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Briefing note

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Islamic Asset Finance

Despite the difficulties that continue to hinder the global financial markets, Islamic finance has continued to grow since 2010, when global Islamic finance assets were valued at US$1 trillion. Standard & Poor's expects the industry to double in size by 2015.

In this briefing, we consider how a conventional secured lending and leasing structure for an asset, such as an aircraft, can be developed into a *Shari'a* compliant product, thereby providing asset leasing companies and operators with the opportunity to meet their financing needs by accessing the liquidity of the Islamic finance market.

Conventional Financing Structure

Whilst a variety of conventional financing structures can be used to finance the acquisition of assets, the typical secured lending and leasing structure tends to feature in the majority of transactions. This structure combines a secured loan and a finance lease to develop a tax and accounting efficient financing structure.

The structure typically operates as follows (see also figure 1):

- a group of lenders will provide a loan facility to an offshore special purpose vehicle (the **SPV**);
- the SPV will use the loan to acquire the asset and will grant security over the asset in favour of the lenders;
- as the owner of the asset, the SPV will lease the asset to the asset operator in return for rental payments. The rental payments will be determined by reference to the principal and interest due under the loan; and
- at the end of the lease term (which will mirror the term of the loan), the loan will have been fully repaid and the SPV will transfer ownership of the asset to the asset operator.

A critical aspect of the conventional secured lending and leasing structure, and one that lends itself very well to the principals of *Shari'a* compliant financings, is its asset based nature. The asset is used to generate income in order to repay the financing and where a default occurs and enforcement is sought, the lenders have recourse to that asset in order to seek repayment of their outstanding debt.

Relying on the assets to generate revenues to service financing costs are key requirements of the majority of Islamic finance transactions. The financing of assets, perhaps more so than any other form of financing, is therefore particularly well suited to the Islamic finance industry.

Key issues

- Liquidity in Islamic finance market presents opportunities for asset leasing companies and operators
- Asset-based nature of asset financings is well suited to the principles of Islamic financing
- The use of *ijara* arrangements in conjunction with other Islamic financing techniques provides a viable *Shari'a* compliant alternative to conventional asset financing structures
- *Sukuk* issuances offer a further alternative to asset financing and re-financing

Islamic Financing Structures

In this section we look at how market standard Islamic financing structures can be adopted to mirror the commercial effects of the two components of a secured lending and leasing structure, the finance lease and the secured loan.

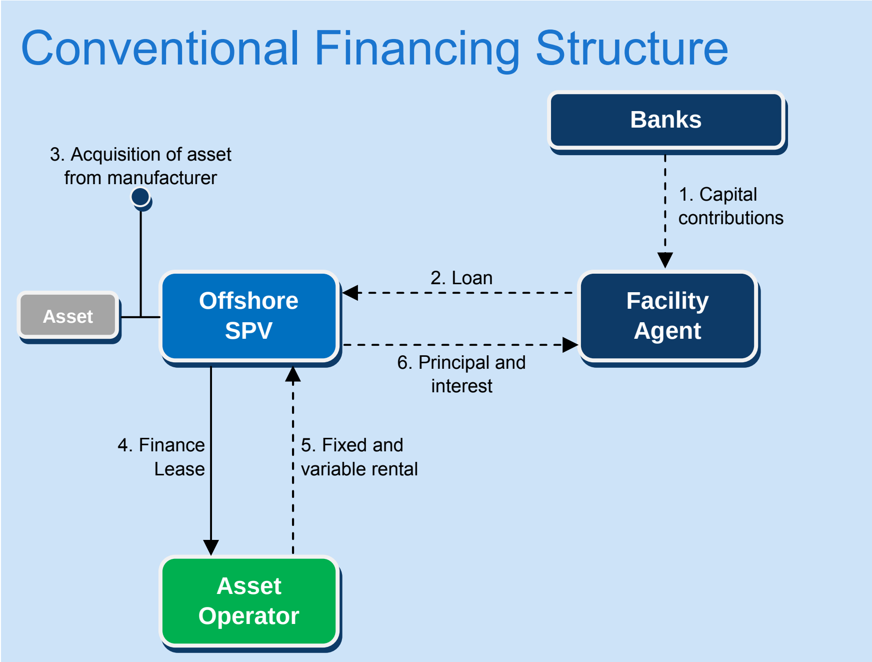

Figure 1

Finance Lease

A *Shari'a* compliant lease (an *ijara*) is regularly used in Islamic financing transactions and can be used to replicate the commercial effect of a conventional finance lease. Whilst the *ijara* would be structured identically to the finance lease, some of the terms of the *ijara* will differ substantively including:

1. maintenance responsibilities in respect of the asset need to be separated into major maintenance (and made the responsibility of the lessor) and minor maintenance (which can be made the responsibility of the lessee);
2. the lessor will also need to be responsible for insurance over the asset. *Shari'a* scholars can insist that the insurance arrangements are *Shari'a* compliant but often acknowledge that this may be difficult, either because Islamic insurance for the cover being sought doesn't exist or is too expensive;
3. due to the SPV having limited operational functionality, servicing agency arrangements need to be implemented in order to allow the SPV to perform its maintenance and insurance obligations;
4. the lessee cannot be liable for repaying the financing if the asset is totally lost or destroyed. This responsibility must be borne by the SPV, as lessor, and consideration should be given to ways to mitigate that risk through the servicing agency arrangements; and
5. stand-alone purchase undertakings would be required in order to allow for the asset to be transferred to the lessee on the final maturity date or in an acceleration scenario, in each case, in exchange for a cash payment equal to any amounts due under the financing.

The *ijara* could also be used to replicate operating lease structures on substantially the same terms as highlighted above.

Secured Loan

In seeking to replicate the conventional secured loan (which is essentially the mechanism by which the financiers provide the loan to the SPV) in a *Shari'a* compliant manner, the key requirement is to ensure that the rental income from the underlying *ijara* is not passed to the Islamic financiers in the form of an interest payment. In practice, the payment of rental income is normally documented as an entitlement to profit and can be structured in several alternative ways, for example:

- ***Mudaraba*** – a *mudaraba* is a contractual arrangement between a group of investors (the *Rab Al Maal*) and a manager (the *Mudarib*). The *Rab Al Maal* provide capital to the *Mudarib* to invest on its behalf. Any profit generated from the investment is shared between the *Rab Al Maal* and the *Mudarib* in accordance with pre-agreed profit sharing ratios. Any loss of capital is borne solely by the *Rab Al Maal*. In an Islamic asset financing, the Islamic financiers would act as *Rab Al Maal* and the the SPV would act as *Mudarib*. The

Mudarib will only be permitted to invest the capital of the Islamic financiers to acquire the asset and to lease it pursuant to the *Ijara*. The rental revenue would constitute *Mudaraba* profit and be shared between the SPV and the Islamic financiers.

As a result of this profit-sharing arrangement, the rental under the *Ijara* will need to be fixed in a manner that ensures the Islamic financiers' share of the rental is sufficient to service the financing.

Careful legal consideration would need to be given to this structure, as it may be construed as a partnership in some jurisdictions and be subject to specific laws and regulations.

- **Declaration of Trust** – the SPV could declare a trust in favour of the Islamic financiers in return for capital. The SPV would use the capital to acquire the aircraft from the manufacturer and lease it pursuant to the *ijara* to the asset operator. The asset and any rental income would form part of the trust and therefore the beneficial interest and entitlement to the rental income would lie with the Islamic financiers.

The implementation of such an arrangement would need to be considered on a case by case basis taking into account the jurisdiction of the SPV and the enforceability of local or English law governed trust arrangements.

By combining one of these arrangements with an *ijara*, a structure can be developed that would allow asset operators to meet their financing needs competitively through the liquidity that exists in the Islamic finance industry and would allow Islamic financiers to participate in asset financing transactions in a *Shari'a* compliant manner.

Islamic Financing Structure

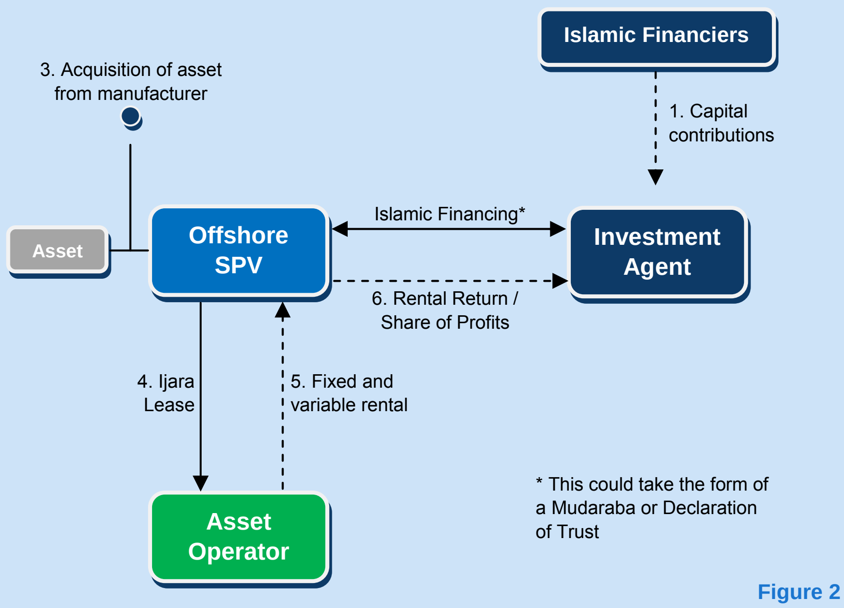

Figure 2

Outlook

Notwithstanding the difficult global challenges being faced, as populations increase and emerging markets develop, there will be a demand in a number of jurisdictions for more aircraft, ships and other assets. The challenge that will be faced by asset operators and asset leasing companies will be how best to finance those assets effectively in light of global political and economic developments. In this paper we have suggested Islamic finance as a viable alternative.

Finally, as the cost of commercial bank lending increases, experts estimate that 15% of aircraft deliveries in 2013 will be financed through the capital markets. The Islamic finance market has already seen general corporate *sukuk* (*Shari'a* compliant capital market instruments) issuances by leading asset leasing companies (for example, the GE *sukuk* in 2009 and Nomura *sukuk* in 2010). We see no reason why sukuk structures cannot also be used to finance assets as an alternative to conventional bond financing.

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