ANSWERING TO A HIGHER AUTHORITY

Islamic finance has grown into a $1 trillion practice with its own compliance sector. Brunswick's HASSAN FATTAH and TASHA YOUNG examine how Shariah has taken a seat at the board table

Yasser Dahlawi's epiphany came in the early 2000s. After more than a decade spent working in the growing area of Islamic finance, he had begun to realize that efficient controls were lacking to ensure compliance with Islamic codes, or Shariah.

"We kept seeing gaps between what was being proposed to the Shariah boards at these institutions and the implementation of the product," Dahlawi says. "There was no audit, no quality check. But people were calling it Shariah compliant, and that was a major problem."

What this rapidly growing industry needed, he realized, was a new level of professionalism – external advisory specialists who understood all the concerns in such transactions. In 2004, he helped found the Shariyah Review Bureau, a business he now runs as CEO. It is part of a growing industry of Shariah advisers that help structure financing transactions and certify that financial products conform to Islamic law. These advisers are increasingly important to company boards as more businesses embrace the Muslim world as a source of capital and inspiration.

At its core, Shariah (sometimes Shariyah or Sharia) finance eschews usury, or *riba* – the collection of interest. Based on the Quran, the sayings of the Prophet Muhammad and religious case law, the code requires that money be used only to represent the value of a commodity or product, not something of value in itself. Investment returns should serve a common good and encourage partnership between lender and borrower, with the risks and rewards shared by both sides.

Shariah compliance requires some interpretation to adapt to the modern age. Profits from pork, gambling, alcohol and tobacco are clearly forbidden, but so are financial derivatives. And gray areas exist, such as whether a company can lend itself money as an accounting method, with no asset attached.

Historically, companies would retain three to six scholars and experts as an independent Shariah review board that would make recommendations to the corporate board regarding compliance. However that practice created wide variation among rulings between companies. To encourage greater reliability and consistency, many companies in recent years have chosen to outsource the process of Shariah review.

The Shariyah Review Bureau is an organization that offers this service. SRB's scholars use their experience as authorities and their expertise in finance to find precedents for a financial process, product or institution. If they find a non-compliant feature, they will offer alternatives. Cases involve everything from the simple (how a bank account can be set up) to the complex (the leasing structures of private equity deals). When they are stumped, the researchers appeal to the wider network of Islamic scholarship.

The Shariah compliance sector carries an exciting air of innovation. SRB's own office is reminiscent of both a dotcom and a library or financial research facility, with a ping-pong table, mini golfing range, multiple screens on each desk and a large supply of pantry perks. Sheikh Muhammad Ahmad, one of SRB's scholars, wears an Apple Watch, but represents an ancient tradition of Islamic scholarship and authority. He is also a Shariah finance expert, having structured more than 400 transactions over 11 years.

SRB is not alone in the space. Others include Amanie Advisors, based in Kuala Lumpur, and Dar al Sharia, a subsidiary of Dubai Islamic Bank, one of the first Islamic banks – both offer Shariah services around the world. Headquartered in San Francisco, IdealRatings offers Shariah compliance checks tailored more toward Western markets.

INTEREST IN SHARIAH compliance services has spread globally. US agriculture technology company Fresh Box Farms, based in Massachusetts, specializes in hydroponic farming of produce in specially designed units. The company approached SRB to help it reach out to Islamic investors.

"The main activity of the company is Shariah compliant – producing vegetables," says Mansoor Munir Ahmed, SRB's Assistant General Manager. "But the minute you tap into the financial world, new questions are raised from a Shariah perspective."

In Fresh Box Farms' case, SRB found Shariah compliant funds could buy stock in the company, in return for a proportional piece of the profits.

In another example, Italian law firm NCTM wanted to build a Shariah-compliant bond that small- and medium-sized enterprises, or SMEs, could offer to investors. In addition to helping SMEs gain access to Islamic finance, NCTM hoped to provide an alternative investment and tax-advantaged returns for clients in Europe.

SRB thought a single-bond structure for NCTM might not meet the range of needs required and it suggested a suite of products instead: one arranges profit sharing; another permits the purchase of equipment in a "leaseback" arrangement; and a third allows financing for companies seeking to acquire another business.

Occasionally, it's just not possible to create a bridge between the moral strictures of Shariah and modern financial practices. "Clients come to us for various options and scenarios," says Sheikh Muhammad Ahmad. "But sometimes, no matter how you tune it, you simply can't make it compliant. So my job becomes finding an alternative product."

The first Islamic banks appeared as a niche offer in the 1970s. In the early 2000s, a new generation of bankers and investors sought to widen the appeal of Islamic finance by applying modern banking concepts and systems.

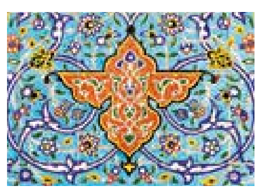
BANKING IN GOOD FAITH

Shariah, or Islamic religious law, offers a guide to moral business conduct. Profits from pork, alcohol and gambling, for instance, are forbidden. Investors also cannot be guaranteed returns on investment and must share in losses as well as gains.

The Quran has several verses that scholars believe condemn *riba*, generally understood as the charging of interest. Other religious authorities echo that interpretation, and it sits as the bedrock of most Shariah-compliant financial products. Many forms of loans, bonds and other transactions need to be redesigned before they can be considered acceptable for religiously minded investors.

To allow for profits while not charging interest, money must represent the value of a specific commodity. Several Shariah concepts that build on this idea (see right) have spread internationally throughout Islamic countries and are increasingly popular in Europe and the US.

Sukuk Also called "Islamic bonds," these are one of the most popular forms of Islamic finance. Where normal bonds represent debt and pay an investor interest, sukuk represent the value of an underlying asset. An investor buys a piece of a company, for instance, and is entitled to a share of the profits associated with that asset. The payment is a substitute for the interest that a bond investor would collect in a non-Shariah transaction. The issuance of sukuk can raise money for infrastructure projects or business expansions.



Shariah-compliant risk tends to be lower, due to the asset-backed nature of the debt

Murabaha This is a type of deferred sale in which an intermediary, such as a bank, buys property and sells it to a customer on terms that include a payment schedule and a disclosed mark-up. This is the basis of the most popular form of corporate financing in Islamic banking.

Ijara Similar to murabaha, this is a lease-to-own agreement that functions in place of a loan. The bank, for example, buys an asset, such as a car or a house, and leases the right to use it to the customer for a specific period, with a profit added. The term and the total amount are agreed up front. The main difference from murabaha is that the bank retains ownership until the end of the term; only then is ownership transferred to the customer.

Mudaraba This type of arrangement is an agreement between a financer, who provides capital, and an entrepreneur, who provides work. While commonly described as a "profit and loss sharing" arrangement, losses in mudaraba are actually borne by the financer, while profits are shared between the two parties. The financer has no control over management of the project.

Musharaka Used in place of an interest-bearing loan, musharaka gives all parties joint ownership, including shared equity for mortgages. In an Islamic mortgage the bank and investor share equally in any loss of equity, as well as the profit.

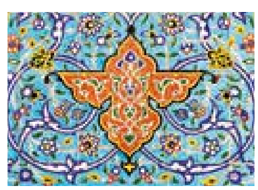
Takaful An Islamic form of cooperative insurance, takaful policyholders share both profits and losses from the fund. In non-Shariah insurance, companies pool money from policyholders and invest it, and policyholders do not earn money from the investments. Takaful, on the other hand, is based on the idea of a cooperative, in which every member of the contributing community is directly affected by the profits or losses of the fund.

By the end of 2015, Shariah-compliant assets had reached close to $1 trillion, growing nearly 16 percent between 2014 and 2015, according to Ernst & Young. In the core markets of Qatar, Indonesia, Saudi Arabia, Malaysia, United Arab Emirates and Turkey, assets will approach $1.8 trillion by 2019.

Terms such as *sukuk*, *mudaraba* and *ijara* (see above) are becoming common for everyone from homeowners to venture capitalists.

SHARIAH-COMPLIANT RISK tends to be lower, due to the asset-backed nature of the debt. This is one aspect that makes it compelling for all kinds of investors and, as international standards for compliance materialize, more clients are entering the space, Dahlawi says.

A global trend toward ethical investment has also helped energize the field of Islamic finance. Since 2014, governments from the UK to Hong Kong have issued Shariah-compliant bonds, along with Goldman Sachs and GE, in response to growing demand. The first issue of Islamic bonds by the UK in 2014 was more than 11 times oversubscribed, with $3.9 billion in orders, according to *The Wall Street Journal*.



A global trend toward ethical investment has also helped energize the field of Islamic finance

Equities are a critical area for compliance screeners. Every quarter, analysts at SRB pore over the filings of 140 or so companies on the Saudi Stock Exchange to spot how shifting business practices may have affected Shariah compliance. According to Shariah codes, an equity fund found to have non-compliant holdings must divest and donate gains from those shares to charity.

SRB also helps some companies increase the effectiveness of their in-house Shariah boards, which must combine the functions of a ratings agency, financial auditor and legal adviser, all from the foundation of religious scholarship.

"The boards need professionals and they need people with technical skills to advise them," Dahlawi says, "because ultimately, you have to live up to the tenets of Shariah."

HASSAN FATTAH is a Partner in Brunswick's Abu Dhabi office and **TASHA YOUNG** is an Associate in Dubai. Additional reporting by **DOMINIC WHITING**, a Director in Abu Dhabi.

PHOTOGRAPHS: JEREMY HORNER, CORBIS / TYPHOONSKI, ISTOCKPHOTO