# A road map for new entrants in Islamic finance

**With oil maintaining its high prices, the liquidity of Islamic investors continue to increase making Islamic markets more and more attractive for all seekers of financing including sovereigns, corporates and financial institutions. This article intends to shed some light on the practical aspects new entrants should focus on while considering an entry into the Islamic finance space.**

Islamic finance is open to all and not restricted to Muslims only. Contrary to certain beliefs, this approach applies to corporates and financial institutions as well. As Islamic finance focuses on the transaction rather than counterparties (except where the transaction relates to equity of a particular company) it gives room to all types of institutions (whether Islamic or conventional) to participate in it, as long as the underlying transaction (and asset) is Shariah compliant.

**Shariah compliant transaction**

When Shariah scholars review a financial transaction, they consider certain aspects while determining the Shariah compliance of the transaction. These aspects include:

i) Economic sense: The transaction should make economic sense for all parties involved in the transaction;

ii) Purpose: The purpose of the transaction and the underlying asset should be Shariah compliant;

iii) Structure: The mechanism of executing the transaction should be in compliance with the Shariah requirements; and

iv) Legal enforceability: The legal documents of the transaction should not only be Shariah compliant, but they must also reflect the structure and should enforce Shariah requirements of the transaction.

**Shariah perspectives on corporates and financial institutions**
From a Shariah perspective, corporates and financial institutions do not have any religion. It is their operations which determine whether or not the organization complies with the Shariah requirements.

Shariah scholars have developed Shariah screens which are used to identify whether a corporate is Shariah compliant or not. These Shariah screens are based on (i) screening of business activities and (ii) financial ratios. These screening requirements are well set out in Shariah guidelines issued by Islamic bodies (e.g. AAOIFI), and methodologies published by Islamic indices (e.g. MSCI, Dow Jones, etc.) and Shariah screening service providers (e.g. Amiri).

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It is important to note that Islamic financial institutions do not require to be screened for business activities and financial ratios. Shariah scholars have provided certain requirements, all of which needs to be met for an institution to be considered as an Islamic financial institution, including:

i) The company is a separate legal entity and established solely to transact in a Shariah compliant manner;

ii) The company has appointed a Shariah supervisory board which provides oversight and sign-off on all product development, implementation and on-going Shariah monitoring. They will also be responsible for providing operational guidance on all Shariah-related matters, and issuing Fatwa(s) to that effect; and

iii) The above aspects are formally documented in its formation documents and clearly set out in its annual audited financial statements.

**Considering venturing into Islamic finance?**
The key considerations for corporates venturing first time into Islamic finance can be segregated into three phases:
Phase I – Understanding local framework;
Phase II – Developing the structure; and
Phase III – Sales and distribution.

**Phase I: Understanding local frame work**
As part of this initial phase, the following aspects need to be considered:

a) *Regulatory requirements*:
The organization should review the regulatory environment of its jurisdiction i.e. whether it promotes or allows Shariah compliant transactions. It should be noted that for a Shariah compliant transaction, it is not necessary for it to be formally referred to as 'Shariah compliant' or its legal documents to specifically mention that. The important aspect is that it needs to be reviewed and approved by Shariah scholars as a Shariah compliant transaction.

b) *Tax considerations*:
Islamic financial transactions normally involve overseas investors investing into local jurisdiction. This exposes Islamic investors to potential local income tax implications.

From a tax perspective, there may be certain structures which are tax efficient and have been developed to promote overseas investment. The corporate can consider using such structure, in a Shariah compliant manner, to attract Islamic investors. Further, certain jurisdictions have made appropriate changes in tax laws to promote Islamic finance (for example the double stamp duty exemption available to Islamic mortgages in the UK).

**Phase II: Developing the structure**
a) *Identification of Shariah advisor*
Most of the conventional corporates (or institutions) do not have in-house Shariah structuring expertise and look for Shariah advisors who can help and guide them throughout the Shariah structuring, review of Shariah scholars, approval of Fatwa and placement of the transaction.

Appointment of the right Shariah advisor is extremely critical for the success of the product. A Shariah advisor should not only have the right team which understands the product and have proven credentials of managing and delivering similar products, but he should also have access to the Shariah scholars, who will eventually review and approve the Fatwa confirming the Shariah compliance of the transaction.

b) *Target markets and Shariah scholars*
It is important for the corporate to identify the jurisdiction(s) of potential investors at an early stage. This would not only enable the Shariah advisor to propose a structure which is generally acceptable to potential investors in those jurisdictions, but it will also enable the Shariah advisor to identify Shariah scholars, who are well known in the target jurisdiction(s), to be involved in the transaction.

c) *Underlying structure and credit enhancements*
The product will use one of, or a combination of, Islamic financial instruments (e.g. Ijarah, Murabahah, Wakalah, Salam, Musharakah, Mudarabah, etc). The Shariah advisor should be in a position to advice on the most appropriate structure based on the purpose of financing, underlying assets and its tradability, and maturity of the instrument..

Further, depending upon the jurisdiction and credibility of the corporate, the structure may need to involve certain credit enhancements to provide more comfort to the potential investors. Credit enhancements can be achieved in various ways including over collateralization of underlying assets, additional collateral or arranging a guarantee of a sovereign/recognized financial institution.

d) *Appointment of legal advisors:*
Legal advisors also have an important role to play. Depending upon the nature of the transaction and structure, it may be that two sets of legal advisors are used for the transaction.

Legal advisors need to be identified and appointed not only based on their expertise on the proposed structure but also their recognition and acceptability in the target market. Shariah advisors can play a key role in assisting the corporate in the identification and appointment of legal advisors.

e) *Disclosure in legal documents*
Depending upon the jurisdiction of target investors, there are certain information or disclosures about the transaction, which although may not be a legal or regulatory requirement, potential investors still expect such disclosures to be included in the relevant legal documents.

> **"They need assurance that their investment continues to be in compliance with Shariah on an ongoing basis"**

Shariah and legal advisors are expected to work together with the corporate to identify such additional information and disclosure expectations and appropriately incorporate it in the legal documents.

f) *Pre-marketing*
For a successful placement of an Islamic product, it is extremely essential to do some pre-marketing before the structure and legal documents are finalized. As part of this process, a handful of potential investors will need to be approached and informal feedback on the transaction to be obtained so that the appropriate amendments to the final transaction could be made to make it more attractive to the target audience.

**Phase III: Sales and distribution**
This is probably the most important phase of the transaction. As part of sales and distribution of Islamic transaction(s), several aspects will need to be considered, including:

a) *Identification of sales/placement partner*
Depending on the type and nature of the financial instrument, the corporate may appoint an arranging firm to partner with the corporate and help in the successful placement of the financial instrument.

The selection of the arranging partner is a very important aspect. This partner should not only have relationships with investors in the target jurisdiction but also a successful track record of placing similar instruments in that region. As Shariah advisors do not have the capabilities to act as arrangers or placement agents for the transaction, they can instead play a key role in identifying potential placement agents to the corporate.

b) *Understanding of Shariah aspects by the sale team*
The most important aspect for Islamic investors is the Shariah compliance of the product. Only once they have comfort over Shariah compliance, will they want to discuss the commercial aspects of the transaction. As most of the sales team come with a conventional sales background, they are very well versed with the commercial aspects of the product but they may lack the depth of knowledge required to explain the Shariah considerations (and structure) of the product.

Islamic investors can be put off if they are not made comfortable on the Shariah aspects, which could spell an immediate rejection of the transaction. The corporate should consider including a Shariah advisor in roadshows and meetings with potential investors so that all Shariah-related queries are appropriately addressed and responded.

c) *Ongoing comfort over Shariah compliance*
Islamic investors not only need to be comfortable over the Shariah compliance of the transaction at the inception, but they need assurance that their investment continues to be in compliance with Shariah on an ongoing basis.

Shariah advisors normally take over the role of a Shariah monitor, who under the guidance of Shariah scholars, review the transaction on a periodic basis. Upon successful completion of each monitoring period, an 'Opinion on Shari'a Compliance' is issued. This opinion is shared with Islamic investors to provide them with the comfort they need over ongoing Shariah compliance.

*This article is not a financial or a Shariah advice but personal thoughts of the author and is intended for discussion purposes only.*

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