Islamic finance: From the Cayman Islands to the Middle East and beyond

The use of offshore companies in Islamic finance is driven by many of the same factors as in conventional banking, as tax efficiency, bankruptcy-remoteness and privacy are considerations common to most cross-border transactions. LOUISE GROOM and JOANNA HOSSACK write on how the Cayman Islands are in a fortunate position as the preferred jurisdiction for Islamic financing structures originating in the Middle East and the UK.

Benefits of using a Cayman SPV in Islamic financing

There are numerous reasons for Cayman's popularity among Islamic investors. As a British Overseas Protectorate, Cayman is politically stable and its laws are based on the English common law system. Since English law is the preferred governing law for Islamic finance transactions (as the courts will uphold a Fatwa from a Shariah board that a contract complies with Shariah), it makes sense for the offshore element to be based on English law.

Cayman law recognizes the concept of a trust — a vital tool in many international structures. It has also proved flexible in response to the needs of the growing Islamic finance industry. For example, since 2007, companies have been permitted to register their names in Arabic as well as in English and in 2008, amendments were made to two statutes so as to make the regulatory regime less onerous for Sukuk. Before these amendments, there were two concerns: first, if an issuer held assets on trust for Sukukholders (as is often the case), it could have been deemed to be conducting trust business, meaning it would be required to maintain a trust licence under the Banks and Trust Companies Law; and secondly, issuers could be categorized as mutual funds, meaning they would need to be regulated under the Mutual Funds Law. As a result of the revisions, Sukuk are classed as "alternative financial instruments" and these concerns have fallen away.

In addition to Cayman's tax-free status (companies are not required to pay income, capital gains, corporation or withholding taxes), companies receive an undertaking from the Cayman Islands government that such tax-free status will be maintained for a period of 20 years from incorporation, irrespective of any subsequent generally applicable law change. The period can be extended for a further 10 years if the transaction requires it. This guarantee against future tax law change is not provided by other leading offshore jurisdictions.

Subject to satisfying relevant Know Your Client requirements, companies can be incorporated quickly (usually within 24 hours) and the cost of forming and maintaining them is competitive. Cayman companies also provide an appropriate level of privacy for investors, since neither the register of directors nor the share register of a company is required to be publicly filed in Cayman.

Cayman is one of the largest banking centers in the world in terms of assets and has retained a rating of 'Aa3' from Moody's continuously since 2000. The outlook for the rating is stable, encouraging investors to have utmost confidence in the jurisdiction. Further, there is an established and reliable stock exchange (the CSX), which has "recognized stock exchange" status from the UK HM Revenue and Customs. At the time of writing, the CSX has more than 1,100 listings (including Shariah compliant funds and Sukuk) and a listed market value of US$170 billion.

As one of the first offshore jurisdictions to implement an intergovernmental agreement with the USA post-FATCA, Cayman has balanced its commitment to transparency and the need to comply with international regulators with the requirements of its investors.

Cayman prides itself on a high standard of professional services, with lawyers, auditors, trust companies and fund administrators familiar with complex cross-jurisdictional structures. The banks are viewed as reliable and responsive and the local infrastructure for communication is sophisticated. All of the big four accountants maintain offices in Cayman, as do Goldman Sachs, HSBC, Deutsche Bank, UBS and other leading service providers.

Below, we look at the current market for Islamic finance in the Gulf and elsewhere, and explain how a Cayman entity can benefit common Islamic structures.

The Islamic finance market post-credit crisis

Despite recent global financial turbulence and political unrest in the Middle East, the Islamic finance industry has remained remarkably stable and is even achieving impressive growth. According to reports, the size of the industry as a whole has been increasing for seven consecutive years and is estimated to have grown by between 8-9% since 2012.

Business is booming in the Gulf. Dubai, who is making a promising recovery from its 2009 difficulties, is celebrating its selection as the host of the World Expo 2020 and has stated its aim to become the world capital of Islamic finance. An hour up the road, Abu Dhabi has announced a plan for a new financial center (much like the DIFC) and is committed to its Economic Vision 2030, a long-term plan to diversify the emirate's economy away from oil.

Also looking to diversify its economy, and in possession of huge reserves of oil and natural gas, is Qatar. At the time of writing, the central bank of Qatar is poised to issue US$6.6 billion-worth of government debt, around 50% of which is to be in the form of Sukuk.

Saudi Arabia remains a very strong market for Islamic finance (the second-largest in the world, after Malaysia) and, like the UAE and Qatar, has historically used Shariah compliant structures to fund industrial and infrastructure projects. This looks set to continue with a recent announcement that Sukuk may be issued to finance a new airport in the west of the kingdom.

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Kuwait has an ambitious economic development plan and has in the past few years shown an appetite for significant infrastructure development. The Kuwait Investment Authority is one of the top 10 largest sovereign wealth funds in the world.

As the host of AAOIFI and with a high concentration of Islamic institutions, Bahrain has always played a very important role in the Islamic finance industry. Despite a challenging few years, the economy appears to be making a recovery and an ongoing series of mergers and acquisitions of financial institutions is likely to assist the process.

Oman, having previously been opposed to Islamic finance, has opened its arms to the sector since 2011 and has issued licenses to two Islamic banks as well as allowing several conventional banks to establish Islamic windows.

Outside the GCC, the Islamic finance market looks set to grow even in the wake of the Arab uprisings. Libya, Tunisia and Egypt have all begun work on a regulatory framework to support Islamic finance and Morocco is preparing to issue a sovereign Sukuk. Elsewhere in Africa, Nigeria, Senegal, Gambia and Sudan have issued Sukuk and South Africa is planning to follow suit.

London is a major hub for Islamic finance and English law is usually the law of choice for international Islamic finance transactions. London is one of the main listing venues for Sukuk and the London Stock Exchange plans to launch an Islamic index along the same lines as the recently-launched S&P GCC Composite Shariah Dividend Index. The UK has legislation in place to issue a sovereign Sukuk; this plan is now likely to come to fruition around the fourth quarter of 2014 and will make it the first western country to issue such a Sukuk.

The role of the Cayman SPV in common Islamic finance structures

Cayman companies can provide significant benefits in many different Shariah structures and the products described below can be combined and varied according to the requirements of the transaction in question.

Real estate finance — Musharakah and Murabahah

A Musharakah structure is a joint venture, involving two or more partners investing in an asset in order to gain a return. In a simple structure with two Cayman SPV Musharakah partners, one will be the financier, contributing cash, and the other will be the sponsor, sometimes investing cash but commonly making a contribution in kind or, in the case of a real estate development, providing the land on which the property is to be constructed. The two partners form a joint venture entity (also a Cayman SPV) and it is this company that will enter into the contracts for the purchase, management or development of the underlying asset.

The shares of the joint venture SPV will be owned by the partners and the shares of the partners may be held by a Cayman trust as an additional safeguard. Profits will be passed to the partners in proportion with each one's contribution (any losses will also be apportioned between them). Musharakah products are favored by Islamic scholars because of their risk-sharing nature. A common variation on the Musharakah model is a Musharakah Muntanaqisah, or diminishing partnership, whereby ownership of the asset is gradually transferred from one partner to the other.

Another very common structure used for real estate financings is the Murabahah. It is best described as a sale of goods with an agreed profit mark-up on the cost price. In its simplest form, it involves the purchase of an asset by the financier, who then immediately sells it on to the client, usually for a deferred payment. On top of the cost price, the client will pay the financier a pre-agreed profit margin and the cost price and profit are often paid in instalments over a period of time. The profit margin is usually benchmarked against a conventional index such as LIBOR. In this structure, Cayman SPVs are also commonly used to reduce liability and provide tax efficiency.

Asset finance — Ijarah

An Ijarah is similar to a leasing structure. The owner of an asset transfers the right to use (or benefit from the use of) an asset for a specific rent and for a specific period. The subject of the lease must be valuable, quantifiable and identifiable, so aircraft and vessels are ideal subjects for Ijarah financings.

In an Ijarah aircraft financing, a financier purchases the aircraft on the client's behalf and then leases the right to use the aircraft to the client in exchange for regular rental payments (with profit benchmarked against LIBOR). A Cayman SPV can provide a great deal of protection for the financier in this instance, as the financier, as lessor, will otherwise remain the legal owner of the aircraft and will therefore be liable for any losses resulting from such ownership. To diminish the risk for the financier, the parties can establish a Cayman SPV to act as legal owner and lessor. The client might also establish a Cayman SPV to act as lessee and operator of the aircraft.

The Ijarah model is flexible, as it can be created as a forward lease to finance assets that have not yet been constructed.

Project finance — Istisnah/Ijarah

An Istisnah agreement is a procurement or manufacturing contract to deliver an asset, often for a deferred (but fixed) sale price. Title is transferred to the procurer at the end of the construction period. In a project financing, a parallel Istisnah or an Istisnah/Ijarah model may be used. In every permutation of this type of financing, it is common to use Cayman SPVs to procure, finance and lease the underlying asset.

In a parallel Istisnah financing of a factory, the client will commission the financier to deliver the factory for a deferred set price. The financier will "on-commission" and pay a contractor to build and deliver the factory for a lower set price. Once the factory is built, title to it will pass to the financier, from which it will pass to the client. The client pays the deferred sale price to the financier, whose profit is the difference between the price it has paid the contractor and the price it receives from the client.

The prices and timeframes are fixed at the outset of a parallel Istisnah, so this model is often not flexible enough for a long-term project financing. An alternative is to combine the parallel Istisnah with an Ijarah, so that, once

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completed, only part of the factory is transferred to the client and the financier retains a portion. This portion is then leased to the client using an Ijarah agreement (which is able to incorporate a floating profit rate).

Capital markets — Sukuk
Sukuk are instruments or certificates which represent an ownership interest in an underlying asset. Unlike in the case of conventional asset-backed securities, the underlying asset must be a tangible, profit-generating asset and cannot be a financial asset such as a loan receivable.

The diagram below shows an example of the structure of a sovereign infrastructure project, using a Sukuk Istisnah model with an Ijarah between the issuer and the project company (both of which are Cayman SPVs):

Shariah scholars require the obligor and the issuer to deal at arm's length, so the issuer is typically owned by a trust. A Cayman STAR trust (falling under the Special Trusts (Alternative Regime) (STAR) Law 1997) is a commonly-used vehicle, due to its flexibility. With a STAR trust as its owner, the issuer is also bankruptcy-remote and will not appear on the balance sheet of any party to the transaction. An additional layer of protection can be achieved by appointing a local trust company as trustee of the STAR trust. The trust company can also provide independent directors, company secretarial services and a registered office for the issuer.

Conclusion

As the Islamic finance industry continues to grow and be welcomed into new jurisdictions, it follows that the products and techniques on offer will evolve. The emphasis in Shariah on justice and publicly-beneficial activity is beginning to attract the interest of non-muslim investors and in the future we may see a stronger emphasis on socially responsible finance, such as environmentally-friendly projects, microfinancing and crowd funding.

It is important for offshore jurisdictions and their service providers to remain open to such developments and to maintain their expertise and appetite, so that investors will continue to see them as vital components in the process.

Cayman has proved itself to be an adaptable and receptive jurisdiction and looks set to continue as the jurisdiction of choice for Islamic investors in the Middle East and beyond.

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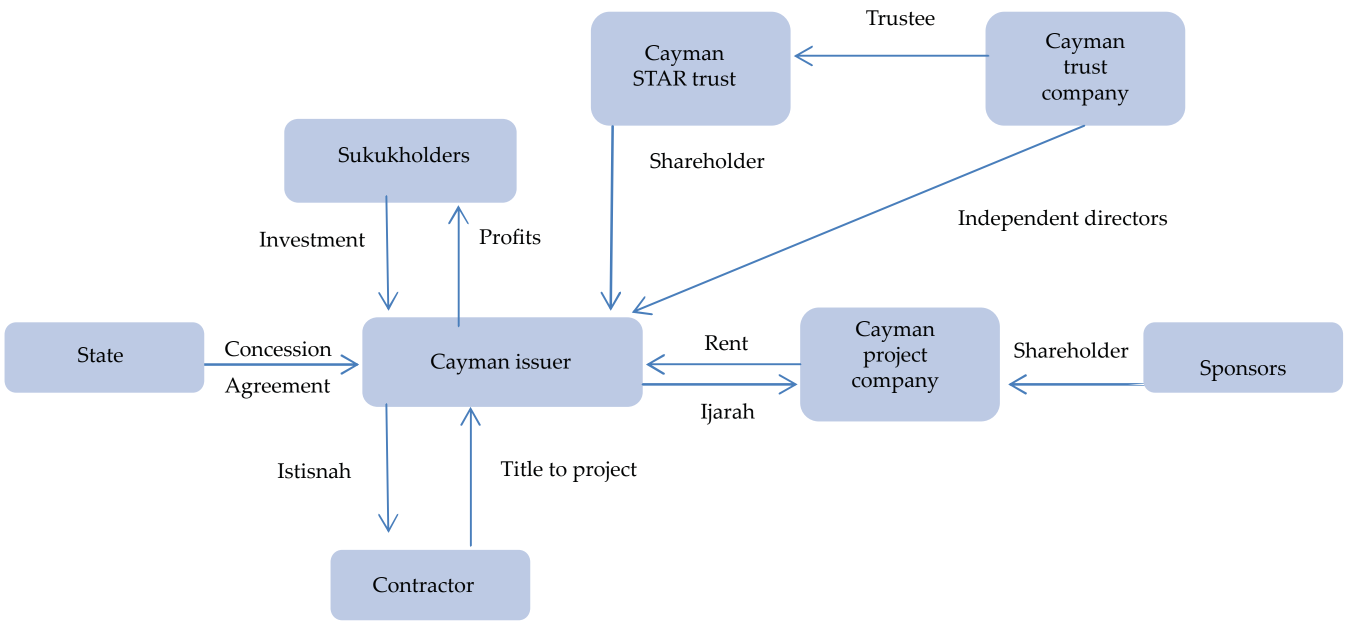
Chart: The structure of a sovereign infrastructure project, using a Sukuk Al Istisnah model with an Ijarah between the issuer and the project company (both of which are Cayman SPVs)



1. The issuer issues Sukuk to the investors in return for their investment proceeds.
2. The state enters into a concession agreement with the issuer to develop the project.
3. The issuer uses the proceeds of the issuance to procure the construction of the project with a contractor under an Istisnah agreement.
4. Once constructed, title to the project passes to the issuer.
5. The issuer enters into an Ijarah with the project company to lease and operate the project.
6. The project company pays rent to the issuer, which is passed up as profit to the Sukukholders.
7. On maturity of the Sukuk, or on an event of default, the project company usually has an obligation to purchase the assets from the issuer, so as to enable the issuer to repay the sukukholders.