

Your domicile of choice for Shariah- compliant funds

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explains how Bermuda
is encouraging the
development of Islamic
finance*

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The Bermuda government is actively engaged in promoting the development of Islamic finance in Bermuda and exploring ways to support its growth. These initiatives build on the existing relationship between Bermuda and the Gulf Co-operation Council (GCC). Investors from the GCC already invest heavily in Bermuda-based investment funds and have significant interests in the local hospitality industry. Financing vehicles originating from the GCC use Bermuda-exempt companies and trusts in sukuk, investment holding and wealth management structures.

Bermuda provides a favourable environment for establishing Shariah-compliant funds given its position as one of the world's leading jurisdictions for the asset management industry and the government's receptive attitude to new entrants to the market. Bermuda offers an excellent and stable platform from which fund promoters and investment managers seeking to expand their Shariah-compliant product offerings globally can confidently launch, manage and administer such products.

Bermuda is not only attractive for the domiciliation and administration of funds, it also benefits from the presence of the world's top investment management firms, as well as large independent hedge fund and private equity fund managers. Asset managers locate their operations in Bermuda because it offers one of the world's highest standards of living and low taxes together in a prestigious international financial centre.

Bermuda is a perfect location for Shariah-compliant asset managers to expand globally, access the US market and

develop a globally recognised Shariah-compliant asset management brand.

Bermuda's value proposition for Shariah-compliant funds

Bermuda has certain competitive advantages that make structuring Shariah-compliant funds particularly attractive.

These include:

- Its concentration of intellectual capital arguably exceeds that of competing jurisdictions. Bermuda has a pool of talented people including administrators, lawyers and accountants who are used to dealing with complex products. They also have a long history of working with emerging markets and can provide a high level of customised service, which is a requisite of private equity funds.
- Bermuda's situation geographically (with easy access to and from New York and London) serves as a hub for the asset management industry and it is, therefore, well placed to emerge as an offshore platform for Shariah-compliant funds originating and/or targeting the US market.
- Bermuda's tax neutrality is a competitive advantage over its onshore competitors. As more innovative and complex Islamic financial products are developed by the global market, Bermuda offers promoters the advantages of effective tax structuring and speed to market.
- A double tax agreement signed with Bahrain provides structuring opportunities for investors accessing the GCC region.
- Bermuda has a strong alternative fund industry, a highly regarded regulatory environment, good speed

to market and high-quality infrastructure.

- Shariah-compliant fund sponsors benefit from the presence of worldclass asset management firms, fund administrators and other professionals. Funds can be listed on the Bermuda Stock Exchange.
- Bermuda offers opportunities for asset managers to provide Shariah-compliant asset management services to Bermuda's emerging retakaful/retro-takaful (Islamic reinsurance) industry.

Structuring Shariah-compliant investment funds

Shariah-compliant funds are similar in their set up to conventional funds and the Shariah element can be viewed very much as an overlay, comparable to a fund established with a 'socially responsible' investment ethos. The same principles and requirements under the Bermuda Investment Fund Act apply to Shariah compliant funds. Generally there are no restrictions in the investment objectives under the Bermuda's Companies Act and Investment Fund Act. The specific Shariah-compliant requirements and restrictions can easily be incorporated into a fund's offering memorandum/prospectus.

There is growing demand from affluent Muslim investors living in Western countries (US & Europe) for global Shariah-compliant investments. Moreover, there is a shift in investors' preference away from traditional Shariah-compliant asset classes, such as equities and real estate, in favour of alternatives such as ETFs and hedge funds. There is also pressure on GCC/Middle East

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institutions such as sovereign wealth funds and government pension funds to include a Shariah-compliant mix within their portfolio allocations.

Despite the current shortage of acceptable alternative investment products and limitations of certain hedge fund strategies, the future for the development of Shariah-compliant alternative investment funds looks promising. The recent ISDA/IIFM Hedging Master agreement is a positive move for Shariah-compliant hedging products that will help Shariah-compliant hedge funds develop.

Bermuda, as a centre of excellence for the alternative fund industry, can help develop innovative Shariah-compliant alternative investment funds and, therefore, can contribute to the development of a globally recognised Shariah-compliant asset management brand in this sector.

Private equity/venture capital, real estate and global infrastructure funds

The choice of domicile for GIFs and PEFs is driven by investors' need for tax-efficient and transparent structures, balanced with robust regulations and regulatory oversight. GIFs often take the form of traditional PEFs domiciled in an international financial centre, such as Bermuda.

There is a close relationship between Islamic tenets of investment and PEFs. Both are participatory in nature, lead to the sharing of risks and rewards, invest in the real economy, take a long-term view on investments with an exit plan, and align the

interest of the stakeholders. Shariah-compliant PEFs focus on acquiring majority stakes in privately held Shariah-compliant companies and projects. One significant difference is profit and loss sharing and manager remuneration determination.

Two of the main Shariah principles governing Shariah-compliant PEFs are *mudarabah* and *musharakah*.

A *mudarabah* contract is a partnership under which an investor provides capital to another person/body (such as the manager), who uses his expertise to devise a suitable investment strategy. Profits generated by that enterprise or activity are shared in accordance with the percentage specified in the contract, while losses are borne solely by the capital provider unless the losses are due to the entrepreneur's misconduct, negligence or breach of contracted terms.

Musharakah is a profit and loss sharing contract that involves a partnership between two parties both of whom provide capital towards the financing of new or established projects. Both parties share the profits on a pre-agreed ratio, allowing managerial skills to be remunerated, with losses being shared on the basis of equity participation. One or both parties can manage the project.

A Shariah-compliant PEF is typically structured as an exempted limited partnership. Bermuda's limited partnership rules accommodate both the *mudarabah* and *musharakah* structures. The Bermuda Partnership Act does not attempt to regulate the affairs of a partnership to any great extent. The

specific requirements of either structure can easily be incorporated into the partnership agreement. Bermuda structures are also suitable parallel vehicles to accommodate both Muslim and non-Muslim investors.

Structuring and listing global sukuk transactions

Sukuk, Islamic fixed-income securities, has emerged strongly over the past 15 years as an important asset class. The GE Capital Sukuk, offered under Regulation S and structured using a Bermuda limited liability exempted company, represents a significant development for the global sukuk market because it was the first sukuk issued by a US corporation ranking in the top 10 Fortune 500 companies. Also, it was the first sukuk to be based on ownership interests in aircraft assets and rights under the aircraft assets' leases.

The recent credit crisis did much to strengthen the case for alternative investment approaches and ways of raising capital in the global capital markets. Sukuk is one of the fastest emerging alternative instruments and is increasingly used by governments and corporations in the Middle East and south-east Asia to access global capital markets.

The sukuk market is emerging as a new global asset class, bringing diversification and widening its geographic reach. A number of jurisdictions in Europe (UK and France) and Asia (Japan, Korea and Thailand), have developed or are developing legislative and regulatory initiatives to enhance their ability to explore the sukuk market for the first time. Such moves could also prompt other jurisdictions, such as the US and Canada, to

pursue similar efforts.

The growth in the global sukuk market presents an opportunity to further strengthen the development of sukuk funds. Sukuk funds provide investors with diversification away from traditional equity and real estate funds and at the same time produce fixed income returns.

Unique value proposition for structuring global sukuk transactions

Already recognised as a centre of excellence for the domicile, management, administration and listing of investment funds and structured finance vehicles, Bermuda is a natural choice as a jurisdiction for sukuk issuers, and has certain competitive advantages that make structuring sukuk particularly attractive.

These include:

- There is no stamp duty on any instrument affecting or relating to international businesses in Bermuda. This is a key consideration for global sukuk issuances.
- There is no exchange control for nonresident undertakings and no restriction on repatriation of funds.
- Bermuda has modern corporate and trust legislation, both of which are attractive for sukuk structures. In Bermuda, a special purpose vehicle (SPV) typically takes the form of an exempted company under the Companies Act 1981.
- Bermuda companies may adopt a secondary name in non-Roman script such as Arabic with the approval of the Registrar of Companies.
- Bermuda's private trust company legislation is attractive for Islamic finance structures. A private trust company is a company with trustee powers that is not

required to be licensed under Bermuda trust legislation, provided that by the terms of its memorandum of association it is empowered to act as trustee of only a limited number of identifiable trusts.

- A double tax agreement signed with Bahrain provides structuring opportunities for accessing the GCC region.

Structuring global sukuk transactions

The GE Capital Sukuk is proof that Bermuda's laws are tried and tested by rating agencies, regulators and investors globally for sukuk structures. Bermuda vehicles are suitable for financing structures for the acquisition of global portfolios of assets, for example the GE Capital Sukuk, structured as an ijarah sukuk was issued to finance a global portfolio of aircraft leases.

Bermuda companies and trusts are attractive for various sukuk structures such as mudarabah (investment partnership), musharakah (profit and loss sharing), murabaha (cost plus), ijarah (leasing), istisna'a (construction contract), and wakala (agency contract).

Bermuda Stock Exchange: an attractive listing location for global sukuk transactions

The Bermuda Stock Exchange (BSX), as the world's leading fully electronic offshore securities market, is an attractive listing location for cross-border sukuk transactions:

- It offers issuers the opportunity to be listed on an internationally recognised stock exchange with the unique geographic position between two of the deepest capital markets in the world.
- It provides high regulatory standards, visibility for

issuers and transparency for investors, which facilitates crossborder flow of capital and bridges cross-border investment gaps.

- It adopts a non-discriminatory, religion-neutral regime for sukuk listing under its Specialised Debt listing rules.
- The fully electronic capabilities offer attractive opportunities for listing Regulation S sukuk offerings.
- Bermuda offers administrative and cost efficiencies in that issuers may structure and list sukuk in a single jurisdiction.

The BSX is suitable for listing a diverse range of Islamic financial products, including investment funds and ETFs.

Cross-border investments and capital raising transactions

Bermuda not only serves as the domicile of choice for structuring Shariah-compliant financial products such as funds and sukuk, but plays an even more important role in facilitating Shariah-compliant cross-border investments and capitalraising activities, particularly in relation to the US capital markets. An independent study carried out in May 2010 by Albright Stonebridge Group (US – Bermuda Economic Relations: Economic Impact Study – 2010) confirmed that Bermuda's international business environment provides competitive advantages for US businesses striving to compete globally.

Bermuda offers an excellent and very stable platform from which sukuk issuers can confidently structure and list crossborder sukuk transactions originating from and/or accessing US capital

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markets. To the extent that sukuk issuances, or similar capital raising activities, seek to attract US investors, or if a US corporation is involved, close attention must be paid to ensuring that the transaction falls within the scope of at least one exemption from the registration requirements of the US Securities Act of 1933. The two main exemptions relevant for US sukuk transactions are provided under Rule 144A and Regulation S.

The GE Capital Sukuk was offered under Regulation S, and a number of recent sukuk issuances have been structured to meet the requirements for 'resales' to US investors under Rule 144A. This could signal the beginning of a trend to attract US investors and issuers to the emerging global sukuk market.

Moreover, Bermuda provides an attractive platform for investors seeking global diversification to their Shariah-compliant investment portfolios and access to US investments. Bermuda investment structures are attractive for global fund platforms targeting mainly US, as well as global, investors seeking investment opportunities in the GCC/Middle East and south-east Asia regions.

There are several value propositions regarding cross-border investments and capital-raising activities, focusing on the US market, using Bermuda as a gateway:

1. US access to global capital markets

The first value proposition is for US-based corporations seeking alternative ways of raising capital globally (mainly from GCC and south-east Asia), for

debt refinancing and/or more suitably to finance a global portfolio of assets, to structure and list a Bermuda-based sukuk. For US corporations such as GE, a sukuk issue can diversify their funding base and boost their profile in the increasingly important Middle East and south-east Asia regions. Using Bermuda corporate and trust vehicles, which have been trusted by investors and capital markets globally for many years, will facilitate such objectives.

2. Global access to US capital markets

The second value proposition is for sukuk issuers from GCC and south-east Asia seeking to raise capital from the US, to finance growing infrastructure projects and other ventures, to structure and list a Bermuda-based sukuk to benefit from Bermuda's reputation as a jurisdiction of choice for structuring cross-border transactions.

3. Access to US investments/ Innovative alternative Shariah-compliant investment funds and sukuk structures

Investors such as sovereign wealth funds, institutions and high-net worth individuals (HNWIs) from GCC and south-east Asia regions who are seeking to diversify their global Islamic investment portfolios and access US investments can do so by investing in Shariah-compliant US securities such as sukuk, listed securities screened for Shariah-compliance and private equity. There are significant opportunities for US promoters to service such investors and Bermuda structures which are accepted and trusted globally can be used to develop innovative sukuk structures as well as alternative

Shariah-compliant investment funds such as hedge funds, private equity funds, fund of funds, ETFs, commodities funds and sukuk funds.

There has been an influx of money into the US capital market, the biggest in the world, from Middle Eastern investment groups, particularly in the past decade. Gulf-based institutions have been making large investments in US real estate and private equity. Banks and lawyers in the US have had to come up with innovative structures that are suitable for Islamic investments. These deal flows are less visible, though large, because they are done privately.

4. Global fund platforms

Recent economic developments in the GCC/Middle East and south-east Asia regions present US, as well as global, investors who are seeking geographic and product diversification with lucrative opportunities to invest in sukuk issuances (either directly or via Sukuk funds) and other investment products (such as investment funds, private equity and infrastructure projects) targeting these regions. To facilitate such cross-border investment flows, it is vital to have tax-efficient global fund platforms in a reputable jurisdiction, such as Bermuda, and benefit from its regulatory environment, high-quality infrastructure, and world-class fund administrators.

To summarise, the key benefits of having Bermuda-based global fund platforms targeting investment opportunities in the GCC/Middle East and south-east Asia regions are:

- They provide access to alternative asset classes in emerging markets.
- They are attractive to US/global ethical investors seeking access to socially responsible investments in emerging markets.
- They are attractive to investors seeking investment diversification.

The US offers significant opportunities for a second phase expansion of the global Islamic finance market, in particular the global sukuk market. The increasing numbers of sukuk offered under 144A and Regulation S is strong evidence that US regulators understand this Islamic financial product and apply a non-discriminatory regulatory regime. Additionally, it demonstrates the growing willingness among US investors to invest in such products and presents opportunities for US corporations to explore alternative ways of raising capital in the global markets.

Bermuda, as a premium international financial centre, is well positioned to become the most important Islamic finance hub in the western hemisphere for such Shariah-compliant cross-border investments and capital-raising activities.



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