

# Can Islamic and Conventional Financing Co-exist?

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November 2015

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The past decade has witnessed a flourish in the growth of Islamic financing, with the majority of the main banks in the United Arab Emirates either operating as fully fledged Islamic financing institutions or having Islamic banking windows.

One of the commercial objectives driving Islamic banks is the ability to offer products which are at par or at least comparable with conventional products, both from overall suitability and pricing. This has spurred the development of new Islamic financing products which are gaining ground with their conventional counterparts, and the flexibility to cater to a wider range of financial needs.

## **Can all Corporate Customers Apply for Islamic Financing?**

Unless a sufficient proportion of the company's business or the underlying purpose of the financing breaches Shariah principles, there should generally be no restriction against a company from availing both Islamic and conventional financing. As no laws or regulations have been formulated on who can obtain Shariah compliant funding, ultimately, it is the Islamic banks, upon the advice of their Shariah Boards, which decide the appropriate parameters for their customers. For example, one aspect which falls in a grey area is whether the proceeds of an Islamic financing transaction can be used to refinance existing interest based loans.

More generally, there is sometimes a need for the corporate customers to obtain both Islamic and conventional financing. This may be due to their specific lines of business, and also due to lending limits on the parts of conventional banks which may restrict the amounts that such bank may offer as financing to the customer. The pooling of resources between a conventional and Shariah compliant financier offers the customer a wider range of financing options and competitive pricing.

It is common that the conventional and Islamic financing are offered separately to fund specific needs of the customer. These normally comprise unrelated transactions, which are independent of each other.

A complication arises when a company wishes to raise conventional and Islamic financing under the same loan documentation or under the same transaction. The issues are not just limited to pricing differences, but more fundamentally, clashes in structures, values and approaches between conventional and Islamic financing.

We next explore the boundaries and under what circumstances Islamic and conventional financing can co-exist.

## **Same Loan Documentation?**

Under conventional financing, it is accepted practice for a single loan document to provide for multiple facilities. Hence, it is common for a range of lending and trade finance facilities to be bundled in one master loan agreement, whether involving bilateral or syndicated lenders. In such a situation, a range of financing needs can be addressed with the minimum combination of loan and security documents.

The issue is not as clear cut for Islamic financing documentation. As a starting point, Islamic financing is a relatively new area, and is guided by Islamic principles rather than codified laws on the various structures employed. No specific statute has been passed to govern Shariah aspects of a financial transaction, which leads to the players in this field drawing analogies from and needing to work within secular laws, such as the Civil Code and the Commercial Code.

However, it is agreed practice by most banks to adopt the guidelines issued by the Accounting and Auditing Organisation For Financial Institutions ("AAOIFI Guidelines"). The AAOIFI Guidelines are not a codified set of laws, but rather accounting standards which set the benchmark for Islamic financing.

According to the AAOIFI Guidelines, the combination of contracts in one set is allowed as long as one contract does not impose a condition on the other and provided that each contract is permissible in its own right. A common example of a combined contract is in the case of Islamic trade financing documentation containing a variation of different murabaha (sale) products.

The AAOIFI Guidelines also prohibit contracts which are contradictory regarding underlying rules and goals. Hence, it is conceptually impossible for entirely separate structures under which the parties have multiple or conflicting roles, to be combined in one contract, for example, an ijarah (leasing) arrangement to be combined with a murabaha arrangement.

There is also a clear prohibition in the AAOIFI Guidelines against combining Shariah contracts with those that are explicitly banned by Shariah or those which are to be used as an excuse for practicing riba (usury). For this reason, an interest based lending cannot be combined with an Islamic structure under the same document. The prohibitions against such an approach are not based on legal arguments rather than Shariah observance. For this reason, it is the general consensus that conventional and Islamic financing should not be combined in the same agreement. This restriction also generally applies to the sharing of security.

## **The Legal Difficulties**

Apart from the Shariah restrictions, assuming that the AAOIFI Guidelines are not adopted, one would still have difficulty in combining Islamic and Shariah structures in a single loan agreement or security document.

In a conventional lending scenario, the bank always maintains the role of the lender and the customer is always the borrower. For Islamic financing, the bank and customer can have multiple roles depending on the Shariah structure being adopted. In an ijarah scenario for example, the bank is the landlord or lessor, while the Customer is the tenant or lessee. In a goods murabaha transaction, the bank is the seller and the customer is the buyer. This situation leads to issues in ascertaining and separating the capacities in both the main financing document as well as the security documents. For example, for property finance transactions, under an ijarah structure, the bank owns the underlying land and leases it out to the customer. In a conventional structure, the customer owns the underlying land and mortgages the land to the bank as security for the loan. These essentially two conflicting approaches in ownership make it conceptually impossible for the sharing of the same loan document or even type of security. The difficulty would not just be limited to reconciling the various roles in one document, but it would spill over to issues such as the types of representations and warranties applicable to the customer, and the different remedies for enforcement under each structure.

While secular law is still being applied to govern Shariah compliant financing documents, the documentation traditionally includes language for the governing law to be interpreted in reference to Shariah principles. There are also other related provisions, such as the express statement usually included in Shariah financing documentation that interest is considered repugnant and is therefore waived in enforcement proceedings or court judgments. Such clauses would be at odds with conventional interest-based practice, and would introduce an inherent conflict into the transaction document potentially undermining its legal enforceability.

## **Is Co-Existence Possible?**

Given the above difficulties, majority of the Islamic and conventional banks refrain from providing a joint document for Islamic and conventional facilities.

However, especially in larger scale projects, it may be necessary for Islamic and conventional lenders to pool their resources in order to provide attractive financing rates to the customer, and also due to limitations in the single customer limit.

One of the ways to overcome this challenge is to separate out the conventional and Islamic limb for the same underlying transaction. Each of the conventional and Islamic portions will have a separate set of documentation, and each supported by a separate set of securities of comparable value. Therefore, the Shariah elements of the financing can still be retained without impeding the rights of the conventional lenders.

In order to achieve a level playing field between the conventional and Islamic lenders, an intercreditor agreement can be entered into by all parties, under which a facility agent is appointed to regulate the administration of the financing (to ensure parity in drawdown, interest/profit rates, application of payment or repayment etc), including during the enforcement proceedings under the security documents.

There are issues to be mindful of, in particular to coordinate the expectations of both sets of banks. One of the commercial challenges is to allocate assets of comparable value so that neither conventional nor Islamic bank is disadvantaged. Such an approach is especially useful in the cases of syndicated lending where the pool of banks comprise conventional and Islamic financial institutions.

## **The Way Forward**

The sharing of a conventional and Islamic transaction is possible, although it can require several extra steps in the drafting and negotiating process. But Islamic financing is still a relatively new field in the UAE and therefore it is expected that the legal framework and market practice will develop as this industry matures—absorbing international best practice and cultivating its own local characteristics. We look forward to the developments in this field and will keep abreast of the key advancements that occur.