

BUSINESS & FINANCE

SHARI'A COMPLIANT METHODS FOR THE FINANCING OF SHIPS

Following the virtual economic meltdown in 2007/8, the banking system teetered on the brink of collapse and the period of prolonged economic growth ended with a bang. Trade slumped and, as a consequence, freight rates fell to alarmingly low levels, as did ship values.

The immediate legacy of the banking crisis was a severe credit squeeze. Whilst levels of new lending dropped dramatically, the cost of borrowing (if you could source it) went up and covenants were tightened. Most banks looked to restructure debt and "repair" their capital base. Many simply closed to new business.

In early 2011, whilst there are signs that new loan facilities are becoming more readily available, the ship finance banks remain circumspect about who they will lend to, indicating that we are still a long way from the heady days of 2003-2007.

In short, the liquidity crisis is far from over, especially for those owners falling into the lower end of the SME bracket.

In such a situation owners (who may have existing commitments to a shipyard or who otherwise see this as an opportunity to expand their fleet) will inevitably look for alternative sources of funding. One such source is *Shari'a-compliant finance*.¹ Although certainly not immune from the effects of the worldwide downturn, Islamic banks expanded their assets in 2009 by 28.6 percent. *Shari'a-compliant* assets are now said to total about US\$1 trillion, making this a significant source of liquidity. Muslims and non-Muslims alike have shown that they are willing to tap this particular source of funding.

If they do, what can they expect to be offered? In this article we examine some of the most common forms of *Shari'a-compliant* financing structures with which we have been involved.

Some Typical Islamic Financing Structures

1. *Murabaha*

The *murabaha* is often referred to as "cost plus" financing. It is the most commonly encountered instrument in Islamic finance and is used (amongst other things) in financing trade, the

acquisition of assets and for the provision of working capital. The *murabaha* arrangement broadly involves:

- a. the bank's customer (A) identifying and inspecting the asset it wishes to acquire (e.g. a second-hand ship) and requesting finance from its bank (B).
- b. A and B enter into a *Murabaha* Agreement in which A promises to (i) buy the asset from B immediately B acquires ownership, see (d) below, and (ii) pay for the asset on a specified date or dates in the future at a specified price (the **deferred price**, being the cost price, plus a declared profit margin).
- c. B appoints A as its agent to purchase the asset from the seller (C) on B's behalf.
- d. B purchases the asset under a purchase contract with C and pays the price (the **cost price**) under that contract and title to the asset vests in B.
- e. B then sells the asset to A for immediate delivery (with title passing to A) for the deferred price on terms that it is payable by specified instalments throughout the *murabaha* period or in one lump sum on the last day of that period.

The profit element is intended to reflect B's risk (e.g. credit and title risk). It is usually benchmarked against LIBOR plus a margin. Whilst it has been suggested this is akin in many respects to a loan with interest, scholars have opined that the profit element does not amount to a charge for the use of money over time (which is prohibited as *riba*² and therefore not enforceable under *Shari'a* law) and that the bank is entitled to charge for the risk it assumes in taking title to the asset.

This type of *murabaha* is sometimes referred to as a "true" *murabaha*.

Another type, now frequently employed in financing the acquisition of assets, is called a *Tawarruq* or *reverse murabaha*. This commonly involves the purchase and sale of commodities such as metals in order to raise funds for the acquisition. In

¹ *Shari'a'* (literally the "Way") is Islamic law derived from the Qur'an (as the primary source) as supplemented by the Hadith (or sayings of the Prophet Muhammad (PBUH)) and the Sunna (or customs, habit or way of life of the Prophet (PBUH)).

² *Riba* (literally "increase" or "excess"). The payment or receipt of interest is prohibited under *Shari'a'* law. An obligation to pay interest will not be enforceable.

many respects the steps are similar to a *straightforward murabaha* but include the following:

- a. B purchases the commodity (through a broker) at the current market value for immediate delivery.
- b. B immediately sells the commodity to A at an agreed (marked-up) deferred price for immediate delivery.
- c. A then sells the commodity (through another broker - B usually acting as A's agent on such a sale) to a third party at the market price for immediate payment and delivery.

Although these back-to-back sales take place in sequence they will occur as near to simultaneously as possible and so, again, B holds title to the commodity but for a brief time only.

The consequence of these transactions is that A ends up with cash in hand coupled with an obligation to pay a sum of money to B either in a lump sum or by installments on a specified payment date or dates.

Such facilities are increasingly structured as revolving facilities by which a succession of purchase (or *murabaha*) contracts come into existence under a *Master Murabaha Agreement* with (say) six month maturities and on each rollover date a new purchase contract replaces the maturing contract and the cash-flows are simply netted off at that time.

B can take security for A's obligations under the *Master Murabaha Agreement*. The "cocktail" of security will usually include a ship mortgage and an assignment of earnings and insurances (as in a conventional ship financing). A's obligations may also be guaranteed by its parent or other related entity (subject to the usual qualifications as to capacity and authority). The *Master Murabaha Agreement* will frequently contain corporate and ship related covenants as well as representations and warranties and events of default and will, to that extent, look similar to a conventional loan agreement.

Whilst in the past the *murabaha* was used for short-term funding, the trend with the *reverse murabaha* is more towards the medium term with facilities running for up to five years.

Facilities of this kind can be offered on a syndicated basis by using a *mudaraba* or investment agency agreement in which the participants/investors (known individually as *rab al mal*) agree to place funds with the *mudarib* (or agent) for investment in the transactions to be entered into under the *Murabaha Agreement*. This Agreement can also serve as the vehicle by which the *mudarib* is appointed as facility agent and as security trustee/agent. The participants will share in profits and losses each according to its contribution to the commercial venture whilst the *mudarib* will earn a fee for acting as such.

2. *Istisna'a*

An *istisna'a* is similar in character to a *murabaha*. It is used for funding major construction projects and can be used for the pre-delivery financing of a ship under construction. In brief, the pre-delivery instalments of the contract price are funded by the bank (B) paying them to the shipbuilder. Title to the ship will pass to B on completion and delivery. B will then transfer title

to the ship to its customer (A) on the basis that A will pay the deferred price (the cost price plus the mark-up on the same basis as for a *murabaha*) by instalments over a specified period. As an alternative, at the outset B could (i) agree to retain title on completion and (ii) enter into a future or forward lease of the ship to the shipowner. This arrangement is known as an *ijara mawsufa fi al dhimmah*.

3. *Ijara and ijara wa iqtina* (lease and lease purchase)

As with a *murabaha* arrangement, the shipowner (A) will seek finance from its bank (B) for the acquisition of a ship it has selected and inspected. Assuming this is not a pre-delivery financing (dealt with above), B will purchase the ship from the seller (which could be A) under a purchase agreement and will then lease it to A (or preferably an affiliated entity as a sale and leaseback as such is not generally permitted) under an *ijara agreement*.

A straightforward *ijara arrangement* amounts to a sale by the owner of the usufruct (*manfa'a*). In effect, the lessee (A in our example) purchases the right (by paying rentals) to use the leased asset for a period of time. In order to comply with *Shari'a law*, the lessor/owner of the ship (B in our example) is entitled to be paid a fixed rent and must retain and exercise (itself or by its agent) all the rights and obligations which are incidental to ownership. This will include maintaining, insuring and repairing the ship. This differs from a conventional finance lease where the risk and reward are substantially transferred from the lessor/owner (usually a bank lessor or maybe a group of investors) to the lessee.

In practice, B (as lessor) will enter into a Service Agency Agreement with A (as lessee) by which B will delegate responsibility for maintaining, insuring and repairing the ship to A. B will pay a related service charge to A and the rental is usually increased to cover that charge.

Given the nature of the *ijara arrangement*, if A is deprived of the use of the ship for any part of the lease period, the obligation to pay rentals during that time will cease. So, unlike a conventional lease, *Shari'a law* does not recognise a "hell and high water" payment obligation. B will need to ensure, in the Service Agency Agreement, that A arranges adequate insurance cover for any shortfall that might arise. It should also be considered that if A is in breach of any of its obligations under the *Ijara agreement* (or the Service Agency Agreement) such that there is a right to terminate the Agreement, B cannot "accelerate" payments of rental due to it in the future. B must therefore ensure that it can "put" the ship to A for a price which reflects the outstanding amount of the facility it granted to A. This is usually accomplished by a form of Purchase Undertaking.

The fixed rentals will be broadly calculated in the same manner as for a *murabaha*. The instalments of rental will comprise (i) the relevant percentage of the original facility actually made available by B and (ii) a profit element benchmarked against LIBOR or some similar reference rate plus a margin. *Ijara* arrangements have been structured so that the rentals are periodically re-calculated so that there is a fixed element and, in effect, a floating element. Whether this strictly complies with *Shari'a law* may be open to question and will ultimately be a matter for B's *Shari'a* Board to examine in each case.

A lessor will always be exposed to those risks that are inherent to ownership of an asset. With a conventional finance lease, however, most of this risk is passed on to the lessee. With an *ijara*, as mentioned above and in accordance with the principles of *Shari'a law*, the risks (which will include the usual owner's liabilities for such things as pollution, tax and regulatory matters) are potentially greater. The onus is on B (and their lawyers) to analyse the risks before making a commitment to grant this type of facility to A and to ensure that A (acting in its capacity as service agent) arranges insurance cover that is satisfactory to B.

Where the facility involves a finance lease (as distinct from an operating lease) it will usually be structured as an *ijara wa iqtina*. In addition to the elements referred to above, A will undertake to purchase the ship on expiry of the lease (in effect a put option) and there may also be an undertaking by B to sell the ship to A (in effect a call option) exercisable at specified intervals and at a price reflecting the outstanding amount of the facility on the relevant date.

Syndication of such a facility is achieved by using a *mudaraba* arrangement in the same manner as for a *murabaha* (see above).

Other structures

We briefly touch on other Islamic financing structures that can be, and often are, used for the financing of ships.

1. Sukuk

Where the funding requirement is substantial, the offering and issue of sukuk (often referred to as Islamic bonds but which is roughly translated as investment certificates) may be considered. Sukuk can be listed and rated. Issues are structured around real transactions, the most common being the Sukuk al *ijara*. Investors generally receive periodic payments which are benchmarked to LIBOR.

2. Musharaka

This form of equity financing has not been widely used in financing ships. It is perhaps the purest form of Islamic financing technique as it involves parties sharing in profits and losses in a form of partnership. This arrangement cannot be structured so as to give a guaranteed rate of profit to one party. Generally there will be an agency agreement accompanying the *musharaka* by which one partner will have the management delegated to it. It is similar to (but distinct from) a *mudaraba*.

Governing law

Often parties choose to have their Islamic finance documents governed by English law. In 2004 the English Courts were asked to look at whether there was a conflict of law issue where *Shari'a law* would prohibit something which is otherwise allowed under English law. The Court of Appeal³ resolved this in favour of English law as the national system of law chosen by the parties to govern the contract. The Court made the point that:

- a. *Shari'a law* is not a system of national law;
- b. interpretation of *Shari'a law* is sometimes a matter for scholarly debate (and not for interpretation by judges in a secular court); and
- c. that it would be "unusual and improbable" for parties who have chosen English law to govern their contract to expect an "English Court to determine and apply the *Shari'a* in relation to the legality or enforceability of the obligations clearly set out in the contract".

However, a recent case⁴ raised the issue as to whether a company entering into a contract is acting beyond its powers where it is restricted by its constitution or by the law of the place of its incorporation to engage only in transactions that are *Shari'a* compliant. As a consequence, certain practical steps should be taken in any Islamic financing arrangement to ensure that the Islamic counterparty waives any *Shari'a* based defences, gives suitable representations as to its capacity and provides copies of any fatwa relating to the transaction in hand.

The lesson in both cases is that it is necessary to obtain *Shari'a* Board approval of the documentation before it is entered into.

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³ In *Beximco Pharmaceuticals Ltd and others v. Shamil Bank of Bahrain EC* [2004] EWCA Civ 19

⁴ *The Investment Dar Company KSCC v. Blom Developments Bank SAL* [2009] EWHC 3545 (Ch)

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