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BRIEFING

Islamic asset finance

Summary

Islamic finance, a way of raising funds in accordance with Sharia principles, is no longer confined to a few specialised institutions and is becoming increasingly popular in the mainstream market. This briefing explains in more detail what Islamic finance is, how Ijara-based financing works and why it is becoming so attractive to financiers worldwide.

Just doing it

Once viewed as the realm of a small number of specialised institutions, Islamic finance has now moved into the mainstream, with specialised regional Islamic institutions experiencing a significant growth and global banks such as HSBC, Citibank and UBS coming into the market.

In July 2003 HSBC became the first mainstream UK bank to offer mortgages in the UK designed to comply with Islamic law or Sharia using the Ijara (lease-based finance) structure. That month also saw United National Bank Ltd launch its first Islamic product in the UK, the UNB Islamic mortgage, also based on the Ijara model. This move followed the government's decision in April 2003 to remove double stamp duty on home purchases under Sharia-compliant borrowings, so opening the path for this type of product.

What is Islamic finance?

Islamic finance is finance in accordance with Sharia principles. It is not confined to the Middle East or to the Muslim world. In fact, in some countries, such as Malaysia, a significant number of non-Muslim Chinese and Indian customers access Islamic banking products and services. The providers of these products and services believe that if Islamic banking offers a better alternative, the clients will opt for it no matter what their religious affiliation is.

One of the essential pillars of Islamic finance is the prohibition of payment or receipt of interest, or *riba*. Lending and/or dealing in money in the same way as you

would trade commodities is prohibited. Returns on lent funds must be based on actual profits generated and not on a pre-determined interest rate. The financial institution lending the money must take part in the risk to make a legitimate gain in accordance with Sharia law.

Another core principle of Islamic finance is the prohibition of investment in businesses engaged in the alcohol, gambling, drugs or tobacco industries, or any other industry engaged in activities deemed unlawful. Sharia law also provides that capital must have a social and ethical purpose beyond pure, unfettered return. Other fundamental Sharia proscriptions are *maisir* (gambling and speculation) and *gharar* (uncertainty in contracts).

Islamic finance structures are increasingly used in aircraft finance and are not restricted to lessees based in Islamic countries. These structures provide an opportunity to tap into the significant funds of Islamic investors seeking Sharia-compliant investments and can be combined with conventional funding sources and export credit agency support (Dubai's Emirates Airline recently closed an innovative transaction combining Islamic investment with ECA support).

In addition, the aviation industry is, in principle, Sharia-compliant and the financing is asset-based, making it a good choice for Islamic investors. Emirates has frequently used Islamic leases to finance its fleet expansion. In 2002 it financed additional Airbus A330s through Islamic lease structures. Other Asian carriers, such as Thai Airways, SyrianAir and Royal Brunei Airlines, already lease aircraft

under Islamic-style leases. The 2002 Brit Air sale and operating leaseback of six CRJ-100 aircraft is a good example of a structure that combines conventional lending with Islamic investment. Similar transactions were closed during 2002 involving other European carriers, such as British Airways. As Bruno Lecerf, CFO of Brit Air, said after collecting the 2002 *AirFinance Journal* Most Innovative Deal of the Year award for the Brit Air 2002 transaction, 'it was a sophisticated transaction, but the pricing was very attractive'.

Many of these transactions are based on the Ijara structure, which is one of the more traditional Islamic methods of financing now increasingly used across the globe. An Ijara is a form of leasing contract that is permitted under Sharia law. It provides for the financing of assets by the financiers at the request of the client in return for an agreed rental.

So, what are the differences between an Ijara contract and a non-Islamic lease? Not many. Sharia law does not object to payment for the use of an asset. The lessor will acquire the asset and will lease it to the client for an agreed sum, payable in instalments over a period of time. Ijara contracts may be entered into for the long, medium or short term and may be adapted to fulfil the functions of either conventional finance or operating leases. Moreover, these contracts can be subject to English or New York law (in international transactions, Sharia compliance is a moral rather than a legal issue). There are, however, a few significant differences between a conventional Western lease and an Ijara lease. Four of the main differences are discussed below.

Rental payments based on interest

Where an asset is financed by way of floating-rate funds, the owner will usually pass the risk of rate fluctuations down to the lessee through the rentals payable by the lessee. This creates a problem in the Islamic context where lease rentals cannot be expressed by reference to interest rates.

This difficulty is, to a certain extent, surmountable. In leasing transactions the lessor is providing an asset, not funds, so the return is in the form of rent, rather than principal and interest. The lessor is, in effect, using its funds productively to invest in an asset and is accepting the associated risk. In an Ijara lease the amount and timing of the lease payments should be agreed in

advance, though the agreed schedule and amount of those payments need not be uniform.

In some leases the problem has been overcome by referring to the rental payable under the lease at the date of signing, but subject to adjustments by reference to provisions in other documents. In another lease, the rent was adjusted by cross-reference to fluctuating rentals payable under a non-Islamic lease being signed at the same time and at the same rentals. Other transactions have included a rental adjustment letter linking rentals to the London interbank offered rate.

Default interest

Western conventional leases usually provide for default interest on late payment of amounts due, which is not possible in Islamic leases. In an Ijara lease the same effect can be achieved in different ways, for example by providing for some form of discount formula, where an agreed rate of discount is applied for each day that payment is made prior to a backstop date. The backstop date is chosen to reflect a commercial period in which funds might be expected at the latest to be paid. However, if payment is made after the backstop date, then the lessor cannot recover any additional amount.

In other leases we have seen late-payment fees replace the conventional default rate of interest.

Insurance and maintenance

In contrast with most conventional leases, in an Ijara lease the responsibility for maintaining and insuring the leased asset remains that of the lessor throughout. Therefore, the owner/lessor will agree in the lease to procure the maintenance and insurance of the asset.

The conventional position of the lessor relieving itself of these burdens can be achieved within the Ijara framework if the owner/lessor recovers the insurance costs by increasing the rental payments and if the lessor appoints the lessee or another third party as its agent to obtain the required insurance in return for a fee.

Maintenance obligations can be dealt with in a similar way, where the lessor agrees in the lease to perform all maintenance and repair obligations but appoints the lessee or another third party to perform such obligations on behalf of the lessor in return for a fee. The extent to which maintenance responsibilities have been transferred

is usually reflected in the lease payments due from the lessee.

Sharia board clearance

One distinct feature of the modern Islamic finance movement is the role of the Sharia board, which forms an integral part of an Islamic financing institution.

The role of the Sharia board is to monitor the workings of the Islamic financing institution from a Sharia standpoint and to review every new transaction to make sure that it is Sharia-compliant. These boards include some of the most respected contemporary scholars of Sharia law. Yet Sharia law is open to interpretation and Sharia boards often have divergent views on key Sharia issues. In this regard, there is no practical guide as to what constitutes an acceptable Islamic financial instrument, and the suggestions mentioned above, which are designed to achieve the same effect as conventional leases within an Ijara framework, need to be viewed in this light. A document or structure may be accepted by one Sharia board but rejected by another.

So why use Islamic finance?

Given the added complexity and uncertainty, you may be asking yourself why non-Muslims would agree to use Islamic finance structures. The answer lies in a combination of availability of funds, a demand for fund diversification and, occasionally, a pricing advantage to such structures, particularly those that adhere most strictly to Sharia principles.

Sukuks (commercial paper providing the subscriber with ownership or part ownership in the underlying asset) are becoming an attractive investment instrument. The Ijara-based Sukuk is the most common and well established, but Sukuks have been developed under other Sharia-approved financing methods.

With over 250 Islamic finance institutions worldwide, Islamic finance continues to expand both geographically and in product richness, and this despite the difficult conditions in the global financial markets and the regional uncertainties of the past year. In aircraft finance, there has been an increase in the number of new airlines tapping into the market. As the orders at the 2003 Paris air show have shown, the Middle East is set to be one of

the world's growing aviation markets. Retaining 'conventional style' documentation and a bankable governing law together with a greater consistency in approach among the Sharia boards seem to be key aspects in the growth of Islamic finance. The Islamic Financial Services Board, an association of central banks, monetary agencies and governmental organisations, was established on 3 November 2002 to develop universal Sharia-compliant finance standards and harmonise practices in the Islamic financial services industry. It is still early days, but things appear to be moving in the right direction for Islamic aircraft finance.

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