From a conventional loan scheme to an Islamic finance structure

- re-framing your model -

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Who should have a look at this presentation

At present you have a concrete project that needs financing and you are looking to attract financiers / investors with conventional, interest based finance.

Together with your accountant / auditor, you probably drafted an executive summary with the financial data that your prospected financier / investor expects to see, with the projected IRR and any further merits of the deal. You probably are ready to start your roadshow.

Who should have a look at this presentation (ctd)

And then someone did mention the possibility of "Islamic finance" to you. It is a buzzword, but you have no experience yet.

You wonder : is Islamic finance something for me ?

Maybe you even plan to present your existing financial exec-sum to some Middle East or Southeast Asia based Islamic bankers to obtain Islamic finance.

Then this small presentation is meant for YOU.

First orientation :

I am not a Muslim – Islamic finance therefor is nothing for me ?

WRONG : Islamic finance is accessible to everyone

I am a Muslim – when I lend money from another Muslim, we are making "Islamic" finance ?

WRONG : when a Muslim lends money from another Muslim, that is not necessarily Islamic finance. In fact, any loan of money could involve Riba. It is not the religion of the people involved that decides if something is Islamic finance.

First orientation (ctd)

You did hear that Islamic finance actually is the same as conventional finance ? Islamic finance is “only hiding the interests” ?

WRONG :

YES: it is finance consisting out of a business transaction for a profit

BUT NO: Islamic finance is about the way money “is put to work”. That is in business situations that create permissible profit and NOT by a mere loan of cash that generates impermissible profits (interests) or RIBA.

The Islamic finance project and its' documentation and structuring will therefore not be centered around a loan agreement, but around a business agreement. We will touch this aspect briefly later in the slide show.

Option 1 – you want to finance 1 single project only

In a conventional environment you prepare your financial data and you look for the necessary collateral. Then you go to your bank to ask for a loan and you negotiate the terms and conditions thereof.

Depending on your creditworthiness, the value of your collateral and the solidity of your project you will get more / less money in the form of a cheaper / more expensive interest-based loan .

Lesson 1 – the Islamic Bank / Investor does not extend pure financial loans

Basically, in Islamic finance a financial loan is extended for charitable reasons only (Qard Hasan) .

It does not mean however that Islamic finance is "for free". The same as in conventional finance, you are entering in a business transaction that will cost money. Only this time it will be structured in a "real economy"-deal with a more transparent and just profit margin.

Solution – package your finance needs in a business deal or partnership

If your finance needs can be translated to the acquisition or production of assets, you could have several ways to solve your problem :

1. isolate the assets or activity into a partnership that meets Islamic standards (Mudarabah or Musharakah are widely used) OR maybe – if accepted - even use a Special Purpose Vehicle-structure. You put labor (and maybe some investment) into your partnership and your financier helps out with the rest of the needed financial means.

Negotiate with your financier the way of profit sharing and - if so desired - the conditions of his exit out of the project.

Solution – package your finance needs in a business deal or partnership (ctd)

2. look for an Islamic based or at least Islamic compliant business structure

Islamic law recognizes different types of nominate contracts (Murabaha, Ijarah, Istisna, Salam etc) that may allow the acquisition or construction of assets against deferred payment and various delivery conditions (hence : finance). Such will be subject to specific rules and regulations that might differ from the conventional framework that you are familiar with.

Example: your financier buys the asset cash from a producer. He then sells it down to you with deferred payments against a fixed mark up (using a Murabaha contract).

Other structures that resemble conventional construction contracts, leasing etc are also available.

It is important to know that your Islamic financier will exclude some industries (gambling …). Or that he might be able to allow certain “haram” activities (sale of alcohol …) and some exposure to conventional interest based products. Such will be in minor proportion only and probably with limitations in time. And then again certainly after “cleansing” of any profits thereof. Such cleansing will mean less residual profit and will therefor diminish the appetite of your potential Islamic financier to go ahead.

Other financial ratios and business reasons also might prevent the financier from easy dealing with structures that are for example too cash-liquid.

The use of conventional trust.. structures mostly is allowed, but whilst the Islamic partnerships and nominate contracts resemble sometimes closely the conventional ones, small differences can have big consequences that may decide on the viability of the project.

Option 2 – you are looking for stable business partner

In a conventional environment you prepare your financial data, you look for a partner and convince him of the viability and profitability of the enterprise.

The partner will analyze the projected return on investment, market evolutions etc. Subsequently he will negotiate the conditions of his entry. Conventional legal structuring is very flexible in terms and conditions. We assume that you are familiar with those aspects (waterfalls, convertible bonds etc).

Lesson 2 – observe Islamic limitations

As stated above, the use of conventional trust and company structures mostly is allowed. But even when the traditional Islamic partnerships are set aside in favor of those, certain of their ground rules will have to be respected. It is important that you are aware of the basic understandings.

Some activities or industries are not suitable for Islamic investments and the presence of conventional interest based financing or even liquidity management can cause problems.

There also will be some financial ratios to be taken into consideration, next to industry screening.

Option 3 – what about the so-called SUKUK ? (ctd)

The Fiqh Academy decided already more then 30 years ago that the issuance of and trading in shares is permissible.

Conventional bonds however represent a pure debt obligation and and the trading thereof on the secondary markets could cause problems (it actually is trading money against a profit that could be unlawful). And as you know: interests are RIBA.

Islamic finance developed a hybrid financial paper : the Sukuk or 'Islamic bond'. In short, that instrument gives title to a part of an underlying asset and the income thereof: it is not a debt obligation. That underlying asset mostly generates fixed income streams (for instance rental income), that on their turn result in regular pay outs to the Sukuk holders. Sukuk usually have a 3 up to 10 year maturity. One could say that it is a share (equity) that in normal circumstances behaves like a bond (medium term maturity and fixed income streams).

Option 3 – what about the so-called SUKUK ? (ctd)

A lot of the Sukuk structures are freely trade-able and can be listed on the stock exchange.

Some jurisdictions already have relevant Sukuk-regulations in place.

Most types of Sukuk structures are acknowledged by the different Islamic jurisdictions.

But not ALL structures will be allowed everywhere, nor be freely trade-able everywhere.

Not all Sukuk therefore are aimed to the global market and some structuring might prevent international Islamic investors to participate.

Option 3 – what about the so-called SUKUK ? (ctd)

Approaching Islamic financiers to place Islamic financial paper therefore needs sufficient consideration. You should comply with the local standards of the place of issuance, but if you also want to target an international audience, you might need more consideration and use different structures or different jurisdictions.

This makes that whilst most Islamic projects can be the subject of Sukuk issuance, not all those Sukuk will attract investors from all over the world. Your project may be suitable for Islamic financing, but might or might not fill the (Sukuk) bill.

Shari'ah differences and perceived Shari'ah risk

It is possible that the same “Code Napoleon”-based civil law allows 'blue' in Spain but prescribes 'yellow' in the Netherlands, because of different cultural and jurisprudential interpretations.

Know that such differences also exist between the various Islamic jurisdictions and interpretations. The Shari'ah indeed knows several mazhab (schools of thought) that geographically can be located on the global map.

Just be aware of this and relax. Do not get influenced by a spectacular fatwa of some Shari'ah scholar representing a minority position from a school different from the one that dominates the jurisdiction where your deal will be executed or eventually tried in court or later on enforced.

The basic wisdom is always the same: ***Respect the ground rules. Do what you are allowed to do. Stay away from what you are not allowed to do. And be careful and slightly conservative when you enter a gray zone.***

SUMMARY

Islamic finance needs a somewhat different approach. It does not only consider facts and figures. There are different ethical and financial standards to be met. It requires different structuring.

Just as your conventional banker wants to see your hard data, experience learns that your Islamic investor also appreciates you to present a concrete Islamic offer that will or will not be evaluated.

It therefor is important NOT to ask him for money, but to offer him an acceptable Islamic proposal for discussion.

You will need to evaluate and re-qualify your existing finance project into an Islamic based (or at least Islamic compliant) structure. Then you will need to weigh if the outcome still suits your needs. And only then you can start building your facts and figures again and prepare for a different roadshow.

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Be aware that your competitors are asking the Islamic bank / investor for “ a loan” and that such is exactly what he does not want to hear.

You may talk “loans and interests” with your conventional banker. But your prospective Islamic financier deserves to hear the arguments and tools that he is used to work with.

His interest or disinterest in a project depends on the way it is presented. Good or bad first impressions often decide on success or failure. The first talks, even the first contact or deal proposal will decide on further development or not.

Your conventional documentation cannot simply the "translated" to an Islamic finance-environment by changing dots and commas.

A first analysis will help you understand the accepted possibilities of Islamic finance that suit your specific needs.

It will give you insight into the mechanisms of your specific deal and make you understand if they are what you are looking for and whether or not you stand a chance in obtaining a positive result.

These are the vital questions : Is your underlying project suitable for Islamic finance ? What structure might be advisable ? And if needed : can trade-able Sukuk be issued ?

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Do not blindly assume that your conventional executive summary and roadshow will convince (or even interest) your potential finance partner.

First understand your own needs within the framework of Islamic finance. Then translate them to the language of your prospected financier/ investor. Have the cutting edge.

From project analysis to deal closing .

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