

BANKING & CORPORATE FINANCING | BY SHERICE ARMAN AND CAROLINE MCCANN

Where desert sands meet Cayman shores

The size of the Shari'ah financial industry has grown tremendously over the last four decades. As a direct result of this, we have seen a dramatic increase in the number of transactions which have an Islamic element flowing through the jurisdictions of Bermuda, the British Virgin Islands, the Cayman Islands, Jersey and Mauritius, as well as through the financial centres of Hong Kong, London and Zurich.

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The principles of Shari'ah law are based upon the Qur'an and the teachings of the Prophet Mohammed. It is a system which has existed for over 1400 years and the financial world has over the last 40 years developed a new appreciation for what is available under this system. The renewed interest in Islamic financing concepts in recent years has provided access to Islamic funds, otherwise unavailable in the financial markets, through the use of financial instruments which are compliant with the principles of Shari'ah law. This is done by apportioning any profits earned directly to the risk undertaken in the investment thereby removing the concept of returns without risk. Riba, which is the equivalent of conventional interest, is prohibited by the Qur'an.

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There are many reasons why parties favour the Cayman Islands for these transactions. These include: (i) its political and economic stability; (ii) the English law basis for its legal system; (iii) the Privy Council as the final Court of Appeal; (iv) the willingness of its legislators to implement cutting edge legislation which meets the robust requirements of international watchdogs, while providing the flexibility needed by multi-jurisdictional clients; (v) its creditor friendly laws; (vi) the availability of the trust structure; and (vii) its tax regime – no income tax, capital gains tax or withholding tax are currently payable on transactions.

There are several methods of Islamic financing which may be used. The most common forms of which are musharaka (joint venture), mudaraba (profit sharing), murabaha (cost plus), ijara (leasing) or wakala (agency) all of which may be used to finance various types of assets or to provide access to funds. Access to such funds may be gained mainly through the capital markets or through both Islamic and conventional banks.

Access to financing through the capital markets is done through sukuk transactions. In sukuk transactions the issuer, usually a Cayman Islands exempted limited liability company, issues sukuk or trust certificates to investors in exchange for subscription money. The money received from investors by the issuer is used to acquire an acceptable asset or assets either through musharaka (joint venture), mudaraba (profit sharing), murabaha (cost plus) or ijara (leasing), from the entity which is raising the financing (usually called the obligor), thereby creating a partnership whereby the potential for both risk and profit are shared. The shares of the issuer are held on trust for the investors through a Cayman Islands charitable trust. Income generated by the assets, in some cases by leasing the assets back to the obligor, is used to make payments to the investors or sukuk holders.

The role of Cayman Islands service providers, in sukuk transactions is a significant one. As a result of the similarity between sukuk issuances and securitisation transactions, lawyers in the Cayman Islands are very comfortable with the structuring of these transactions and can offer their vast skill and experience in the set up and operation of sukuk structures.

Cayman special purpose entities are also playing an increasing role in Islamic financing through banks such as through acquisition financing, real estate financing and asset financing for assets such as ships and aircraft.

Acquisition financing may be done through wakala, which is similar to Mudaraba. Under mudarab, however, the parties divide any profit between themselves whilst under wakala the investor receives an agreed ratio against its investment.

Under the wakala, the wakeel, usually a Cayman Islands special purpose entity set up by the syndicate of banks pursuant to the terms of ►►

an Investment Agency (Wakala) Agreement, invests certain amounts received from an investor. The wakeel's obligations are secured then by the granting of various forms of security in favour of the Islamic syndicate.

Under *mudaraba*, the *mudareb* becomes legally indebted to the investor however, the *wakeel* is acting as an agent, so the funds never become the property of the *wakeel*.

The Shari' supervisory board of financiers have declared a pronouncement (Fatwa) of compliance in respect of syndicated Islamic financing structures utilising monies contributed to a Cayman incorporated *wakeel*.

Shari'ah compliant financing of both commercial and residential property has also become quite common.

It is very important to note that in order for property to be financed by Islamic investors, the use to which the property will be put is significant. Islamic investors will not finance property to be used for purposes which are not religiously permissible or *haram*, such as property to be used for the sale of alcohol, pornography or for gambling, just to name a few.

Murabaha financing is the most common method of Islamic financing used by banks in real estate transactions. This is essentially a 'rent-to-own' arrangement whereby the financier purchases the property for the client and re-sells it to them on a deferred basis for the original purchase price, plus a reasonable, pre-agreed profit margin and any other costs incurred. The sale price is then repaid in installments.

Under the *musharaka* structure, three Cayman Islands companies are typically used. The *musharaka* structure is a joint venture partnership whereby two or more partners invest capital for the purpose of generating a return. In *musharaka*, any profit sharing ratio may be agreed beforehand, but losses must be proportionate to the amount invested. In this type of transaction the funding company purchases the property from the vendor and leases the property to the end user. The funding company then enters into a joint venture agreement with a partner company which in turn enters into a joint venture agreement or *Musharaka Agreement* with a project company. The shares of both the funding company and the partner company are owned by a Cayman Islands charitable trust on trust for the Islamic investors while the shares in the project company are owned by the Islamic investors.

The *ijara* structure for financing commercial property involving the Cayman Islands typically sees the use of two companies and involves the purchase and lease back of the property. In this structure, the proper-

ty is sold by the vendor to a funding company and is leased to a project company which in turn leases the property to the end user. The end user pays rent to the project company which in turn pays rent under the *ijara* lease to the funding company. The rent paid by the project company to the funding company includes a premium for the grant of the *ijara* lease. The shares in the funding company are owned by a Cayman Islands charitable trust and the shares in the project company are owned by the Islamic investors. As in conventional leasing, an option to buy the property at the end of the *ijara* may be built into the contract.

Similar to real estate financing transactions, Shari'ah compliant financing has become quite popular for vessel acquisition. The most frequently used structures are *mudaraba* and *ijara*, which are sometimes used together. Usually in a limited recourse Shari'ah compliant financing, a Cayman Islands company will be formed to act as *mudareb*, which carries out the management of the *mudaraba*. A non-Cayman vessel owner will usually transfer beneficial (not legal) interest in a vessel to the Cayman company. The company then often leases back the interest in the vessel to the owner. The acquisition by the company of the beneficial interest is usually financed by a syndicate of banks who acquire the beneficial interest in the vessel and leases it back to the company in return for rent. Once all payments are made the beneficial ownership may be transferred to the company.

In addition to providing registered office services to the Cayman companies involved in these various transactions, trust companies in the Cayman Islands will also usually have the following roles in Islamic financing transactions: (i) the provision of trustee services, whereby they act as trustee of the trusts which holds the shares of the relevant Cayman companies; (ii) the provision of directors or a secretary or assistant secretary for the relevant Cayman companies; and (iii) the provision of client accounting services.

In recognition of the increasing number of Islamic transactions, the Cayman Islands legislature has pioneered legislation which allows for the registration of companies with both English and Arabic names. This move has greatly enhanced the position of the Cayman Islands in the world of Islamic finance. In response to the needs of the industry several Cayman Islands service providers have established a presence in the Islamic world, thereby making themselves more accessible to their clients. ■

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