

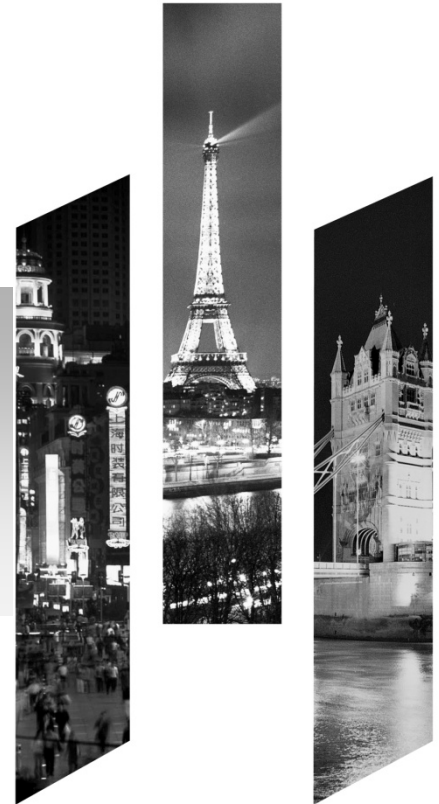
▪ Islamic Finance and French law

2 July 2008 – Paris Europlace International Financial Forum

Gilles Saint Marc, Partner, Chairman of the Paris Europlace Islamic Finance Committee



Gide Loyrette Nouel



Introduction

- A liquidity pocket for financial markets in crisis
- Strong competition from the London financial market
- Applicable law and *shariah* compliancy



A liquidity pocket for financial markets in crisis

- **15%:** annual growth rate of activities relating to Islamic finance since 2003
- **500 billion USD:** volume of Islamic finance transactions worldwide. This volume is divided up as follows: 60% in the Gulf, 20% in South East Asia and 20% in the rest of the world
- **5000 billion USD:** amount of liquidity surplus available in the Gulf and South East Asia



Strong competition from the London financial market (1/2)

- Initiatives from the private sector
 - Four Islamic banks have been licensed in the UK (the first one was the Islamic Bank of Britain in 2004)
 - Opening of “Islamic windows” by non-Islamic retail banks (ex. HSBC Amanah)
 - Signature of two memorandums of understanding by the International Islamic Financial Market: one with the International Capital Markets Association (issuance of *sukuk*) in January 2007, the other with the International Swaps and Derivatives Association (Islamic derivatives) in April 2008
- Public initiatives
 - The Financial Services Authority (FSA) has expressed positive feedback on Islamic finance and has approved *Shariah* compliant operators and products (investment funds, credit institutions, *sukuk*...)



Strong competition from the London financial place (2/2)

- Initiatives public (*cont.*)
 - Four *Shariah* compliant legislative reforms have been enacted since 2003:
 - end of double taxation upon the double transfer of ownership implied by Islamic finance (2003)
 - the profit return under Islamic financing is treated, from a tax perspective, as interest and therefore constitutes a tax deduction for the debtor (2005)
 - foreign purchasers having entered into a *murabaha* are not considered as having a permanent establishment in the United Kingdom (2006)
 - the profit return paid to holders of *sukuk* is treated, from a tax perspective, as interest and therefore constitutes a tax deduction for the issuer
- Strong objectives
 - To have *sukuks* issued by the UK Treasury (2 billion GBP before the end of 2008);
 - Report by the end of 2008 clarifying the role of the government in the development of Islamic finance and indicating the next steps to be taken in the industry in order to turn Islamic finance into a “British success story” (Kitty Ussher, Secretary of State of the Treasury).

Applicable law and *shariah* compliancy (1/2)

- Exclusive application of a national law
 - It is not possible to stipulate that the national law governing a contract is subject to *shariah* principles;
 - This has been ruled out by the British courts in the decision “Shamil Bank of Britain EC vs. Beximco Pharmaceuticals Ltd” (Court of Appeal, 28 January 2004)
 - There is no reason to believe that French courts would adopt a different position
- The specific validation of *shariah* compliancy
 - The *shariah* compliancy of a finance transaction is assessed by a *shariah* board (hired or set up by the bank) which issues its opinion in the form of a *fatwa*

Applicable law and *shariah* compliancy (2/2)

- The specific validation of *shariah* compliancy (*cont.*)
 - The *madhhab* (schools of thought) are divided on the interpretation of the *Shariah*. The Sunnites (around 90% of the worldwide Muslim population) are split into:
 - the *Hanafi* school (in central Asia, particularly in Pakistan);
 - the *Hanbali* school (in the Middle East, particularly in Saudi Arabia);
 - the *Maliki* school (in Africa, particularly in Morocco); and
 - the *Shafi* school (in South-East Asia, particularly in Malaysia).
 - The development of a global integrated market for Islamic finance faces two problems:
 - the diversity of the schools of thought; and
 - the relativity and absence of binding effect of the *fatwas*

The Paris Market

A generally welcoming environment for Islamic finance subject to certain legal and tax adjustments

- Similarity between *shariah* principles and principles of French law
- Asset management
- Asset financing
- Project financing
- General activity financing
- Refinancing
- Insurance (*takafu*) and Islamic retail banking



Shariah principles and French law: an analogous tradition

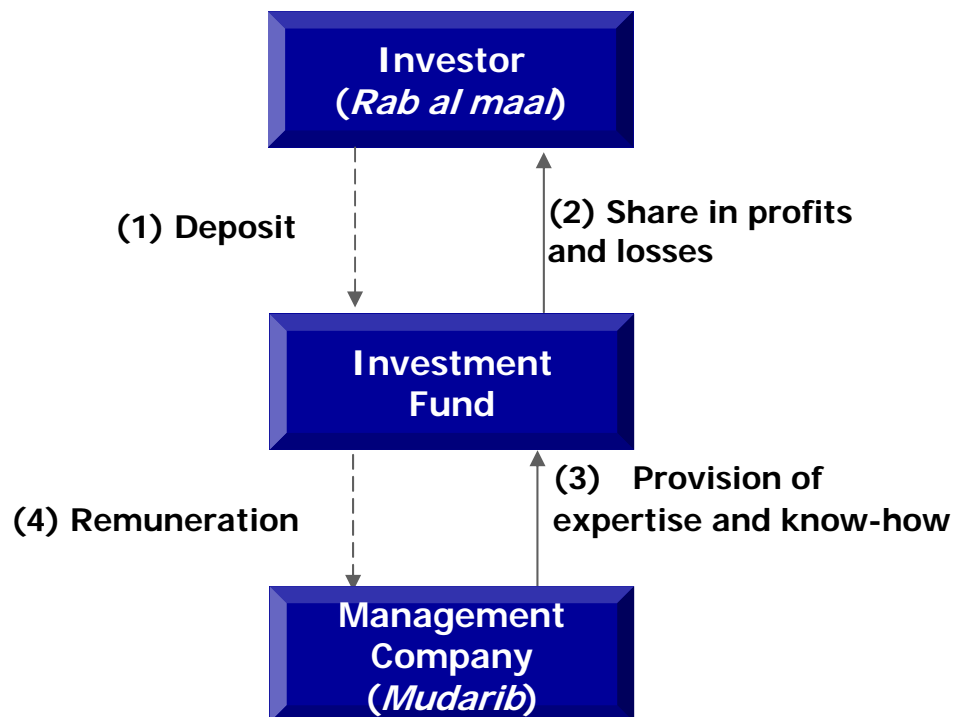
Shariah principles

Principles of French law

<p>Prohibition of <i>riba</i> Islamic finance does not authorize remuneration based on the mere passing of time</p>	<p>Prohibition of usury (French Commercial Code, art. L. 313-3 and CMF, art. L. 313-5; applicable to professionals et legal entities until 2003/2005) Prohibition of remuneration of deposit accounts until the decree of 8 March 2005</p>
<p>Prohibition of <i>garhar</i>, of <i>maysir</i> Islamic finance does not authorize speculation or situations of uncertainty</p>	<p>Regulations on gambling (French Civil Code, art. 1965) Recent opening of future markets (cf. laws on deferred markets dated 28 March 1885 and 31 December 1987) Requirement to have a determined or determinable purpose (French Civil Code, art. 1129)</p>
<p>Prohibition of <i>haram</i> Islamic finance does not authorize investment in certain sectors (arms, alcohol, pornography...)</p>	<p>Protection of the public order and good behaviour (French Civil Code, art. 6)</p>
<p>Share of profits and losses</p>	<p>Obligation to share profits and losses under corporate law (French Civil Code, art. 1844-1) Regime applicable to participating loans (French Monetary and Financial Code, art. L. 313-13 s) Regime applicable to participating instruments (French Commercial Code, art. L. 228-97)</p>
<p>Asset-backing Islamic finance implies financing backed to a tangible asset</p>	<p>FCC units representing a joint ownership over the underlying assets</p>

Asset Management (1/3)

The conceptual scheme for investment funds: the *mudaraba*



- Similar to a limited liability partnership (*société en commandite*): one party (*rab al maal*) provides the funding, the other the expertise and know-how (*mudarib*)
- Under French law, the *mudaraba* would allow for the structuring of any type of collective investment company [UCITS (*OPCVM*), REITS (*OPCI*), securitisation vehicles (OT)]
- Two constraints:
 - exclusive investment in *halal* activities; and
 - exclusive investment in companies with a debt ratio of less than 33% of their total balance sheet.

Asset Management (2/3)

- Compatibility of French law
 - The memorandum of the French Financial Markets Authority (*Autorité des Marchés Financiers (AMF)*) dated 17 July 2007
 - Authorize UCITS:
 - to have recourse to non-financial selection criteria (by developing, for example, index-based management on the basis of a *sharia* compliant index: Dow Jones Islamic Index, FTSE Islamic Global Index, S&P *Shariah* Index...)
 - to clear the impure part of their dividends by making donations for the benefit of recognized public interest bodies (such as the *Institut du Monde Arabe*) up to a limit of 10%
 - to have recourse to the services of a *shariah* board, subject to the autonomy of the management company remaining intact
 - Constitutes the first reference under French law which expressly refers to Islamic finance

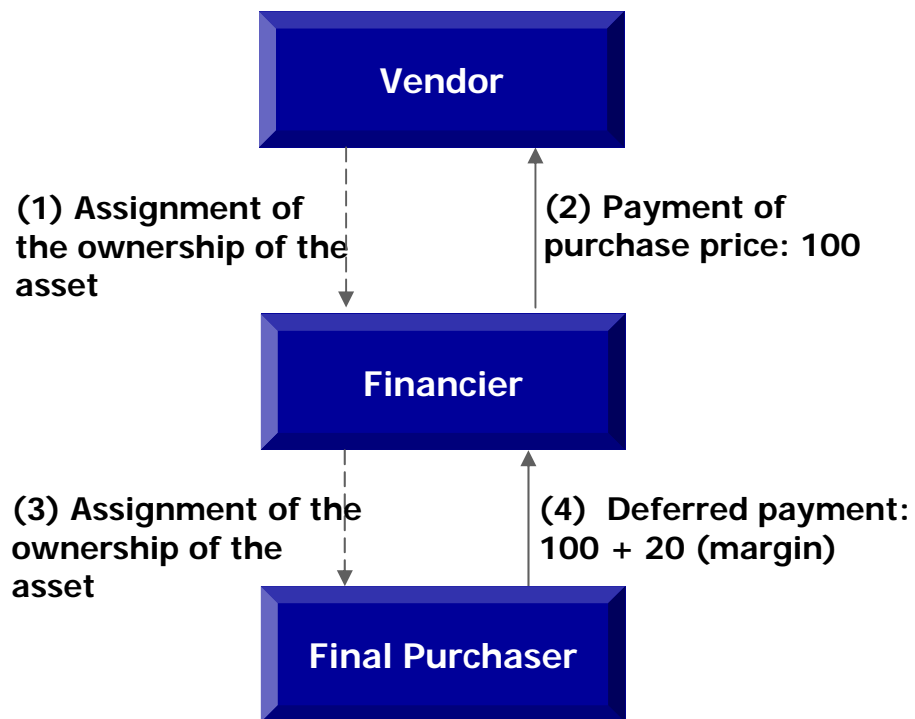
Asset Management (3/3)

- Few modifications are necessary
 - A satisfactory legal framework
 - The criteria set out by the AMF for the approval of Islamic UCITS are clear and simple
 - On this basis, BNPP obtained approval for a *shariah* compliant fund in July 2007
 - The creation of an index of *shariah* compliant stocks on NYSE - Euronext would be useful for the development of the French Islamic asset management industry



Asset financing (movable assets, immovable assets, trade finance, vehicle fleet leasing...) (1/2)

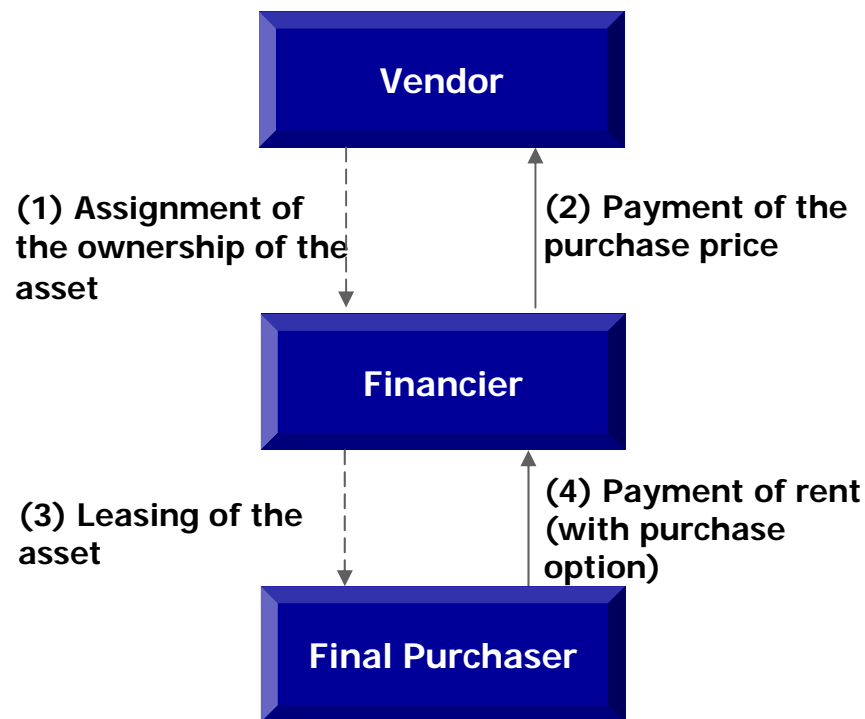
The n°1 conceptual scheme for asset financing: the *murabaha*



- Purchase for resale with profit return having the same economic effect as interest. The price (economically, the principal) is paid at a certain maturity date or in different instalments (vendor's financing)
- The Financier is at risk on the Purchaser (which is the owner of the assets) in the event of the Purchaser's insolvency
- The Financier creates a special purpose vehicle (SPV) in order to reduce its legal exposure as owner of the assets
- The Purchaser undertakes to indemnify the Financier against all costs borne by it under the transaction (however, the Financier remains exposed on the Purchaser credit risk)

Asset financing (movable assets, immovable assets, trade finance, vehicle fleet leasing...) (1/2)

The n°2 conceptual scheme for asset financing: the *ijara*

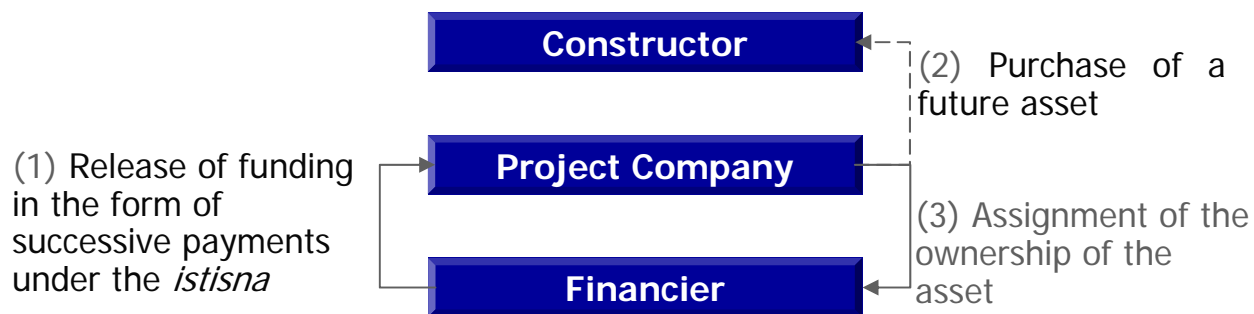


- A lease which may include a purchase option (*ijara wa-ik-tina'a*)
- The Financier retains ownership of the leased asset until the maturity of the leasing (and is therefore not subject to the Purchaser's insolvency)
- The Financier creates a special purpose vehicle (SPV) in order to reduce its legal exposure as owner of the assets
- The Financier often delegates to the debtor the responsibility for the maintenance and insurance of the leased asset. The leased asset is generally insured by a *takaful*

Project financing

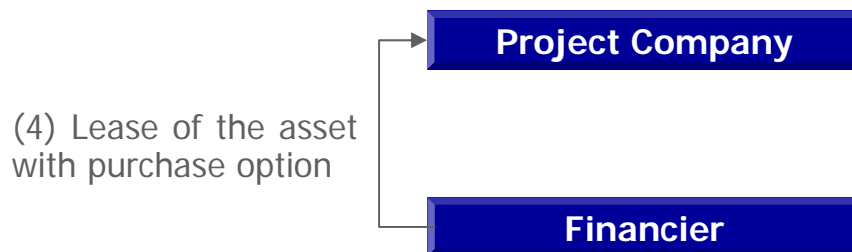
Combination of the conceptual schemes for project financing: the *istisna* and *ijara*

Construction phase: *Istisna*



- Financing of the construction phase: the *istisna* is a form of financing of a future asset of which ownership is transferred upon its completion

Financing phase: *Ijara*



- Financing of the development phase: *ijara* granted by the Financier to the Project Company

Asset or project financing (1/7)

- Compatibility of French law
 - The regime applicable to property dealers (*marchands de biens*)
 - Generally, appears suitable for *murabaha* transactions over real estate assets
 - The leasing regime applicable to movable or immovable assets
 - Articles L. 313-7 and seq. of the French Monetary and Financial Code fits *ijara* transactions
 - Law applicable to public-private partnerships
 - The regime enacted by the ordinance of 17 June 2004 complies with *shariah* public project financing (97% of French project financing)
 - Trust (fiducie)
 - Trust (*fiducie*) allows for the structuring of *sharia* compliant finance transactions



Asset or project financing (2/7)

- Necessary amendments: modification of the French Civil Code
 - Recognition of the civil transfer of receivables by way of security
 - The fact that the Financier used for Islamic financing is not a credit institution means that it may not receive guarantees in the form of Dailly assignments as security. For this reason, it is necessary to provide for the civil assignment of receivables in the French Civil Code and therefore overrule the case law of the Commercial Chamber of the *French Supreme Court* dated 19 December 2006 (cf. current review of the law of obligations by the Ministry of Justice).
 - Exemption of the resale transaction from the vendor's guarantee against hidden effects (rules of public order)
 - Under current legislation, the Financier is obliged to guarantee the purchaser against hidden effects upon the resale of the financed asset to the purchaser. This is illogical in the context of temporary sale/repurchase transactions. It is therefore necessary to provide for the reseller being exempted from the guarantee against hidden effects in event of the resale of the financed asset occurring concomitantly with the initial purchase. Such guarantee should instead be the responsibility of the initial vendor.

Asset or project financing (3/7)

- Necessary amendments: modification of the French Civil Code (*cont.*)
 - Clarification of the regime applicable to lease-purchase (*location-vente*) (without a purchase option)
 - Since, contrarily to a lease with a purchase option, the lease-purchase systematically stipulates the transfer of the ownership of the leased asset, it appears to be the most adapted legal instrument for public project financing. The lease-purchase is an unnamed contract, the rules of which are not clearly defined. It would be useful to make a lease-purchase a named contract.
 - Improvement of the regime applicable to *fiducie* (trust)
 - Trust (*fiducie*) may be used in the context of Islamic finance. The regime implemented by the law dated 19 February 2007 is not entirely satisfactory (cf. draft law for the modernisation of the economy (*Loi de modernisation de l'économie*) and a draft ordinance relating to several provisions in favour of companies in bankruptcy).

Asset or project financing (4/7)

- Improvement of the regime applicable to *fiducie* (trust)
 - It would be desirable to:
 - i. extend the range of participants in a trust (*fiducie*) (in particular, for the trustees, to SPV subsidiaries of credit institutions);
 - ii. specify that the transfer to a trust (*fiducie*) is enforceable against third parties upon the signature of a trust contract or (with respect to assets subject to registration) on the date of registration of the relevant assets;
 - iii. modify the automatic nullity of a trust (*fiducie*) in the event of the opening of bankruptcy proceedings against the settlor;
 - iv. provide for the rights of the trustee in the context of the settlor's bankruptcy: the trust (*fiducie*) could be frozen during a short period (cf. regime applicable to the continuation of ongoing contracts) allowing the bankruptcy receiver to decide:
 - either to recover the asset placed into trust against the immediate payment of the purchase price of the secured obligations;
 - or to let the trustee enforce the beneficiary rights in accordance with the terms of the trust.

Asset or project financing (5/7)

- Necessary amendments: modification of the French Monetary and Financial Code
 - No banking licence for the SPV subsidiary of a credit institution
 - The fact that the Financier used in Islamic finance is not necessarily a credit institution means that it is not normally authorized to grant leases (*crédit-bail*) (lease transactions are considered as banking transactions). For this reason, it is necessary to provide that a subsidiary (at 90%) of a credit institution benefits from the banking status of its parent company (the concept of "banking licence lending"). This complies with the provisions of the EC directive 2006/48 (not implemented in France).
 - Authorization of refinancing leases (*crédit-bail*)
 - It is not currently possible to unwind a lease transaction with a lessor in order to enter into a second lease with another lessor, in relation to the same asset but under more advantageous conditions, without being subject to adverse tax consequences related to the exercise of such option. This does not encourage Islamic finance in France, since such financings often use leases;
 - It would therefore be useful to provide for the transfer of the ownership between lessors without adverse tax consequence for the lessee. This would be an opportunity to increase competition between lessors.

Asset or project financing (6/7)

- Necessary amendments: modification of the French General Tax Code
 - The tax cost of Islamic finance with respect to real estate assets
 - Since most Islamic finance transactions imply a double transfer of property (in particular *ijara* or *murabaha*), they result in doubling:
 - the registration duties upon each assignment (4.89%);
 - cadastral tax (0.615% + 0.10% corresponding to the salary of the conservatory); and
 - remuneration of the notary (0.825% negotiable when exceeding of 80,000 Euros).

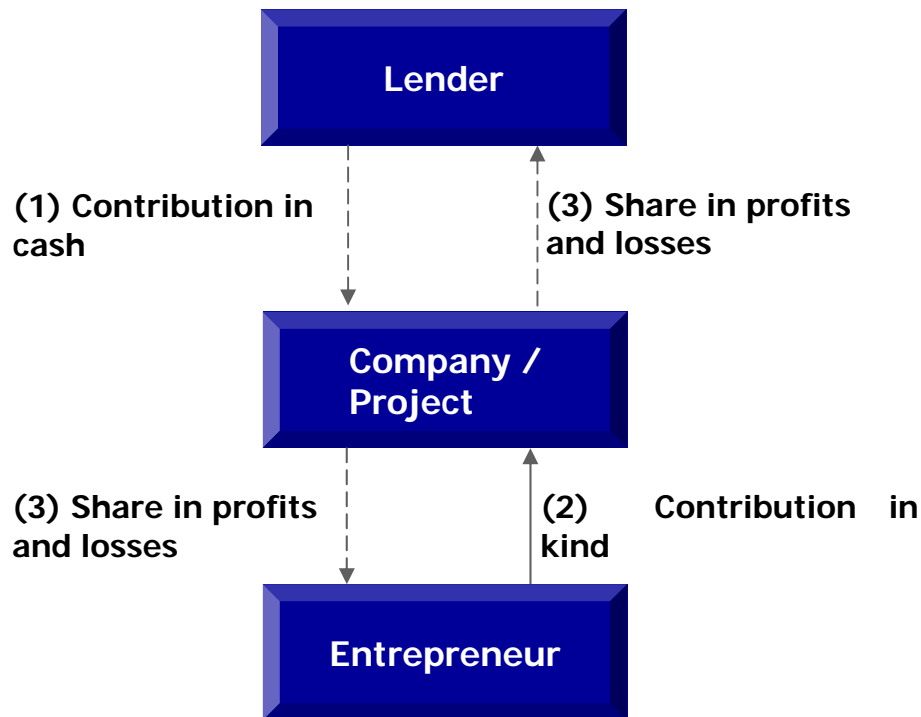
Asset or project financing (7/7)

- Necessary amendments: modification of the French General Tax Code (*cont.*)
 - Reduction of the tax consequences of purchase/repurchase transactions
 - Inapplicability of the property dealers (*marchands de biens*) regime, applicable to transactions made on a regular basis and with speculative intent
 - As a result, a new *ad hoc* regime should be created for purchase/repurchase transactions (similar to the property dealers regime). Such regime would be beneficial for Islamic finance but could also allow for warehousing transactions in the context of the renovation of public property and urban development. Such regime would provide for:
 - i. the set-off of payments of cadastral tax and registration duties paid upon purchase against those payable upon resale in the context of non-speculative purchase / repurchase transactions; and
 - ii. neutralization of the effects of the vendor financing on the taxable amount of the rights (VAT, Corporate Tax) by breaking down the second purchase price between (a) principal and (b) the financial costs of the vendor financing.



Financing of general activity (1/2)

The conceptual scheme with respect to loans: the *musharaka*



- Similar to a *joint venture*
- The client is generally referred to as the manager of the *musharaka*
- A variation of the diminishing *musharaka*, which implies the progressive repurchase of the share in the *musharaka* by the client. The terms and conditions of the repurchase of the investor's share correspond economically to the repayment of principal and the payment of interest to the lender

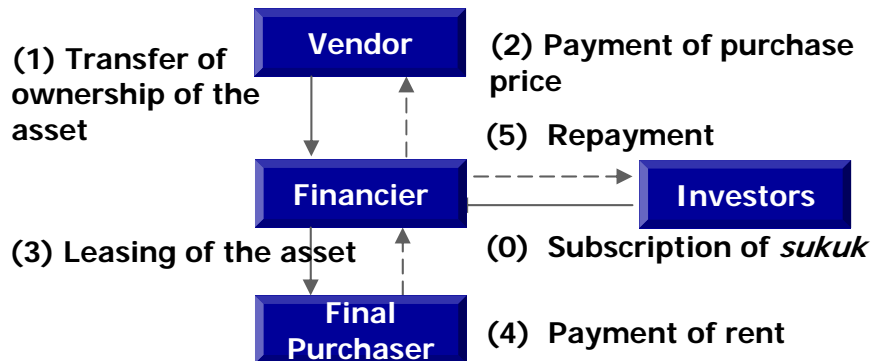
Financing of general activity (2/2)

- Compatibility of French law
 - Existing regime applicable to participating loans
 - Articles L. 313-13 and seq. of the French Monetary and Financial Code: the lender is not necessarily a credit institution; the lender may be remunerated with a fixed share and a floating share; the lender is subordinated in the event of the borrower's bankruptcy;
 - From a tax perspective, the regime applicable to participating loans authorizes the deduction of interest (fixed share and floating share).
 - Recourse to participating loans outside the legal context of Art. L.313-13 and seq.
 - Legally possible;
 - From a tax perspective, the remuneration (fixed share and floating share) should be deducted as interest and exempted from withholding tax if the lender is not resident in France.

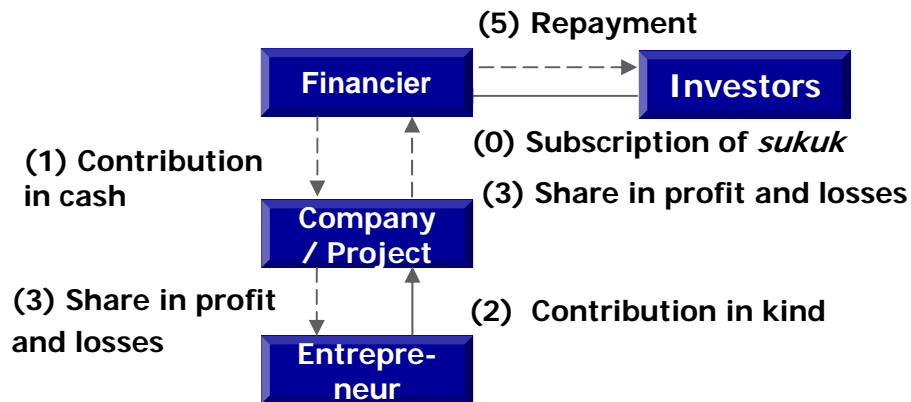


Refinancing via the issuance of *sukuk* (1/2)

Sukuk al ijara



Sukuk al musharaka



- *Sukuk* (*saak*, in the singular) are financial instruments which are similar to asset-backed securities. The remuneration received by their holder is based on the economic performance of the underlying asset and not only on the passing of time (forbidden)
- Conditions for the issuance of *sukuk* (AAOIFI notice dated February 2008):
 - The assets of the issuer must be tangible assets, whether in tangible form (e.g. detention of vehicles) or in usufruct form (e.g. lease flows of a fleet of vehicles transferred by a third party which keeps the ownership cf. AAOIF standard 17);
 - The asset may not be constituted of a debt bearing interest;
 - The originator / management company / guarantor may not repurchase the assets of the issuer at their nominal value (no transfer of risk for investors) but only at their market value or, for leased assets, at their remaining lease value;
 - The remuneration of *sukuks* may be fixed or floating and is capped. It may not be paid if the underlying assets do not produce the expected cash flows (as in any ABS);
 - Upon the issue of its *fatwa*, the *Shariah* board must not only validate the structure, but also review all of the contractual documentation and ensure the compliance of the transaction during its entire life.

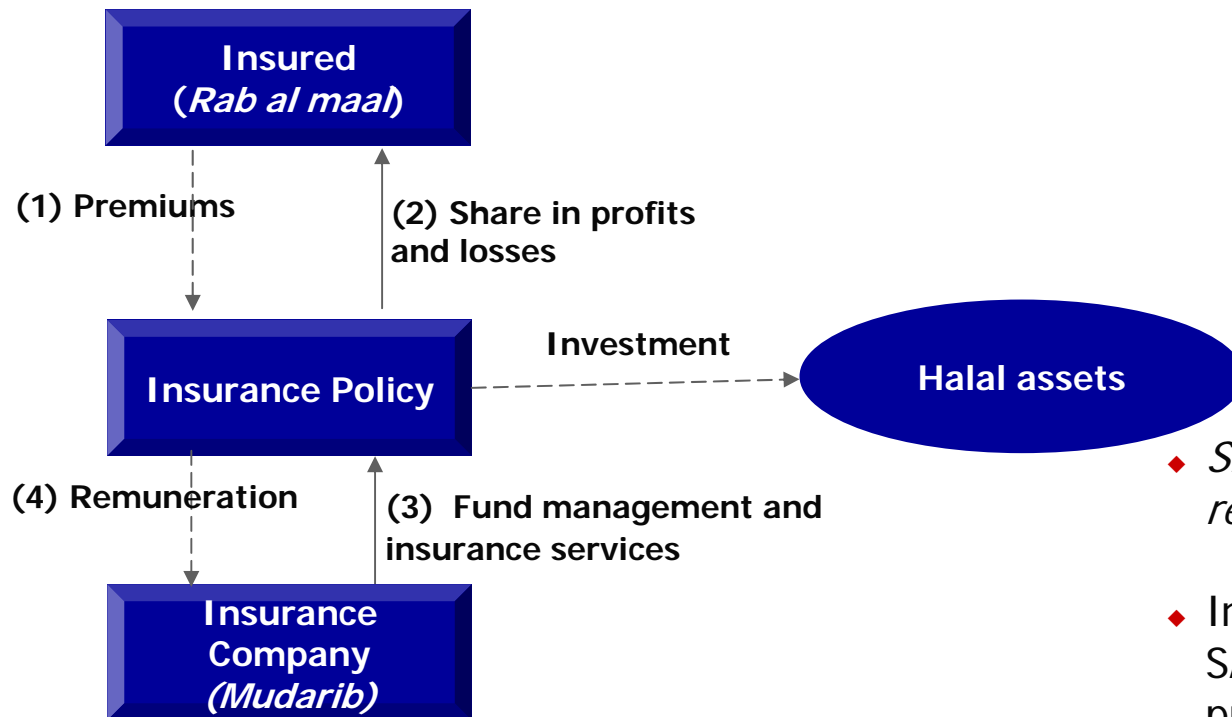
Refinancing via the issuance of *sukuk* (2/2)

- The compatibility of French law
 - Issue of bonds
 - It is possible to issue all types of bonds, including subordinated bonds (French Commercial Code, art. L. 228-97) and participating instruments (French Commercial Code, art. L. 228-37)
 - Index-based remuneration
 - Articles L. 112-2 and L. 112-3 of the French Monetary and Financial Code allow for the indexation of the interest paid to bondholders on the basis of the economic performance of the issuer
 - Possibility of high yield
 - The stipulation of a usurious interest rate is no longer forbidden between professionals
- Necessary arrangements (cf. *musharaka*)
 - Provide for the deduction of amounts paid by the issuer of *sukuk*
 - Provide for the absence of withholding tax on amounts paid to the holders of *sukuk* who are not resident in France

Islamic insurance (*takaful*), Islamic retail banking and French law (1/5)

takaful

The conceptual scheme for *takaful*: the *mudaraba*



- ♦ *Shariah* compliant reinsurance also exists: the *retakaful*;
- ♦ In Europe, the offer remains limited: *Taqafol* SA in Luxembourg and several *retakaful* products are offered in Germany (by *Zurich Ré* and *Hannover Ré*).

Islamic insurance (*takaful*), Islamic retail banking and French law (2/5)

takaful

- Compatibility of French law
 - Possibility for insurance companies to select *halal* assets
 - The investment rules applicable to French insurance companies do not prevent them from investing premiums in *halal* assets.
 - Possibility for insurance companies to benefit from the assistance/advice of a *shariah* board
 - As is the case for UCITS management companies, it is important to ensure that the *shariah* board will not interfere with the management of the insurance company itself. The *shariah* board shall only be a purely consultative body.



Islamic insurance (*takaful*), Islamic retail banking and French law (3/5)

takaful

- Compatibility of French law (*cont.*)
 - Possibility for insurance companies to organize the share of profits and losses
 - With respect to Life Insurance, this principle seems to be always respected, whether the insurance policy be unit linked (increase or decrease of the monetary counterpart of units) or Euro funds (mark-up: beneficiary share (*participation bénéficiaire*); markdown: is the non remuneration of premiums sufficient in itself from a *shariah* perspective?)
 - With respect to Non-Life Insurance, certain legal forms make it possible to share profits and losses. This is particularly the case for mutual companies with variable subscription which have (x) the possibility to call additional subscription premiums from their insured parties and (y) the obligation to redistribute their technical profit between their insured parties. Quid if the insurance company is not a mutual company?



Islamic insurance (*takaful*), Islamic retail banking and French law (4/5)

takaful

- Necessary arrangements
 - The development of a market of eligible *halal* assets
 - In France, the main available assets which are clearly *halal* are real estate assets. However, an insurance company may not concentrate more than 40% of its assets in real estate assets
 - There are a very few *sukuks* listed in the OECD and therefore eligible as "assets accepted as covering technical provision" (*actifs admis en représentation des engagements réglementés*): C. Ass., art. R. 332-2
 - Limitation in the coverage of certain risks
 - Under French law, the insurer is obliged to cover all risks (including drunken driving or speeding) with the sole exception of intentional fault. Some of these risks are potentially *haram*. Is the deductible (*franchise*) with respect to these particular risks likely to make the insurance policy *shariah* compliant?



Islamic insurance (*takaful*), Islamic retail banking and French law (5/5)

Islamic retail banking

- Main products: compatibility of French law and necessary arrangements
 - Residential housing loan
 - As with investment banking, this product will take the form of a *murabaha* or a *ijara*;
 - This product will benefit from a reform of the trust (*fiducie*) regime;
 - The only problem is (even if French law is amended) whether the enforcement of the mortgage by the lender will comply with *Shariah* principles (equity principle).
 - Remunerated deposit account
 - This product may be structured in the form of a *mudaraba*: the account holding bank is *mudareb* and the individual is *rab al maal*;
 - To the extent that the remuneration of the deposits is now permitted, French law allows for the sharing of profits;
 - With respect to the share of losses, it should be verified whether the individual may contractually renounce to the guarantee mechanism organised by the Deposit Guarantee Fund (mechanism defined at the level of the CEE).

Conclusion

- An opportunity for France
 - Simple reforms
 - Enactment of a law modifying the French Monetary and Financial Code;
 - Inclusion of adequate provisions in the next bill of finance and enactment of a tax instruction;
 - Benefiting from other reforms currently underway (trust (*fiducie*) and civil transfer of receivables as security).
 - Access to a new liquidity pocket
 - Positive external factors
 - The integration of Muslims in France;
 - Proof of the modernity and capacity for adaptation of French law.



Contacts

FRANCE

Gilles Saint Marc
saintmarc@gide.com

Gide Loyrette Nouel A.A.R.P.I.
26, cours Albert 1er
75008 Paris

Tel. +33 (0)1 40 75 29 34
Fax +33 (0)1 40 75 37 62

ALGERIE

Samy Laghouati
laghouati@gide.com

Gide Loyrette Nouel
6&8, rue Laroussi Amroune
Les Glycines, El Biar - 16406 Alger

Tel. +213 (0)21 23 94 94
Fax +213 (0)21 23 92 73

TURQUIE

Rémy Fekete
fekete@gide.com

Gide Loyrette Nouel
Büyükdere Cad. Yapi Kredi Plaza
C Blok Kat 3, Levent 34330 Istanbul

Tel. +90 212 325 35 81
Fax +90 212 325 35 87

Pour plus d'informations :

www.gide.com

ROYAUME-UNI

Colin Mercer
cmercer@gide.com

Gide Loyrette Nouel LLP
City Point, 1 Ropemaker Street
Londres EC2Y 9HT

Tel. +44 (0)20 7826 9700
Fax +44 (0)20 7826 9701

Michael Doran
mdoran@gide.com

MAROC

Hicham Naciri
naciri@gide.com

Gide Loyrette Nouel
63, boulevard Moulay Youssef
20000 Casablanca

Tel. +212 22 27 46 28
Fax +212 22 27 30 16

ARABIE SAOUDITE

Charles-Henri Arminjon
arminjon@gide.com

Gide Loyrette Nouel
P.O. Box 4615
Riyad 11412

Tel. +966 1 476 60 39
Fax +966 1 476 18 96

TUNISIE

Kamel Ben Salah
bensalah@gide.com

Gide Loyrette Nouel
21, avenue Jugurtha
Le Belvédère - 1002 Tunis

Tel. +216 71 891 993
Fax +216 71 893 492

*Ouverture prochaine de
2 bureaux dans les Emirats
Arabes Unis :*

Dubai et Abu Dhabi

Alger

Belgrade

Bruxelles

Bucarest

Budapest

Casablanca

Hanoi

Hô Chi Minh Ville

Hong Kong

Istanbul

Kiev

Londres

Moscou

New York

Paris

Pékin

Prague

Riyad

Shanghai

Tunis

Varsovie



Gide Loyrette Nouel