

Islamic Finance Access Programme: Recent Issues & Career Opportunities

Welcome

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Islamic Finance and Investment Map



- K&L Gates office location
- K&L Gates office with Islamic Finance and Investment coverage

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The route into Islamic Finance

- Religious belief
- Alternative investment strategy
- Alternative source of funds
- Project requirement
- Government requirement
- Regional necessity
- Geographical location
- Ethical finance
- Risk sharing
- “Failure” of conventional finance

Islamic Finance: not only Islamic Banking

- Private equity
- Insurance / Takaful
- Pensions
- Funds / Investment Management
- Compliance and regulation
- Real estate
- Construction / Infrastructure
- Legal services
- Religious knowledge
- Education

Islamic Finance: Recent Issues in the UK

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Islamic Finance: Recent Issues in the UK

- UK Islamic banks
- UK sovereign sukuk
- UK real estate
- The UK's battle for Europe

UK Islamic banks

- Islamic Bank of Britain (IBB)
 - 2004
- European Islamic Investment Bank (EIIB)
 - 2005
- Bank of London and the Middle East (BLME)
 - 2006
- Gatehouse Bank
 - 2007

UK Sovereign Sukuk / Alternative Financial Investment Bond

Lord Sassoon, Commercial Secretary to the Treasury

"does not currently offer value for money, at a time when Treasury gilts are giving their lowest yield. The priority (for the Treasury) is to raise the cheapest debt in relation to fiscal discipline."

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UK real estate

- 2011 transaction volumes:
 - 38.3% office
 - 35.6% retail
- Student accommodation investment:
 - 2010: £261m
 - 2011: £1.076bn
- London and South East: 56.5% deals by volume
- UK funds: £10.8bn of acquisitions
- UK property companies: £13.5bn of assets sold
 - Source: CoStar UK Investment Bulletin

The UK's battle for Europe

- UK
 - Ireland
 - Luxembourg
 - France
 - Turkey
-
- Legal certainty & legislative change
 - Choice of law & Expertise
 - Sovereign Sukuk
 - Muslim population size

Islamic Finance: Recent Issues in Qatar

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Qatar Highlights

- Population 1.7 million (more than 75% expat)
- Muslim population 77.5%
- World's richest country with per capita GDP approaching \$100k in 2011
- Third largest gas reserves after Russia and Iran
- Proven oil reserves of 26 billion barrels
- And . . . winner of the FIFA 2022 World Cup

Qatar's Aspirations

- Twin focus:
 - Stage the world's largest sporting event
 - Implement its National Vision 2030 to diversify its economy away from a reliance on hydrocarbons towards a knowledge-based economy
- Projected public sector spending between 2010 and 2015 is approximately \$100bn

The Big News for Islamic Finance in Qatar

- Closure by Central Bank of Islamic windows of conventional bank
- Opportunities for Islamic finance – 2022 and beyond

Closing the Windows: What the CBQ said

- Conventional banks running Islamic financing activities must:
 - Cease their Islamic finance activities
 - Wind down their existing portfolios by 31 December 2011
- Supervisory issues: Comingling of activities and services leads to difficulties for conventional banks to manage:
 - Bank risks
 - Financial reporting
 - Capital adequacy
 - Financial stability
- Monetary policy issues:
 - Application of monetary policy easier to administer
 - Improve QCB framework of liquidity management

Closing the Windows: Other reasons?

- Unfair competition between conventional and Islamic banks
- Islamic banks more “pure” than conventional banks
- Reputational risk
- Policy to support Islamic banking
- Desire to become regional hub for Islamic finance
- Something else?

Closing the Windows: Pros

- Clears the market for Islamic banks
- Instills confidence in customers
- Promotes transparency and accuracy
- Eliminates possibility of crossover contamination
- Greater focus on fundamental Shariah principles and development of true Shariah compliant products
- Places Qatar at forefront of positive economic development in Islamic finance

Closing the Windows: Cons

- Negative impact on conventional banks
- Reduces competitive pressures that lead to greater efficiency, service, and innovation
- Reduces financing options for corporate borrowers
- Reputational damage to CBQ?

Closing the Windows: Opportunities

- Provides a platform for:
 - Qatar to become an important centre of expertise
 - Islamic banks to develop know-how and technology
 - Improved effectiveness of Shariah governance
- Strengthens Islamic banks in preparation for planned infrastructure development

FIFA and Beyond: Islamic finance opportunities

- Highlight the Islamic finance sector
- Showcase Muslim countries
- Platform for Qatar to start addressing challenges
- Become early leaders in innovation
- Knowledge transfer through teaming with international banks
- Ability to attract top-tier talent

FIFA and Beyond: Islamic finance challenges

- Islamic banks are relatively small
- Over-exposure to real estate and construction sectors
- Developing long-term Islamic financing solutions
- Competing on price and service
- Availability of experienced, talented, and appropriately-trained people to deliver competitive Islamic products and services

The Outlook for Islamic Finance in Qatar

- Islamic banking
- Takaful
- Shariah compliant investment banking
- Sukuk

In Conclusion

- Restructure of Islamic banking structure
- Expansion of Islamic financial services sector
- Need for insurance products will drive takaful sector
- Increasing sophistication of Islamic investment arena
- Recession-resistant, hydrocarbons-based economy enjoying double digit GDP growth
- Government committed to diversification and expansion

Islamic Finance in the United States: Current Issues, Trends and Solutions for Practitioners

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Current State of the U.S. Islamic Finance Market

1. Expansion in the retail market

- Entry of Freddie Mac/Fannie Mae into Islamic home finance market via American Finance House-LARIBA
- Injection of capital
- Alleviation of the “COBM” through benchmarking of Islamic home finance products with falling interest rates

Current State of the U.S. Islamic Finance Market (cont'd.)

2. Continued growth in the wholesale market
 - Entry of Islamic financial institutions which enable Middle Eastern investors to invest in the U.S. using Shariah-compliant methods of finance
 - Arcapita, Codexa, Zayan, GIH and others
 - The Dow Jones Islamic Market Index

Current State of the U.S. Islamic Finance Market (cont'd.)

3. Resilience of Islamic banks in the global financial crisis
 - Growth at double-digit rates (10-20% annually), to \$1 trillion in assets in 2010
 - Survival during downturn largely attributed to avoidance of speculative activities and backing by physical assets
 - Contrast with decline in *sukuk* market and vulnerability to fluctuations in the mortgage market

Current State of the U.S. Islamic Finance Market (cont'd.)

4. Expectation of substantial growth in the future
 - Revisions to tax, legal, and regulatory frameworks to attract and/or accommodate Islamic finance
 - Increase in Muslim population
 - Large number of Islamic investment bank executives with degrees from U.S.

Overarching Regulatory and Domestic Issues

1. Umbrella concerns affecting the U.S. market
 - Higher transaction cost of Shariah-compliant financing
 - Compliance and standardization concerns
 - Improper conflation with *hawala*, leading to terrorist-finance concerns
 - First Amendment concerns

Overarching Regulatory and Domestic Issues (cont'd)

2. Changes in legal and regulatory arena to accommodate and attract Islamic finance
 - OCC approvals leading to case law focus on “economic substance,” rather than mere form, of a transaction
 - *East Cameron sukuk* case and its importance in the U.S. sukuk markets

Specific U.S. Concerns and Solutions for Practitioners

1. U.S. National Banking Act of 1864

- **Problem**: Banks are restricted from owning real property or taking an equity stake in a business
- **Solution**: *Ijara* and *murabaha*, both of which have gained favorable treatment by Federal Reserve and OCC

Specific U.S. Concerns and Solutions for Practitioners (cont'd)

2. FDIC Insurance

- **Problem:** FDIC rules require that all consumer deposits under US\$250,000 be insured against capital loss, creating tension with Shariah law requiring that funds be at-risk
- **Solution:** Refuse to accept payments from the FDIC fund

Specific U.S. Concerns and Solutions for Practitioners (cont'd)

3. Concerns with Retail Financing Products

- **Problem #1**: Double taxation resulting from state property transfer taxes
- **Solution**: New York State has issued rulings to eliminate this double taxation; other states are expected to follow suit

Specific U.S. Concerns and Solutions for Practitioners (cont'd)

- **Problem #2**: Risks of environmental liability and liability for injuries resulting from ownership of real estate
- **Solution**: Conduct thorough due diligence prior to entering into any transaction, seek indemnity from the customer, and use a separate subsidiary for each transaction

Specific U.S. Concerns and Solutions for Practitioners (cont'd)

- **Problem #3**: In *murabaha* transactions, the customer will expect certain express and implied warranties
- **Solution**: Contract should dictate that the customer looks to the supplier, and not the bank, to satisfy these warranties

Specific U.S. Concerns and Solutions for Practitioners (cont'd)

- **Problem #4**: Voluntary prepayment in *murabaha* transactions risks violating U.S. laws
- **Solution**: Shariah scholars have blessed approach of financial institutions rebating the unearned profit back to the customer

Specific U.S. Concerns and Solutions for Practitioners (cont'd)

4. Concerns with Wholesale Equity Investments

- **Problem #1**: Tax benefits would belong to the lessor of the SPE, rather than the investor
- **Solution**: Ancillary agreement between SPE and investor, whereby investor agrees to take on ownership obligations on the SPE's behalf

Specific U.S. Concerns and Solutions for Practitioners (cont'd)

- **Problem #2**: Having an SPE hold title could possibly afford it less remedies than it would otherwise have in a traditional financing transaction
- **Solution**: Place a self-executing subordination provision directly into the *Ijara* agreement between SPE and investor

On the Horizon

- There IS opportunity in the U.S.: prospects for growth
 - Syndication
 - *Sukuk*
 - *Takaful*
 - Home mortgage market
 - Oil & gas