

# Contemporary Islamic Finance: An Introduction to Essential Structural Concepts

*By Michael J.T. McMillen*

This is a continuation of Michael J.T. McMillen, *Contemporary Islamic Finance: An Introduction to Essential Concepts*, 38 INTERNATIONAL LAW NEWS 4 (2009), at 1. The topics discussed in that article and this continuation are addressed in detail in:

Michael J.T. McMillen, *Contemporary Islamic Project Finance: An Introduction to Principles and Structures*, Global Infrastructure, Volume III, Fulbright & Jaworski (2009), which covers all the material presented in both the newsletter and this extension, and includes a bibliography;

Michael J.T. McMillen, *Shari`ah-compliant Project Finance: Collateral Security and Financing Structures*, 24 Fordham International Law Journal 1184 (2000), which describes three transactions from the late 1990s, each of which is in use today: (i) a *rahn-adl* collateral security structure used in The Kingdom of Saudi Arabia; (ii) *ijara* transactions in the United States of America; and (iii) a diminishing *musbaraka* (then called a *sharikat mahassa—murabaha* for a power project in The Kingdom of Saudi Arabia; and

Michael J.T. McMillen and John A. Crawford, *Sukuk In the First Decade: By the Numbers*, Dow Jones Islamic Indexes Newsletter, Issue 3, December 2008, which provides a statistical summary of all *sukuk* issuances from industry inception through November 7, 2008.

Copies of these articles are available from Michael J.T. McMillen at [mmcmillen@fulbright.com](mailto:mmcmillen@fulbright.com).

## Common Shari`ah Structures

### Bifurcated Structures

Most modern Islamic finance transactions involve both a conventional interest-based financing element and a Shari`ah-compliant structure. They are “bifurcated transactions”: children of history and the predominance of interest-based financing.

In the late 1990s and thereafter, Middle Eastern investors sought to use Shari`ah-compliant structures in leveraged U.S. investments. The first transactions were real estate and private equity investments of modest size. The response of U.S. banks, in 1999, when they were asked to do

Shari`ah-compliant financings for these transactions, was incredulity. Persuading conventional banks to become “partners” with these investors on these transactions was a “non-starter.”

Lawyers for the investors determined that the easiest approach was to identify a Shari`ah-compliant structure that was familiar to these U.S. banks, and accommodate that structure to U.S. constraints and market practices. Banks would participate in Shari`ah-compliant transactions only if they could make conventional loans, in the same manner as they always had, using the familiar conventional underwriting and credit standards, risk-allocation criteria, collateral security structures, and documentation. The *ijara* (lease) was chosen because of its ubiquity in both Western and Islamic realms. Transactions were structured on leveraged lease models as “bifurcated transactions.” “Risk grids” demonstrated that the structures adequately and satisfactorily addressed all risks covered in conventional documentation. Concerns about regulatory issues were eliminated, and bank operations were unchanged.

Familiarity begets comfort. Conventional bank participation in Islamic finance quickly spread, and soared, as hundreds of Shari`ah-compliant transactions were done in the United States, and later in Europe. Structures developed in the United States in these years now predominate globally. Willingness to explore other structures increased. Conventional banks are now an integral part of the Islamic finance industry and they actively seek to enhance their competitive advantage by participating in a wider range of Islamic finance transactions. Some of the commonly used structures are discussed in the remainder of this article.

### **Murabaha**

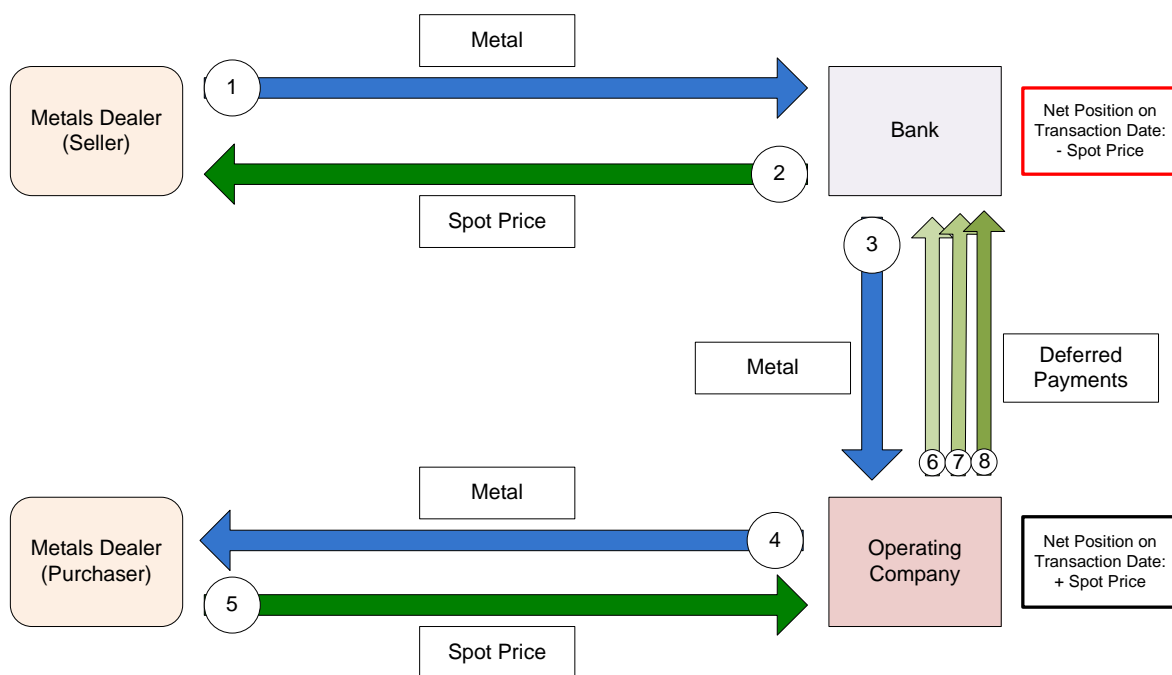
The *murabaha* is the most frequently used, and the most frequently abused, Islamic finance structure. It is a trade-based, nominate “cost-plus” sale contract in which the cost is ascertained and expressly disclosed. Originally, it had nothing to do with financing, but the current focus is primarily on its use in financings. In financing transactions, the financier purchases, from a third party, an asset (usually a commodity) that is desired by the party needing financing and then sells that asset to the needful party on a deferred payment basis at a *disclosed* cost plus a profit margin.

The *murabaha*, in any context, must conform to the Shari`ah requirements pertaining to sales. The price and payment date(s) must be certain and fixed at the inception of the transaction. The price may not thereafter be increased or decreased, even if payment is late or early. At the time of sale, the object of the sale must be in existence and be owned and actually or constructively possessed by the seller, who must have the risks of ownership and possession. The sale, and

delivery, of the asset may not be contingent or conditional. If a deferred payment is involved, the due dates and periodic amounts must be certain, and may not be fixed to an uncertain event.

Only a little imagination is necessary for the conversion of the *murabaha* to a conventional loan equivalent—and that is frequent in practice. In the oft-utilized “metals *murabaha*” (a) the bank purchases a permissible metal (not gold or silver) from a dealer on a spot market basis, (b) the bank sells the metal to the party desiring financing on a deferred LIBOR-based basis, and (c) that party sells the metal to a metals dealer on a spot market basis. The formalities are observed, but the commodity is not itself the true object of the transaction. Figure 1 illustrates a metals *murabaha* transaction; the transactional sequence is indicated by the encircled numbers.

Figure 1: Metals *Murabaha* Financing Transaction



Copyright © Michael J.T. McMillen

Many practitioners encourage the use of the *murabaha* as a loan substitute, assuring their clients of easy adaptability and conformity to the loan format. That is more than a little misleading. The *murabaha* is a complex sale transaction. Consider one issue: how to provide the financier with an enforceable commitment fee obligation from the time of execution of the agreement to the first

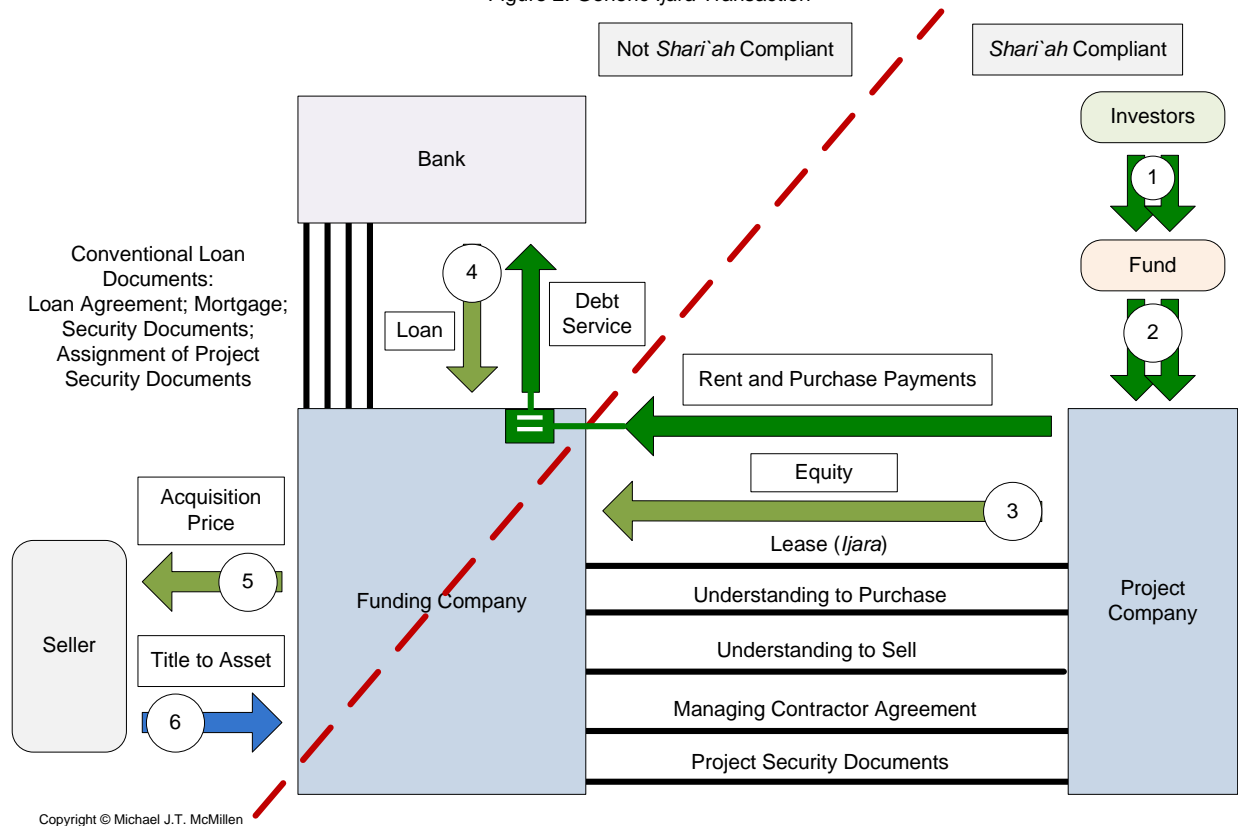
drawdown, and thereafter in respect of each payment period. The commitment fee can only be known retroactively (it is computed on undrawn commitment during a period). It is commonly proposed that the commitment fee from the preceding period be used as the fixed amount for the next period. This presents obvious difficulties if the facility is never drawn. And the accumulated commitment fee during any given period never becomes payable unless a *murabaha* is done after that period. There are solutions to these, and a raft of other similarly vexing, issues. But the solutions are far from simple.

### **Ijara**

The *ijara* (lease) is the most widely used structure in sophisticated Shari`ah-compliant transactions. It is a lease of an object or services involving the transfer of the usufruct or *manfa'a* for a rent consideration. The nature of the *manfa'a* must be precisely defined, the rent must be a fixed value, whether payable in a lump sum or installments, and the term must be precisely determined. The rent may escalate or diminish during the rental term so long as the amounts of such escalation and/or decrease are specified and known to both parties at inception. Rent may be determined using variable rates (e.g., LIBOR), so long as the reference rate, and thus the rental amount, are known at lease inception. The lessor is responsible for structural maintenance of the assets and correlative obligations (e.g., property insurance) and these obligations may not be passed to the lessee in the *ijāra*.

The most-frequently encountered *ijāra* transaction is a “bifurcated transaction.” This is graphically depicted in Figure 2.

Figure 2: Generic *Ijara* Transaction



A “Funding Company” special purpose, bankruptcy-remote, entity is established to acquire, own and hold title to the asset, and lease the asset to the “Project Company,” which is owned by the Shari`ah-compliant investor. The purchase price is obtained through a conventional, interest-based bank loan and “equity” from the investor. The encircled numbers in Figure 2 illustrate (A) the contribution of investments funds, by the Shari`ah-compliant Investors, through the Fund into the Project Company and into the Funding Company, (B) the conventional loan by the Bank to the Funding Company, and (C) the subsequent purchase of the asset by the Funding Company from the Seller.

In U.S. transactions, the *ijara* rent is exactly equal to the debt service payable by the funding company to the bank on the conventional loan. The “substance over form” orientation of the U.S. tax laws and the ability to treat the funding company as a disregarded entity for U.S. federal tax purposes enable this rent structure. Matters are more complex in most of the rest of the world, where the funding company is a taxable entity. The Understanding to Purchase is an asset purchase and sale agreement, similar (in conventional concept) to a “put option,” enables the Funding

Company to sell the asset to the Project Company. The Understanding to Sell is an asset sale and purchase agreement, similar (in conventional concept) to a “call option,” enables the Project Company to acquire the asset from the Funding Company. The “strike price” for the Understanding to Purchase and the Understanding to Sell is equal to outstanding debt service at the relevant time. Pursuant to the Managing Contractor Agreement (i) the Funding Company hires the Project Company to perform structural maintenance and correlative obligations (e.g., obtain casualty and other insurance), and (ii) the Funding Company is removed from decision making in the transaction. Usually, there is a tax matters agreement (not shown in Figure 2) allowing characterization of the arrangements solely for U.S. (or other) tax purposes (in the United States, as a direct loan from the bank to the project company).

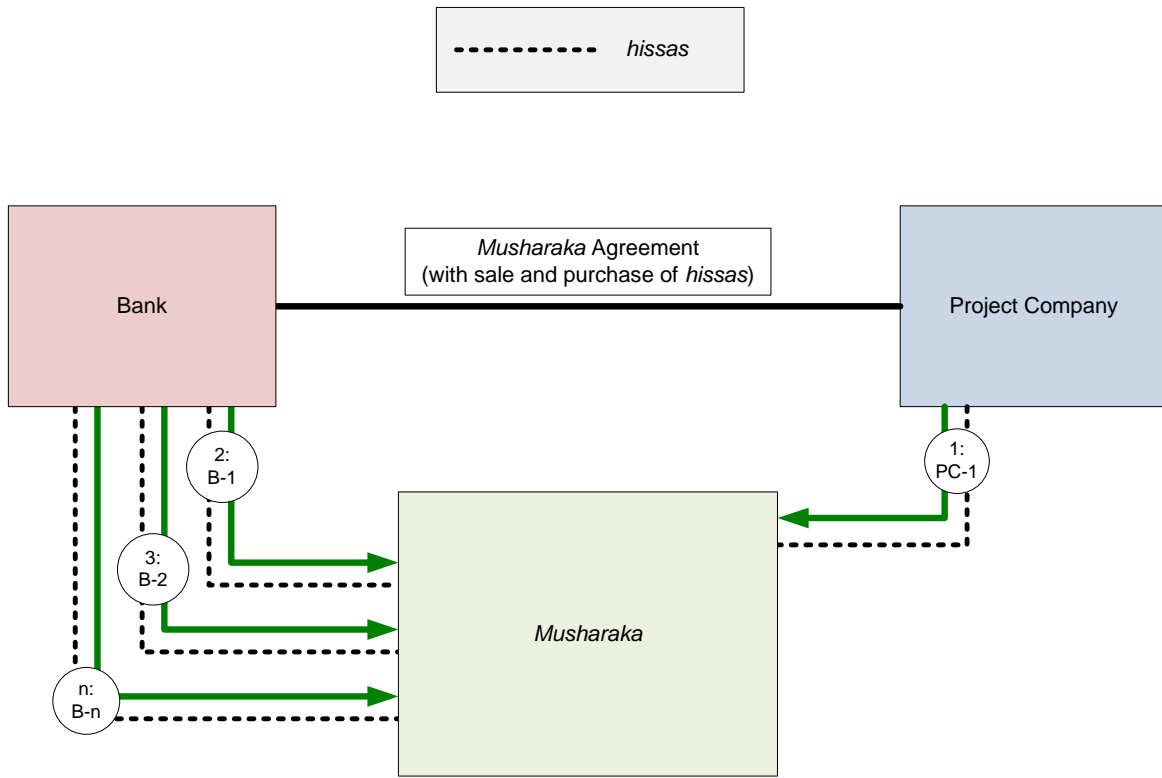
### **Musharaka**

A *musharaka* is a type of partnership arrangement whose name is of recent vintage. Each partner may contribute capital and participate in management. One partner may not assume liability for the capital of another partner, including by way of guarantee, assured payment, lump sum payment, or fixed payment. Profit may be allocated pursuant to agreed formulas, a divergence from the historical contributed capital reference. Losses are allocated in accordance with the ratio of contributed capital.

The bank and the party needing financing (the “project company”) form a *musharaka*, each receiving *bissas* (ownership interests) for their capital contributions. Usually, the bank is the “finance partner” and controls all financial matters. The project company is usually the “technical partner,” controlling technical, construction and operation matters (in a home purchase financing, the “project company” is the homeowner).

The Project Company infuses its equity capital (or down payment). In a project financing, this may take the form of cash, construction and project agreements, land rights, permit rights, and other project essentials. This is designated as “1: PC-1” in Figure 3 (steps are numbered sequentially prior to the colon in each circle). The Bank infuses cash, either in full (in a home purchase) or periodically (in a construction scenario). Periodic Bank infusions are shown as “2: B-1,” “3: B-2,” and “n: B-n” in Figure 3.

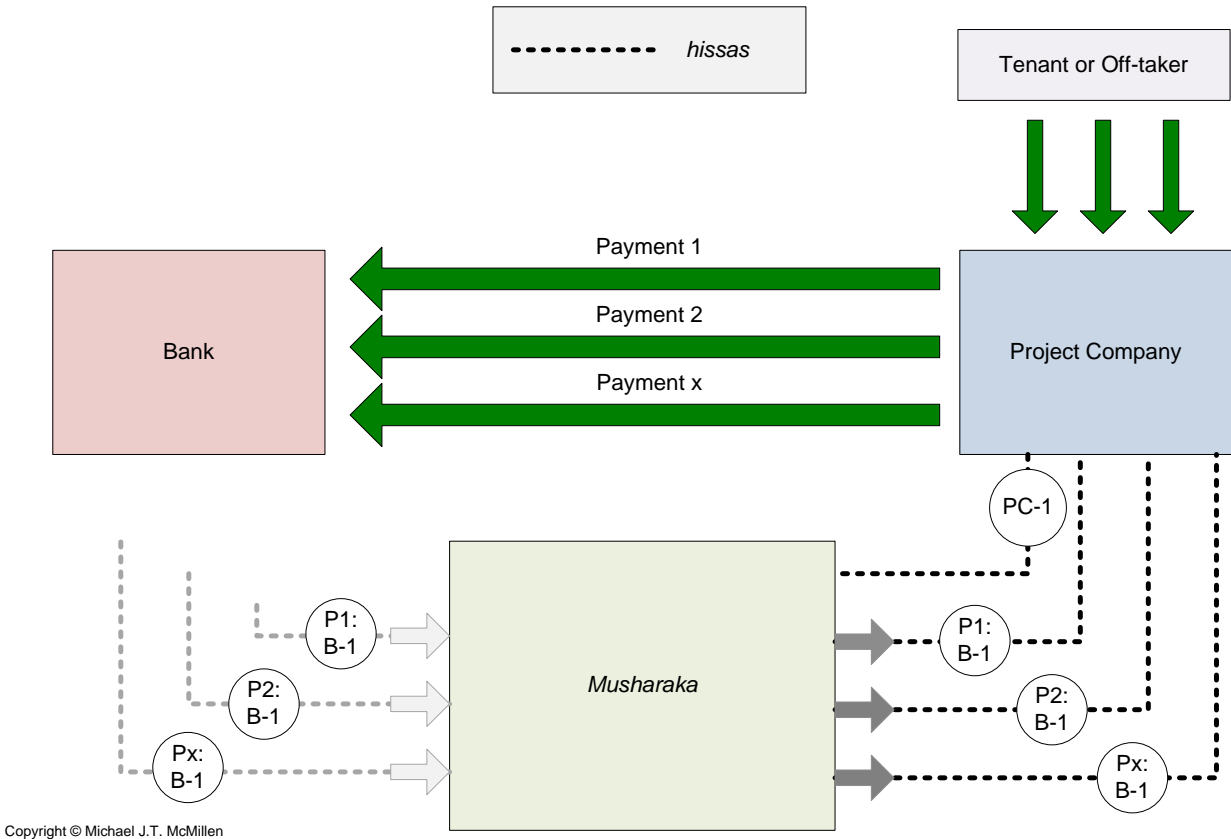
Figure 3: Generic Diminishing *Musharaka* Transaction: Funding



Copyright © Michael J.T. McMillen

Financing repayment is effected by the sale of *hissas* from the Bank to the Project Company on a scheduled, periodic basis. This is represented by the movement of B-1, B-2, and B-n from Bank ownership to Project Company ownership. Thus, the common label of this transaction as a “diminishing *musharaka*”: the ownership interests of the Bank diminish over time and, upon payment in full, are zero. The diminishing *musharaka* is graphically depicted in Figure 3. Matters are more complex in an actual transaction, as the *Musharaka* will have operating income during operations periods (although it may have none during the construction period), and the *hissa* transfers are from the Bank to the Project Company. Cash flows from the *Musharaka* to the Project Company are not shown; for simplicity, all cash flows are shown as going directly into the Project Company, which will likely not be the case in actual practice.

Figure 4: Generic Diminishing *Musharaka* Transaction: Payments



### ***Mudaraba***

*Mudaraba* transactions are preferred, but infrequently encountered except as the model for Islamic banks and some investment funds. It is a profit-sharing partnership defined by the nature of the contributions of the *mudarib* and the *rabb ul-maal* to the partnership; the *rabb ul-maal* contributes capital; the *mudarib* (the manager) contributes services (but, in the classical formulation, no capital). Generally, the *rabb ul-maal* may not participate in the management.

A defining characteristic of the *mudaraba* is that operating losses must be borne by the *rabb ul-maal* absent infringement, default, negligence, or breach of contract provisions by the *mudarib*. The *mudarib* suffers the loss of its services, and therefore no loss of capital (unless it contributed capital). Profit may be allocated in accordance with percentage formulas, including those accommodating thresholds and hurdle rates. There can be no predetermined or conclusive profit allocations, including lump sums, or guarantees and other assurances of capital or profit.

Defining the *mudaraba* profit is complicated. While some expenses may be deductible at the *mudaraba* level, the Shari`ah presumption is that the *mudarib* is responsible for operational expenses. Deductible expenses are usually determined in consultation with the Shari`ah board and thereafter embodied in the *mudaraba* agreement.

## **Conclusion**

The foregoing discussion summarizes a few general principles of four of the structures that are used in modern Islamic finance transactions. The cautionary notes are: the foregoing illustrates the general principles behind the structures that are actually used in practice, not the many nuances of the actual structures. And, as noted in the related article, the legal (Shari`ah) principles applicable in the implementation of these structures are complex and must be harmonized with all applicable legal considerations, including tax, real estate, asset sale, collateral security, and other laws. These are structured finance transactions, and subject to all of the complexities of any structured finance transaction. However, the foregoing should be evidence that these are manageable structures that resemble structures used in conventional structured financings.

*Michael J.T. McMillen is partner at Fulbright & Jaworski LLP, cochair of the Islamic Finance Committee of ABA's Section of International Law, and adjunct professor of Islamic finance at University of Pennsylvania Law School and Wharton School of Business.*

Copyright © 2009 and all intellectual property rights retained by Michael J.T. McMillen.