

OVERVIEW OF ISLAMIC FINANCE

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1. INTRODUCTION

Islamic financing involves the structuring of financial products and transactions based on principles and jurisprudence from Islamic sources (collectively referred to as *Sharia*).² The substantive rules and principles may, in certain cases, be directly extracted from Islamic sources (such as the *Quran and Sunnah, or Prophetic sayings*) where the sources deal directly with those rules and principles.³ In cases where there is no source "on-point" or inconsistencies between sources, an interpretative process (*ijtihad*), involving Muslim scholars to arrive at a position, is involved.⁴

This paper outlines some of the key rules and principles that are relevant to Islamic financing transactions, as well as some of the more common financing structures that have been adopted, particularly in the Australian market.

2. OVERVIEW OF SOME RELEVANT PRINCIPLES

2.1 *Riba* (interest)

One of the cornerstone aims of Islamic finance is to facilitate the more equitable distribution of income and wealth.⁵ Under *Sharia*, any return on funds that have been provided by a financier must be earned as profit from productive efforts.⁶ Accordingly, the practice of lending of money for profit, or lending money with other conditions that commercially benefit the financier, is generally considered to be prohibited among Muslim scholars.⁷ This is generally considered one of the most important principles in Islamic finance.⁸

2.2 *Gharar* (Uncertainty)

Financial arrangements involving uncertainty or doubtfulness, particularly in the fundamental contractual terms, are prohibited.⁹ Fundamental terms such as subject matter, price or time for performance/delivery must be absolutely certain on their face.¹⁰ For example, a contract for sale generally cannot have uncertainty as to the quantity, existence

¹ "The authors would also like to acknowledge the input provided by Dr Imran Lum of National Australia Bank.

² Alsadek H. Gait and Andrew C. Worthington, 'A Primer on Islamic Finance: Definitions, Sources, Principles and Methods' (2007) *University of Wollongong, School of Accounting and Finance Working Paper Series No. 07/05*, 2007, 6.

³ Salim Farrar, 'Accommodating Islamic Banking and Finance in Australia' (2011) 34(1) *UNSW Law Journal* 413, 414.

⁴ *Ibid.*

⁵ Gait and Worthington, above n 2, 6.

⁶ INSOL International, *Guide to Islamic Finance* (INSOL International, 2014) 2.

⁷ Farrar, above n 3, 417.

⁸ Gait and Worthington, above n 2, 8.

⁹ INSOL International, above n 6, 3.

¹⁰ *Ibid.*

or identity of the object, the price or the time of payment.¹¹ This is wider than the English common law principle of uncertainty.¹²

2.3 **Maysir (speculation)**

Transactions that involve speculation are impermissible and void.¹³ This does not mean speculation in a general commercial sense, but instead contemplates speculation based on chance, that is more comparable to gambling.¹⁴ This requires an analysis of the commercial substance of the transaction.¹⁵

2.4 **Prohibited commodities**

Investing in and dealing with certain activities and commodities is prohibited under *Sharia*. The rationale of this principle is to discourage investments related to matters, such as alcohol, tobacco, gambling and armaments, that are in violation of certain religious prohibitions.¹⁶ The aim of *Sharia* is to promote ethical investments that do not affect people and society adversely.¹⁷

2.5 **Unjust enrichment**

An arrangement where either party, financier or borrower, is regarded as having made unjust gains as against the other party is considered void.¹⁸ Each contract must be considered on a case by case basis in order to determine if a party may receive an unjust gain. Associated with this is the principle that one party cannot exercise undue influence or duress over the other party.¹⁹

3. **OVERVIEW OF SOME TYPICAL ISLAMIC FINANCING STRUCTURES**

3.1 **Murabaha (cost-plus or mark-up financing)**

This method of financing is often used in trade financing or asset financing arrangements. The asset subject to the financing transaction is bought by the financier and then on-sold to the "borrower" at an agreed marked-up price.²⁰ The "borrower" can make the payment either immediately or on a deferred basis or in instalments. The profit generated in this manner is regarded as profit earned from the sale of the asset and does not breach the prohibition against the payment of interest on loaned money.²¹ Commercially, the mark-up that will be charged by the financier will reflect the cost of raising funds for the purchase, as well as the commodity and credit risk borne by the financier.²²

¹¹ Gait and Worthington, above n 2, 10.

¹² INSOL International, above n 6, 3.

¹³ Ibid, 2.

¹⁴ INSOL International, above n 6, 2.

¹⁵ Ibid.

¹⁶ Gait and Worthington, above n 2, 12.

¹⁷ Ibid.

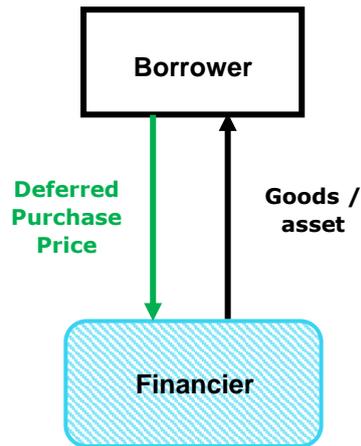
¹⁸ INSOL International, above n 6, 2.

¹⁹ Ibid.

²⁰ Ibid, 4.

²¹ Ibid, 4.

²² Ibid, 4.

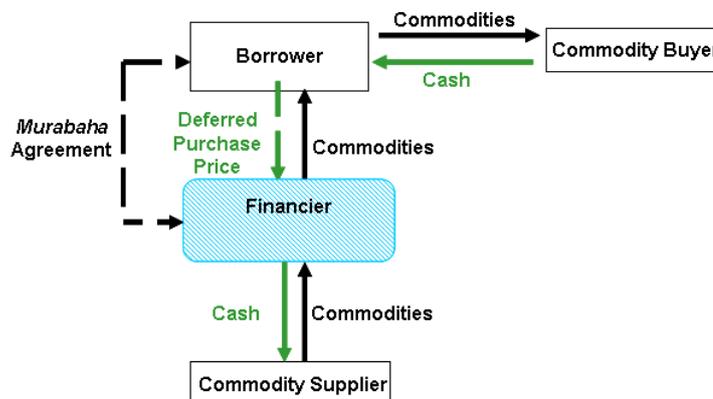


Some of the practical considerations in adopting this structure include the following:²³

- (a) the financier takes actual or constructive possession of the goods or assets before it can sell them to the customer and, under *Sharia*, the financier cannot offer to sell the goods or assets until it has acquired them;
- (b) because this is not viewed as a funding arrangement, financing concepts such as increased costs, mandatory costs, indemnities etc can be more difficult to structure; and
- (c) the goods are being bought and sold twice (by the financier and then by the borrower), which can have tax and other consequences, although in some jurisdictions these are mitigated.

3.2 **Murabaha (commodity)**

The commodity *murabaha* structure is similar to the trade *murabaha* structure, except that the asset being sold is usually commodities (eg. metals) and the customer sells the commodities to a commodity buyer as their intention is not to own the commodities, but to obtain the proceeds.²⁴ The advantage of this structure is that the customer does not ultimately own the asset, so it can be used in a variety of financing arrangements. It is often used in syndicated corporate financings, and it can accommodate term and revolving facilities, amortisation or bullet repayment, and even accordion features.²⁵



²³ Ibid, 12.

²⁴ Ibid, 13.

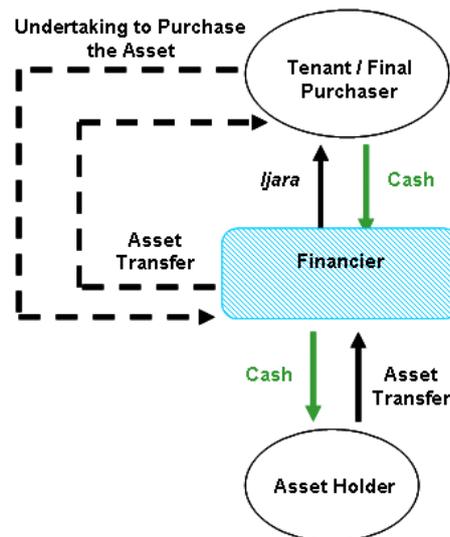
²⁵ Ibid, 17.

Some of the practical considerations in adopting this structure (in addition to those mentioned above in relation to trade *murabaha* which also apply) include the following:²⁶

- (a) the commodity broker is likely to charge an additional fee, which is a further cost to the borrower;
- (b) the financier not only takes the risk of the customer but also takes the risk of the commodity broker not purchasing the commodity; and
- (c) the commodity is being bought and sold three times (by the financier and then by the borrower to a third party), which can have tax and other consequences, although in some jurisdictions these are mitigated.

3.3 **Ijara (lease)**

This structure involves a lessor (ie. the financier) leasing an asset to a lessee (ie. the borrower), in other words it is essentially an operating lease.²⁷ Payments of rent from the lessee continue only while the use of the asset continues and the responsibility of insuring the asset, maintaining the asset and paying taxes relating to the asset is borne by the lessor.²⁸ If the lessee ultimately wants to own the asset, this can be achieved through a variation of this structure.²⁹



Some of the practical considerations in adopting this structure include the following:³⁰

- (a) it is not possible to increase the rent if the lessee does not pay rent when due, however the parties can agree to extend the lease and increase the amount of rent; and
- (b) the parties usually agree that the lessee will meet the insurance, maintenance and ownership taxes, by way of a separate service agency agreement, whereby the lessee is the service agent for the lessor.

²⁶ Ibid, 15.

²⁷ Ibid, 4.

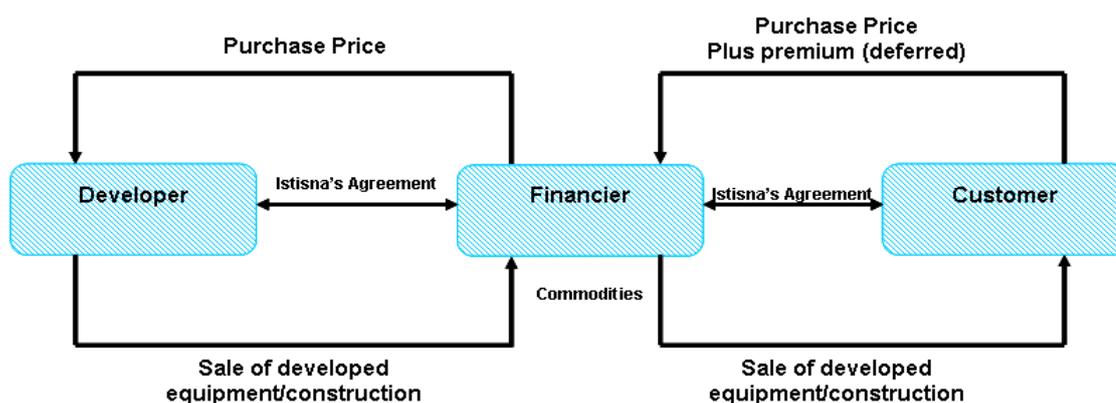
²⁸ Ibid, 25.

²⁹ Ibid, 4.

³⁰ Ibid, 25.

3.4 **Istisna'a (project financing)**

Under this arrangement a financier will fund the development and realisation of a good or project at a fixed price according to specifications that have been agreed in advance.³¹ This arrangement lends itself well to the financing of large construction projects and assets such as ships and aircraft.³² Parallel contracts are entered into by the financier with the manufacturer/developer and the end customer respectively.³³ After commissioning the asset or project with the manufacturer/developer, the financier will have title to the completed project or asset and it is then sold to the customer at a premium reflective of the risk borne by the financier.³⁴



Some of the practical considerations in adopting this structure include the following:³⁵

- (a) in some jurisdictions, it may not be possible to exclude all warranties through contractual exculpatory provisions, and there may be defects liability provisions imposed by statute in respect of the asset; and
- (b) under *Sharia* law, a customer can reject an asset that does not conform with the contractual provisions relating to specifications or quality.

3.5 **Mudaraba (participation financing)**

This arrangement involves an investor, such as a financier, (*Rab al maal*) raising capital to which a manager (*Mudarib*) will invest in *Sharia* compliant investments.³⁶ Profits from the investments will be shared between these two parties according to a ratio of distribution agreed in advance. Where there are financial losses, these are borne by the investor.³⁷

³¹ Ibid, 5.

³² Ibid.

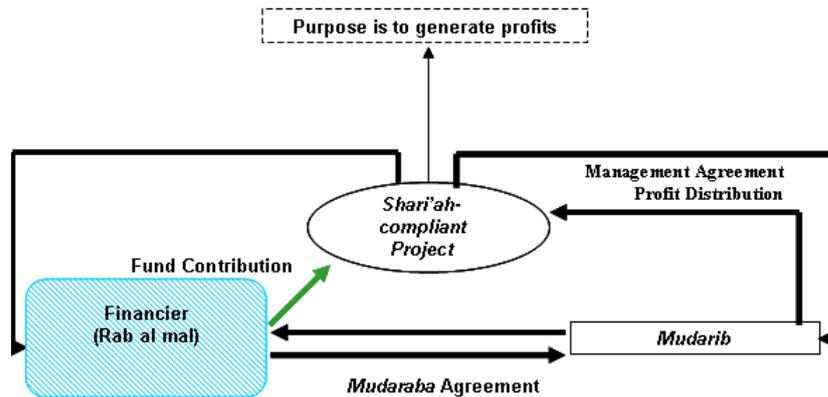
³³ Ibid.

³⁴ Ibid.

³⁵ Ibid, 23.

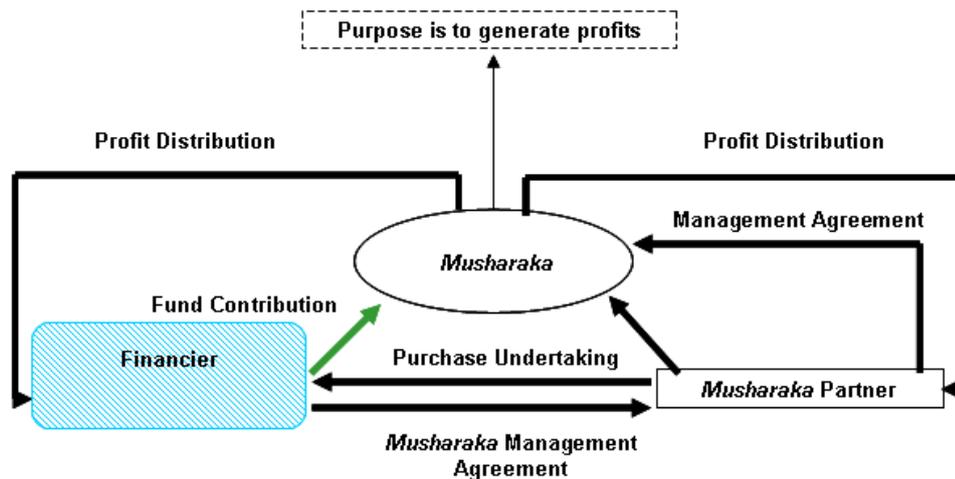
³⁶ Ibid, 39.

³⁷ Ibid, 40.



3.6 **Musharaka (partnership)**

As part of this structure, the financier and the end customer enter into an arrangement akin to a joint venture or partnership and each provide financing for a project in an agreed proportion.³⁸ The customer will act as a manager and will be responsible for the investment of the assets of the *musharaka* to generate a profit for the *musharaka* parties. The profits from these activities are shared between the parties in pre-agreed proportions and any losses will be borne according to the proportions of the initial investment in the *musharaka*.³⁹



3.7 **Wakala (agency)**

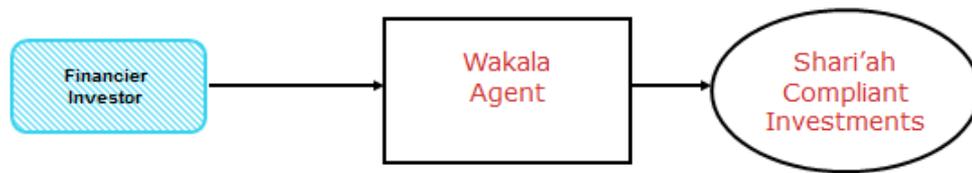
An agency relationship is formed between an investor, such as a financier, (*muwakkil*) and an agent customer (*wakil*) seeking the financing.⁴⁰ On behalf of the *muwakkil*, the *wakil* invests capital in *Sharia* compliant investments, the *muwakkil* receives an agreed profit from the returns with any excess profit retained by the *muwakkil*.⁴¹

³⁸ Ibid, 36.

³⁹ Ibid, 38.

⁴⁰ Ibid, 5.

⁴¹ Ibid.



3.8 **Sukuk (Islamic bonds)**

A *Sukuk* is a negotiable instrument which evidences a proportionate interest in underlying assets and revenues, and which may be able to be sold in the secondary market.⁴² The primary credit risk is that of the originator, irrespective of the performance of the underlying asset. If the *Sukuk* is rated, then the originator's rating is relevant.⁴³

4. **AUSTRALIAN EXPERIENCE**

There have been numerous obstacles to applying Islamic finance in Australia.

Sharia compliant financings can be complex and involve parallel consideration of various *Sharia* structuring, legal and taxation issues to produce an outcome that is not only viable, but which is commercially and legally robust. Furthermore, most local banks do not have the operational capability to book financings in this form, or manage them on an ongoing basis (such as drawdowns, servicing, reporting and review).

Over the past 18 months, a number of structures have been developed which address these requirements. These have largely been demand-led solutions for live transactions, particularly in the real estate sector.

The structures used to date have either been commodity murabaha-based or wakala-based, specifically adapted for the Australian context and using structured finance techniques (such as special purpose vehicles). In particular:

- (a) The structures resolve key operational issues around booking and servicing these kinds of financings.
- (b) The structures are suitable for long and short-term financing, and even for development financing, and resolve key operational issues around booking and servicing these kinds of financings, as well as the usual considerations of credit, security and enforcement.
- (c) The structure can also be adjusted to accommodate the regulatory and operational considerations that individual lenders will need to take into consideration.

5. **RECENT FEDERAL GOVERNMENT TAX ANNOUNCEMENT**

On 13 October 2010, the Board of Taxation (the **Board**) released a Discussion Paper titled "Review of the Taxation of Islamic finance" (the **Discussion Paper**) to facilitate stakeholder consultation. The Board completed its review and submitted its report to the Government in June 2011. The Government released the Board's final discussion paper dated June 2011 to the public on 13 May 2016 following the announcement of the proposed changes to the tax treatment of asset backed financing arrangements in the 2016/17 Federal Budget.

⁴² Ibid, 6.

⁴³ Ibid.

The Board's recommendations are intended to ensure that Islamic finance products are treated at parity with conventional products having regard to their economic substance.

The Board's review confirmed that access to interest withholding tax exemptions, stamp duty on asset backed finance products and uncertainty in relation to the application of general income tax provisions are the main impediments to the provision of Islamic finance products in Australia.

Accordingly, the Board has made a number of key recommendations to address these issues including:

- (a) recommending access to interest withholding tax exemption to publicly offered Islamic finance products that exhibit equivalent economic characteristics to debentures or to the debt interests that are currently eligible for the exemption;
- (b) encouraging the States and Territories to provide relief from stamp duty so that it does not arise where there is a synthetic disposal or acquisition that would not have occurred had it not been to give effect to a financial arrangement under an Islamic finance product;
- (c) amendment to the Income Tax law to ensure that in respect of a deferred payment arrangement, whose main purpose is the raising or provision of debt finance, the finance gain or loss is treated the same as interest on a conventional borrowing;
- (d) extension to the application of the hire purchase provisions (which re-characterise an arrangement as a notional sale and loan); and
- (e) in consultation with industry, the Australian Taxation Office is to provide guidance on the current taxation treatment of Islamic finance products to resolve particular areas of uncertainty.

The measures above are intended to remove tax and stamp duty impediments to the provision and use of Islamic finance products and therefore, encourage greater utilisation of Islamic finance in Australia.

In PwC's view, the release of the Discussion Paper is a positive step to encourage growth of Islamic finance in Australia. Further, the Discussion Paper is a recognition by the Government that it is important for Australia as a net capital importer to have access to diverse sources of foreign capital such as Islamic finance to fund capital projects in Australia. However, there may still be challenges as taxes such as stamp duty is a State based and is not dealt with at the Federal Level. Therefore, there will need to be a coordinated effort at Federal and State levels.

REFERENCES

1. Alsadek H. Gait and Andrew C. Worthington, 'A Primer on Islamic Finance: Definitions, Sources, Principles and Methods' (2007) *University of Wollongong, School of Accounting and Finance Working Paper Series* No. 07/05, 2007.
2. INSOL International, *Guide to Islamic Finance* (INSOL International, 2014).
3. Salim Farrar, 'Accommodating Islamic Banking and Finance in Australia' (2011) 34(1) *UNSW Law Journal* 413.