islamic financing services, there are no US laws specifically addressing Islamic banking in the US. Moreover, the US market for Islamic financial products is much smaller than that of the UK, where there are US$19 billion worth of assets owned by Islamic financial institutions, and more than 20 banks, six of which exclusively provide *shariah*-compliant products. The number of Islamic finance services in the UK is also larger than in the US. Five of the services in the UK are *shariah*-compliant and are behind some of the biggest building projects in London (including the Shard, the Olympic Village, Chelsea Barracks, the Battersea Power station site), the North West and the Midlands (more than 6,500 new homes). In fact, although Islamic finance transactions constitute only 1 per cent of global financial assets, about a quarter of the world's population is Muslim, which is a leading indicator of the growth potential in the United States. Another unexpected leading indicator that has already shown signs of an uptick in the US market is Brexit, whereby London's euro clearing market is expected to cut almost 40,000 jobs in its banking industry.

The same stringent licensing and supervision standards that are applicable to the conventional US financial institutions also govern financial institutions offering Islamic finance services. Therefore, Islamic financial institutions (IFIs) operate as state-chartered entities subject to state and federal laws regulating corporate governance, and banking and insurance operations.[2]

Conventional banking institutions typically use their subsidiaries for Islamic finance transactions. The principal challenge faced by Islamic finance service providers in the US is therefore to offer products that comply with both *shariah* and the applicable state and federal banking regulations. However, unlike conventional US banking regulations, regulation of Islamic finance in the US is market-driven; federal and state regulators respond on a case-by-case basis to applications and inquiries from IFIs that want to offer Islamic financial products in the US. Consequently, any organiser of a *shariah*-compliant bank in the US must confront the challenge of introducing new financial products or services to regulators, and meet significant creditworthiness requirements.

Another regulatory challenge might be the limited number of permissible investments that commercial banks are allowed to make. In the US, any investment made by banks must be limited to fixed-income, interest-bearing securities, which *shariah* prohibits. Moreover, US consumer credit laws require that commercial banks have reporting and disclosure requirements that may be inconsistent with *shariah*. For instance, the Truth in Lending Act of 1968 requires that banks disclose annual interest percentage rates, which is strictly prohibited by *shariah* law. On the other hand, a US financial institution may have a hard time employing *murabahah* or *ijarah* structures to finance the purchase of an asset (e.g., a car or home) if required under the state law to qualify as a licensed leasing company or auto lender.

2 See United States chapter in *Getting the Deal Through: Islamic Finance & Markets*, 2017 (contributing editor John H Vogel), at 55.

ii Supervisory regulatory authorities[3]

As stated above, both federal and state laws regulate the banking industry in the US whether conventional or Islamic. The national regulators include the Board of Governors of the Federal Reserve System (the Federal Reserve), the Federal Deposit Insurance Corporation (FDIC), and the Office of the Comptroller of the Currency (OCC), and the state regulators are responsible for banking activities in each state. A bank in the US must be licensed by either the OCC or an applicable state banking authority, and is supervised by the Federal Reserve and the FDIC. All deposit accounts offered by US banks are required to be insured by the FDIC, which is intended to ensure the overall 'safety and stability' of financial institutions.

US regulators have issued certain opinions applicable to the Islamic finance industry. Preliminarily, while the Federal Reserve approved *shariah*-compliant retail financing products in the US, the Federal Reserve focused on the substance of the products. The Federal Reserve subsequently influenced the OCC to issue opinions aimed at reconciling apparent conflicts between *shariah* and the federal and state laws, and their respective regulations. For example, the US National Bank Act of 1864 prohibits US financial institutions wishing to offer *shariah*-compliant lending services from purchasing, holding legal title to or possession of real estate to secure debts with terms over five years. The OCC issued two interpretive letters, which addressed the special concerns of clients who would otherwise be forced to choose either their religion or their home or business.

Although certain types of *murabahah* and *ijarah* financing are allowed under US laws, the OCC reconciled *musharakah* and *mudarabah*'s apparent violation of federal regulations that prohibited commercial banks from forming partnerships or holding common stock. The OCC allowed commercial banks to take 'as consideration for a loan a share in the profit, income or earnings from a business or enterprise of a borrower'.[4] This interpretation created an opportunity for commercial banks to derive equity return from a loan deal without relying on interest, despite the still-intact prohibition against making true equity investment. US credit unions have also adopted a communal or partnership model that complies with *shariah*.

Savings associations can form joint ventures and own properties through a subsidiary servicing company. These institutions may easily obtain real estate financing through *murabahah* and *ijarah* structures as well as limited joint venture possibilities through *musharakah* and *mudarabah* transactions.

III COMMON STRUCTURES

i Home and other retail finance

Retail Islamic finance has been well established in the US since the OCC approved the *ijarah* structure for home lending in 1997 because it is 'functionally equivalent' to conventional

3 The first two paragraphs were adopted from the first edition of *The Foreign Investment Regulation Review*, written by Andrew M Metcalf.

4 Code of Federal Regulations of the United States of America, 12 CFR Ch. 1 (1-1-00 Edition), §7.1006.

secured real estate lending.[5] Similarly in 1999, the OCC approved the use of the *murabahah* structure for home financial products as it was deemed to be 'functionally equivalent' to conventional real estate mortgage transactions, or inventory or equipment lien agreements.[6]

The OCC opined that under such structures the bank's ownership of the property is only for 'a moment in time' because of the simultaneous nature of purchase and sale transactions. Therefore, the Islamic contracts, the OCC concluded, avoid the type of risk that existing restrictions aimed to limit. In terms of accounting, the bank records the loan as an asset on its balance sheet. The borrower is required to maintain the property and pay all expenses. If the borrower defaults, the bank may sell the underlying property to recover the amount owed, as in a mortgage transaction.

Musharakah is also used for home financing in the US. It is a 'rent to own' financed sale of property where the bank first purchases the property and the customer pays the bank over time the full price plus a cost. With each rent payment, the customer earns a portion of the property's ownership. Under this equity-based structure (also called 'diminishing *musharakah*'), when the customer sells or disposes of the property, losses are shared between the customer and the bank as co-owners based on their percentages of ownership. The bank's return is taxable income to the bank and deductible by the borrower.

ii Insurance

Deposit insurance, which banks use for stability, is inconsistent with *shariah* because a bank having insurance alters the risk-sharing structure required under *shariah*. Therefore, *takaful*, a cooperative form of reimbursement that comes from a fund to which entities contribute regularly, does not work in the US. Reinsurance is necessary in the US because of high minimum capital requirements, but there are not many *retakaful* services. Although structuring a product around this impediment in the US is technically possible, it has been a strong enough practical impediment to prevent further growth of the Islamic insurance market. Another serious obstacle to the successful introduction of *takaful* and *retakaful* in the US is the Establishment Clause of the First Amendment to the US Constitution. Establishment Clause challenges are analysed under a three-part test, to establish that (1) there is a secular purpose, (2) religion is neither advanced nor inhibited, and (3) it does not foster excessive government intervention.[7]

Each state has its own licensing requirements for insurance companies operating in the state, which generally prohibit the proliferation of *takaful*. To be licensed, an insurance company must prove its experience, management capability and sound finances. It must also justify its premium rates, and meet or exceed the solvency requirements. Even after it becomes licensed, an insurance company is often limited in choosing the types and concentrations of fixed-income investments that it must make with its reserves. Moreover, if the insurer becomes insolvent, an emergency loan must be taken out of the shareholders' fund to help meet obligations arising out of the insolvency. This could be a problem in *takaful* insurance, because capital requirements imposed upon the insurance companies

5 OCC Interpretive Letter No. 806 (17 October 1997), [1997–1998 Transfer Binder] Fed. Banking L. Rep. (CCH) 81-253 (Islamic Home Finance Leases).
6 OCC Interpretive Letter No. 867 (1 June 1999), [1999–2000 Transfer Binder] Fed. Banking L. Rep. (CCH) 81-361 (Murabaha Financing Products).
7 The so-called 'Lemon Test': *Lemon v. Kurtzman*, 403 U.S. 602 (1970).

may not accurately reflect the separation between the fund for policyholders and that for shareholders. Nonetheless, some *takaful* are subject to a lesser degree of oversight from the state insurance regulators.

Despite the difficulties associated with *takaful*, American International Group Inc (AIG) first started to offer Islamic homeowner *takaful* insurance in the US in 2008. Currently, AIG's underwriting subsidiaries, Risk Specialist Companies Inc and Lexington Insurance Company, issue *takaful*. Zayan Finance, a New York-based Islamic financial services firm, is the exclusive broker that offers *takaful* in many states. AIG also maintains a *shariah* board made up of Islamic scholars who have given legitimacy to the *takaful* alternative to conventional insurance in the US market.

iii Real estate investment

Islamic finance has widely used real estate on which to base *shariah*-compliant financial structures. Prime or trophy assets (e.g., hotels or large office headquarter buildings) have been its focus. Thanks to rental guarantees, stable demand and rising rental payments, dorms and other student accommodation have also effectively attracted Islamic funds. Further developments may be achieved by expansion of the scope of social infrastructure to include education, healthcare and social housing sectors. Since 2010, however, Islamic funds and banks that offer mezzanine finance have proliferated. Here, a conventional senior bank provides a loan with interest, the investors provide the equity and the mezzanine financing is placed in a *shariah*-compliant way. The senior conventional bank and the *shariah*-compliant mezzanine lender enter into an intercreditor agreement governing the way in which each of their loans is treated while conforming to the mezzanine lender's Islamic sensibilities.

Murabahah is the most popular type of structure used for real estate investment in the US. A typical *murabahah* structure contains an unconditional contract of sale with a cost price, markup and payment date predefined. The profit from the marked-up sales price is paid in instalments. One of the largest examples of recent real estate investments done under *murabahah* is the US$219 million syndicated construction loan for 45 Park Place, a luxury condominium tower in Manhattan, New York.[8] It was led by Malaysia's Maybank and Kuwait's Warba Bank; Italy's Intesa Sanpaolo and MASIC, the investment arm of Saudi Arabia's Al Subeaei family, also participated.[9]

One advantage of *murabahah* is that it may not require credit support. Here, the bank pays the seller for the property for immediate sale to the buyer for the cost plus a profit pursuant to a *murabahah* agreement. A *murabahah* transaction has also been used to refinance a conventional loan to allow the borrower to withdraw cash to pay off interest-bearing obligations, subject to the advice of the *shariah* scholars. For US tax purposes, the profit piece of the purchase price in a *murabahah* transaction is deemed to be interest, such that it is taxable to the IFI and deductible by the customer.

An *ijarah* is a lease structure used in acquiring real estate as well as in other acquisition finance contexts (e.g., aircraft, ship or project finance). Under *ijarah*, a bank purchases a property and places the ownership over the property in a holding subsidiary and then leases it to the buyer for its use pursuant to the *ijarah* lease. Typically, title to the property is only transferred to the borrower after full payment of the cost of the property. The customer

8 Anna Nicolaou, 'Manhattan tower secures $219m in *sharia*-compliant financing', Financial Times (19 May 2016), https://www.ft.com/content/cf6c3a88-1c4d-11e6-b286-cddde55ca122.

9 id.

pays rent to the bank, which consists of, among other things, the purchase price and the profit. Unlike in a conventional finance lease transaction, the bank, acting as an owner and a lessor, has obligations to insure and undertake major maintenance of the leased asset. These obligations may, however, be contracted out to the borrower, who acts as a lessee. The lessee is responsible only for payment of the rent while the lessee continues to use the asset, so the *ijarah* structure cannot become effective before completion of the leased facility construction. Unlike in conventional leases, under an *ijarah*, if there is a total destruction or condemnation such that the property cannot be used for its intended purpose, the rent payment will cease. The lease-to-purchase model (i.e., *ijarah wa iqtina*) is also frequently used in real estate investment in the US. Under the laws of most states, the transaction can be simplified by having the client immediately take title to the property at the initial purchase.

iv Investment funds

A *mudarabah* agreement is formed between two partners, with one contributing capital to invest in some form of commercial enterprise, while the other provides the expertise and management experience. The capital contributor is known as the *rab-al-mal* and the managing partner is known as the *mudarib*. This type of structure is typically used for funded participating arrangements and establishment of an investment fund. The *rab-al-mal* and the *mudarib* share the profit generated from the investment in accordance with pre-agreed profit sharing ratios. However, any loss of capital is assumed by the *rab-al-mal*.

v Other areas

There have been two major *sukuk* issuances in the US – the East Cameron Gas *sukuk*, the first *sukuk al-musharakah* in the US, which was backed by oil and gas assets, and the General Electric *sukuk al-ijarah*, which was backed by aircraft leases. The East Cameron *sukuk* has gone into bankruptcy, but the General Electric *sukuk* is performing well. Both Illinois and New York have begun their efforts to enact legislation to recognise *sukuk*.

For commodity trading, *tawarruq* is used, which essentially is a reverse *murabahah*. Under this structure, a bank buys freely tradable commodities such as platinum and copper (other than gold and silver since they are considered currency) at market value for spot delivery and spot payment, and then immediately sells them, at an agreed price that contains the profit, to the customer on a spot delivery and deferred payment basis. The customer immediately sells the commodities at market value to a third party for spot delivery and spot payment. The end result is that the customer has received a cash amount and has a deferred payment obligation for the purchase price to the bank. Under the *tawarruq* structure, the profit piece of the purchase price also takes into account the bank's commodity risk and third-party supplier risk, in addition to the creditworthiness risk of the customer.

vi Combining conventional and *shariah*-compliant financing capital stack

A *shariah*-compliant lender may participate in a capital stack structure in a transaction that uses both *shariah* and conventional financing, by delineating the assets and the cash flows in the transaction.

In certain circumstances, *shariah*-compliant and conventional lenders may enter into a formal intercreditor agreement that sets out the priority of payments and the ranking of security. This is most likely to occur when the structural subordination is not possible and the borrower under both the conventional and *shariah*-compliant finance is the same entity. The intercreditor agreement between *shariah*-compliant and conventional lenders is likely to address many similar matters covered in such an agreement between solely conventional lenders. Matters that could be addressed may include (1) allocation of the borrower's operating income; (2) allocation of proceeds following acceleration on default; (3) disputes and governing law; and (4) what the different lenders can and cannot do in respect of their facilities.

IV TAXATION

Islamic finance raises many US taxation issues, including strong tax incentives for debt over equity, the tax treatment of sales and additional layers of transactions in certain instruments. In addition, differences in the tax treatment of Islamic and conventional finance could cause cross-border spillovers and encourage international tax arbitrage. For instance, the Internal Revenue Service has yet to issue official guidance on tax deductibility of the payments made under *ijarah* and *mudarabah* structures and on partial treatment of such payments as interest. Real estate transfer taxes and mechanic's liens present another challenge because the *shariah*-compliant financing structures often require multiple transfers of the property with heavy fees incurred by parties with each transfer (e.g., property being purchased by the bank first and then transferred to the borrower). The State of New York has abolished these fees for transactions executed under *ijarah* and *mudarabah* structures, but many other states do still charge.

V OUTLOOK

Globally, Islamic finance has grown in terms of asset size by more than 20 per cent annually since the 2007–2008 financial crisis. Islamic banks are not outperforming other banks as a rule, since what they gain in safety, largely as a result of restrictions placed by *shariah* principles, they may lose in efficiency. It is during crises that the differences appear to have a material effect on performance. Two independent studies by the International Monetary Fund and the Islamic Financial Services Board found that Islamic banks demonstrated superior performance following the 2007–2008 crisis.

Nonetheless, while slow for the past two years and despite geopolitical pressures, for a variety of political and financial reasons, it is estimated that Islamic finance is on the rise in other countries, including the US. Just 20 years ago, there were few Islamic financial products being offered in the US. The opportunity cost for the US dollar, especially in light of Brexit, is quite large in not participating in this global market and opportunity at this moment in time. It is recommended that the US takes steps to introduce the rules and regulations required to engage in worldwide Islamic finance, *sukuk* and *takaful* business. Interest-free financing modes may enhance the system currently in use in the US, and offer a chance for Americans to diversify their portfolios, attract global investors, enhance liquidity and compete in the global village.

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John Dewar is a partner in the London office of Milbank, Tweed, Hadley & McCloy. He is a member of the firm's global projects, energy and infrastructure finance group and leads the firm's Islamic finance practice. John is widely recognised as a leading individual in his field by a number of Islamic finance lawyer journals, among them: *Chambers UK* (which designated him among the first tier in the UK), *Chambers Global*, *The Legal 500*, *Who's Who Legal: Project Finance* and Euromoney's *Expert Guides (*which ranks him among the top 30 lawyers in the world in their *Best of the Best* guide for Islamic finance). He has built an extremely broad practice and outstanding reputation for advising on the most innovative and significant 'market-first' transactions around the world, and has particular expertise in multi-sourced financings, including those involving Islamic institutions and multilateral and export credit agencies. John is also editor of *International Project Finance Law and Practice* published by Oxford University Press and co-author of that publication's Islamic finance chapter.

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Naoyuki Kabata has been involved with an extensive range of financial transactions at Anderson Mōri & Tomotsune, including securitisation, asset management and investment funds, project finance, private finance initiatives and leveraged buy-outs. He advised a fund affiliated with an Islamic bank in Kuwait on their acquisition of real properties in Japan involving the sale and leaseback structure to comply with *shariah* requirements, which is said to be the first transaction using Islamic finance techniques in Japan.

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He regularly advises on the development of *shariah*-compliant investment products and investment structures.

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He also advises in the area of wealth management, including in relation to private family structures and investments, and he advised on the development of a *shariah*-compliant wealth management division for a major regional bank.

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Tony started his career at a leading Australian firm in Sydney where he gained broad experience in banking and corporate transactions. He then worked in-house at one of Australia's largest investment services groups, where he focused on funds establishment and capital markets and structured finance transactions.

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Omar has noted expertise in Islamic finance and investments. He is a visiting professor of Islamic finance law at IE Business School in Madrid, Spain. He is also an expert member of the Sukuk Standardization Working Group of IIFM in Manama, Bahrain. Omar holds a PhD in *sukuk* (Islamic securities). He has been teaching, and conducting research on, Islamic finance law at various universities worldwide (among others: the University of Oxford, the University of Cambridge and the University of Melbourne) and is a frequent speaker at international conferences.

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Sera advised on the first international *sukuk* issuance by the Republic of Turkey and the first *sukuk* issuance by a Turkish Islamic bank. She also works on *murabahah* syndications of Turkish participation banks as well as their annual *sukuk* issuances.

Sera also advises on regulatory mergers and acquisitions across a variety of sectors with a focus on banking M&A transactions.

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ISBN 978-1-912228-61-4