Islamic Syndicate Finance

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Syndicated finance refers to a form of financing where two or more banks or financial institutions (FIs) decide to group together to participate in a deal and each provides a portion of the principal financing sum to a borrower. Similar to conventional syndicated finance, the participating FIs in an Islamic syndicated finance will appoint a lead bank who is responsible for the syndication, coordinating the process of preparing and finalizing the documentations and closing the deal.

In most cases, the lead bank is also a participating FI. The borrower will have no direct communications or dealings with the participating FIs throughout the syndication process and the financing tenure, instead all communications and dealings are carried out through the lead bank acting on behalf of the participating FIs. The concept of syndicated finance from the Shariah perspective works in similar ways to that of the conventional syndicated finance except that it uses structures acceptable to the Shariah. A significant feature of an Islamic syndicated finance is the absence of elements of interest. Instead, the transaction involves trades/ leases of tangible assets and these assets are expected to generate profit for the transaction, however profit cannot be guaranteed. Syndicated finance is advantageous to both the participating FIs and borrowers alike. From the point of view of the creditors, it allows them to participate in high valued transactions otherwise unavailable for varied reasons, such as limitations on the exposure of risks to a single customer, regulatory limits or diversification of loan portfolios. For the borrowers, it means lesser costs and time otherwise spent on preparing prospectuses or information memoranda required for the issuance of Islamic bonds or Sukuk. The documentation involved for an Islamic syndicated finance are much less and relatively easier to conclude than a Sukuk issuance, although arguably the legal documents for a syndicated finance contain more covenants to reduce the risks to the participating FIs. Islamic syndicated finance is usually granted for short term financing ranging from one to seven years of financing tenure and therefore not suitable to borrowers requiring long term financing.

There are two tiers to Islamic syndicated finance. The first tier defines the relationship between the participating FIs and the lead bank. The second tier defines the structure of the financing to the borrower through the lead bank. There are two possible ways which are widely used to structure the relationship between the participating FIs and the lead bank. This is either by way of Wakalah (agency) or Mudarabah (partnership). In the former, the relationship between the participating FIs and the lead bank is based on Wakalah or agency principles where the participating FIs act as the Muwakeel or principals and the lead bank acts as the Wakeel or agent.

The participating FIs will enter into an investment agency agreement with the lead bank, appointing it as the Wakeel to receive, invest the advanced funds with the borrower and execute transactions with the borrower. The borrower will utilize the funds received in the agreed manner. The lead bank as the Wakeel will assume all the rights and duties of an agent, normally stipulated by express or implied terms of the investment agency agreement. The investment agency agreement spells out the terms of the participation, distribution of principal and profit to the participating FIs, the scope of powers and authorities of the Wakeel and matters which can be decided by the Wakeel at its discretion or that which require the unanimous approval, super majority approval or majority approval of the participating FIs. Where no such terms are provided under the investment agency agreement, the rights and duties of the Wakeel may be derived from the fiduciary nature of the relationship with the Muwakeel. The Wakalah relationship may also be governed by the applicable local agency laws. As an agent, the lead bank is entitled to receive agency fees for its role, although at times the Wakeel is granted the right to receive performance or incentive fees. In the Mudarabah structure, the participating FIs, as the Rab Al Mal, appoints the lead bank as the Mudarib through a Mudarabah agreement. The Mudarib carries out the management of the Mudarabah. To a certain extent, the terms and conditions appearing in the Mudarabah agreement are similar to that of the investment agency agreement. However, in the Mudarabah agreement, the Mudarib does not carry the duties of an agent and agency laws applicable in the jurisdiction will not be applied to the relationship. Instead of a fee, the Mudarib is entitled to share in the percentage of profit generated from the investment of the funds but the losses will only be borne by the Rab Al Mal. In substance, both the Mudarabah and Wakalah structures operate similarly, although they are conceptually different. Wakalah is a fee based mechanism where the Wakeel is entitled to take fees upfront and is not entitled to the profit generated by the financing. Mudarabah, on the other hand, is a mode of equity partnership and is performance based. The question on whether to use a Wakalah or Mudarabah structure does not give rise to any significant advantage in choosing one over the other.

The current practice of the Islamic financial industry is to increasingly adopt the Wakalah as opposed to the Mudarabah structure. Although the latter had an earlier start in the industry, there are several factors which may need to be taken into account on whether to utilize Wakalah or Mudarabah for an Islamic syndicated finance. One consideration is that a Wakalah relationship, being an agency, may attract the specific application of agency laws in the jurisdiction of the governing law. Tax issues are another consideration. There may be different tax implications under the local tax laws for each structure depending on how the laws interpret the relationships. There may also be different treatment of the funds received by the Wakeel or the Mudarib which will present significant issues in the event of insolvency of the Wakeel or the Mudarib. Another issue is that where the Wakeel is not one of the participating FIs, the Wakeel would presumably have no incentive in pursuing the interests of the syndicate. The Wakeel will earn agency fees regardless of the performance of the transaction and consequently may concentrate on closing as many transactions as possible rather than ensuring the quality of the transactions. For instance, the Wakeel may compromise on the covenants imposed on the borrower for the sake of closing the deal quickly and therefore exposing the participating FIs to more risks. To alleviate these problems, the Islamic principles are flexible enough for the syndicate to incorporate into the Wakalah relationship incentive fees or performance based fees to be paid to the Wakeel, as in the case of excess profit after distribution of the expected periodic returns to the participating FIs and deduction of expenses and taxes.

In Mudarabah, the Mudarib works on a performance basis, and would want to ensure that the Mudarabah generates as much profit as possible, consequently benefiting the syndicate as a whole. However, such incentive to the Mudarib may result in the Mudarib taking more risks than what is optimal for the syndicate, as any losses will be borne solely by the participating FIs and not the Mudarib.

The decision issued by the English High Court of Justice on Investment Dar Co v Blom Development Bank (on the 11th December 2009) has caused concern among participants in the Islamic financial market on the use of Wakalah arrangements and the wider Islamic financing transactions. One of the arguments by the appellant (the defendant in the first instance) to support its ultra vires argument defence was that the Wakalah agreement was not Shariah compliant as it merely disguised the presence of interests and guaranteed the returns to the principal. Even though in this case the High Court did not specifically rule that the Wakalah agreement in dispute, or Wakalah agreements in general for that matter, was non Shariah compliant, it did state that “where one finds, as one does in this master Wakalah contract, a device to enable what would at least to some eyes appear to be the payment of interest under another guise, that is at least an indirect practice of a non Shariah compliant activity.” This gives rise to the concern as to whether pronunciations by the Shariah boards on if a transaction is Shariah compliant matters at all and if a secular court is allowed to make its own observation in this regard; however that is another discussion altogether. Despite such uncertainties presented by this case, the use of Wakalah in Islamic syndicated finance continues, mainly because participants are waiting for a more definite decision on this matter.

The second tier of the Islamic syndicated finance is the funding to the borrower itself and the structure depends on the purpose of the financing and the available assets. Almost all Islamic finance structures can be used, the most common is the Murabahah (Tawarruq) structure. Despite its prevalent use in the Islamic syndicated market, this structure came under close scrutiny recently when the International Council of Fiqh Academy resolved that Tawarruq or what is known as ‘organized Tawarruq’, as practiced by many banks and financial institutions, was not permissible. In particular they ruled that it came into conflict with the real objectives of the Shariah. It was argued that although Tawarruq has its basis in the Shariah, it was merely paper documents disguising the elements of interest based lending. It was found that in organized Tawarruq, the structure was designed to get around the prohibition on interests and therefore the intention of all participants contradicts the objectives of the Shariah. However, this position was challenged by prominent scholars on the basis that it is in the social interests of Muslims to continue using Tawarruq as a means of financing due to its usefulness, provided that there are proper checks and balances to prevent abuse. Despite such resolution, market players continue to use Murabahah (Tawarruq) for Islamic syndicated finance. The controversies surrounding the application of Murabahah (Tawarruq) prompted the market to move away from such a structure to find alternative structures. One structure which has been increasingly used is Ijarah.

An example worth noting is the US$125 million syndicated Ijarah facility made between Liquidity Management House, Kuwait Finance House, BNP Paribas, Gatehouse Bank, Ahli United Bank and Boubyan Bank (as the lead arrangers), other financiers and Burgan Company for Well Drilling Trading and Maintenance (Burgan) for the acquisition by Burgan of four new oil rigs, marking the debut of Burgan into the Islamic syndicated market. This transaction was the first Shariah compliant corporate syndication out of Kuwait and the GCC in 2009 and was oversubscribed, suggesting confidence in Islamic syndicated finance during adverse market conditions.

In conclusion, there is so much potential for Islamic syndicated finance to grow and expand, being a useful and important financing tool particularly in times of financial crisis due to the spread of risks and pooling of resources. Despite controversies surrounding certain Islamic financing structures, the flexibilities accorded by Islamic principles present the market participants with opportunities to push for more innovative and attractive Islamic syndicated finance products.

Originally published in the Islamic Finance News, Volume 7 Issue 30