A CRITICAL ANALYSIS OF SPECIAL PURPOSE VEHICLES IN THE ISLAMIC BANKING INDUSTRY:
THE KINGDOM OF BAHRAIN AS A CASE STUDY

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Abstract

This thesis examines the concept of special purpose vehicles (SPVs) from a Shari’a (Islamic law) perspective. It thereafter investigates the practice of SPVs in the Islamic banking industry, using Kingdom of Bahrain as a case study. The review of literature explores the concept of SPVs, maqāsid al-shari’a (objectives of Islamic law), main Islamic financial principles, and main Islamic financial products used in conjunction with SPVs. This review of literature provides the theoretical foundation and understanding of SPVs in Islamic banking.

Arguably one of the main Islamic financial hubs globally, the research uses the Kingdom of Bahrain as a case study. The investigation of SPV practice uses industry feedback through forty-four face-to-face semi-structured interviews, and secondary data. The secondary data consists of annual reports (which includes financial and Shari’a Supervisory Board annual reports), regulatory consultations, and a real-life executed SPV structure by an Islamic bank. A thematic analysis is used to qualitatively analyse interview responses, while a content analysis is used to qualitatively analyse the secondary data. A content analysis also led to the formulation of qualitative test questions that may be used to generally determine whether an SPV structure transaction is Shari’a compliant or not.

Out of ten Islamic banks covered in this research, eight of them engage in investment transactions. Out of these eight Islamic banks, evidence tends to suggest that five Islamic banks include conventional loans within their SPV investment structures for genuine causes, while three Islamic banks use hiyal (legal stratagems) to engage in prohibited conventional activities through SPVs. This indicates that although SPVs may be used for genuine causes, there may be some sort of an abuse of SPVs by the Islamic banking industry to override Shari’a (Islamic law) requirements.

Also, whether the practice was genuine or hiyal-based, evidence further tends to suggest that many SPV practices in the Islamic banking industry may have been violating at least one major Shari’a condition, which therefore negates the Shari’a compliance of the SPV transactions. This includes Islamic banks either: (1) indirectly paying for the establishment costs of the conventional SPVs, (2) managing the conventional SPVs, (3) negotiating conventional deals on behalf of the SPVs, (4) having legal control over the conventional SPVs, and/or (5) having influence over the conventional SPVs. According to the findings, the conditions that are being violated are placed by Shari’a Supervisory Boards unanimously, in one form or another.

This raises a question of whether a flaw exists within the Islamic banking industry, where such violations were able to have continued without being spotted by regulators, Shari’a Supervisory Boards, and/or internal Shari’a reviewers. The research concludes that there seems to be a discrepancy between the Islamic banking theory and practice, where the theory strictly prohibits interest-based transactions, while the practice commonly includes interest-based transactions. The research further concludes that evidence suggests that due to several factors, such as the inability to spot violations or management pressure, a considerable number of internal Shari’a reviewers do not report these SPV violations. As a result, most Shari’a Supervisory Boards are not officially informed of the realistic practices taking place.
To my Mother and Father
Who brought me into this world
Who were effortlessly merciful to me
Who raised me, loved me, and cherished me
Who blessed me with their continuous blessings
May Allah shower you with His mercy and blessings
And may you be pleased with me in this world and the next

&

To my Wife, who sacrificed a lot by taking care of my children
To my boys, Yusuf & Khalid, I love you both from the bottom of my heart
May you both grow up to be successful & prosperous in this world and the next

The Requisites of Knowledge:

“A quick mind, zeal, poverty, foreign land, a professor’s inspiration, and a life of long span” – Juwaini of Nishapur (d.1085)
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1. Chapter One: Introduction

1.1 Research Background

“Following a round table discussion with the Waqf Fund involving several notable Shari’a scholars, it was observed that some SPVs [special purpose vehicles] associated with locally incorporated Islamic banks were not subject to Shari’a compliance review which has resulted in some SPVs [special purpose vehicles] to undertake activities that were not Shari’a compliant, or at least their activities had not been reviewed as Shari’a compliant.” (CBB, 2013)

The above extract is a portion of an introductory letter of a circular issued by the Central Bank of Bahrain, which was circulated to chief executive officers (CEOs) of Islamic banks in the Kingdom of Bahrain. The terminology indicates that Shari’a compliance challenges exists with special purpose vehicle practices in the Islamic banking industry.

Furthermore, in a monthly Shari’a scholar session held by the Waqf Fund¹ in the Kingdom of Bahrain, a Shari’a scholar who serves on many Shari’a Supervisory Boards of Islamic banks worldwide, and who therefore is exposed to Islamic banks financial dealings in the Kingdom of Bahrain and globally, brought attention to multiple manipulative special purpose vehicle practices taking place in the Islamic banking industry (Umar, 2013). This includes Islamic banks establishing special purpose vehicles in order to indirectly obtain conventional loans, in which the respective Shari’a scholar explained was clearly not Shari’a compliant (Umar, 2013).

This raises multiple questions. How can Islamic banks, whose essence is mainly based on the principle of the prohibition of interest, obtain conventional loans (or engage in other conventional or prohibited activities) through special purpose vehicles without question? Who is responsible for the actions being taken? Is it the managements and/or the board of directors? Who is responsible to holding such violations to account? Is it the Shari’a Supervisory Boards, internal Shari’a reviewers, and/or regulator? Are there reasonable justifications to such special

¹ The Waqf fund was established by the Central Bank of Bahrain to promote and help the Islamic banking industry through various activities.
purpose vehicle practices, and if so, what are they? Is there a sort of abuse when using special purpose vehicles in the Islamic banking industry? These are some of the questions that may rise, which this research aims to examine.

### 1.2 Significance of the study

First, it may be important for the reader to understand the following facts that may indicate that the practice of special purpose vehicles may be spread across the Islamic banking industry:

- Section 1.1 explained how the Central Bank of Bahrain, in addition to a Shari’a scholar who serves on numerous Shari’a Supervisory Boards worldwide brought attention to problems relating to special purpose vehicle practices in the Islamic banking industry in the Kingdom of Bahrain.

- The primary data collection process in this research was conducted through interviewing forty-four interviewees consisting of managements, regulator, lawyers, and other stakeholders. Ten Islamic banks in the Kingdom of Bahrain were covered through this process, where it was revealed that all of the Islamic banks use special purpose vehicles in their investments. If an Islamic bank did not use special purpose vehicles, this meant it was an Islamic retail bank that does not engage in investment activities.

- An analysis of secondary data, particularly annual reports of nine Islamic banks (selected due to them being partially the main Islamic banks in the Kingdom of Bahrain), revealed that special purpose vehicles are used by all of the nine Islamic banks. This indicates that 100% of the sample selected solely to analyse this issue revealed that all of the Islamic banks selected for the sample use special purpose vehicles in their investment structures and deals.

The above three points may be considered as indications that the practice of special purpose vehicles may be spread across the Islamic banking industry. Also, as witnessed in the next section (1.3), there are indications suggesting that there may be
a shortage of doctoral researches pertaining to special purpose vehicles in Islamic banking. As such, the significance of this study may be summarised as follows:

1. This research tackles a critical issue that is widely practiced in the Islamic banking industry.
2. This research fills a research area gap where low numbers of research have been undertaken.
3. This research may be one of the pioneering doctoral researches related to special purpose vehicles that use the Kingdom of Bahrain as a case study.
4. The research addresses key issues relating to the Shari’ā compliance of special purpose vehicles that have officially been brought to public attention by the Central Bank of Bahrain and Shari’ā scholar who serves on numerous Shari’ā Supervisory Boards.
5. The research may serve as a base for future research conducted in the same field, or may be used for comparative purposes.
6. The research may initiate contemplations, thoughts, or deliberations by managers, Shari’ā managers, lawyers, and regulators for constructive and progressive changes to take place in the Islamic banking industry.

1.3 Research Gap

The researcher could only locate a handful of research papers regarding Shari’ā compliance and special purpose vehicles, each focusing on a specific aspect of special purpose vehicles in relation to one Islamic financial product (for example: sukūk, which may be commonly referred to as Islamic bonds), and were brief research papers rather than in depth dissertations. This provides an argument that this topic may be of significant research interest that may contribute to knowledge. This also indicates that there may be a shortage of research papers regarding special purpose vehicles and Shari’ā compliance.

Furthermore, the Accounting and Auditing Organization for Islamic Financial Institutions (known as AAOIFI), which is an Islamic finance infrastructure organization who issues Shari’ā, accounting, auditing, and governance standards for
the global Islamic finance industry and are used by Islamic financial institutions worldwide (AAOIFI, 2015), issued a number of fifty-four Shari’a standards as of October 2016. However, a Shari’a standard regarding special purpose vehicles does not exist\(^2\) (AAOIFI, 2015a). This further raises the question of the affect the lack of a Shari’a standard regarding special purpose vehicles may have had on the Islamic banking industry, and may serve as another argument for the significance of this research topic.

1.4 Research Aims and Objectives

The research aims for this study are displayed below:

1. To examine the concept of special purpose vehicles (SPVs) from a Shari’a (Islamic law) perspective.

   This includes studying and examining the Shari’a (Islamic law) in relation to special purpose vehicles. It involves the theoretical and Islamic legislative aspect of special purpose vehicles.

2. To investigate the practice of special purpose vehicles in the Islamic banking industry and its compatibility with Shari’a (Islamic law), using the Kingdom of Bahrain as a case study.

   This includes investigating the current practice of special purpose vehicles in the Islamic banking industry in the Kingdom of Bahrain. It involves finding out how Islamic banks use special purpose vehicles, the reasons for using special purpose vehicles, how it differs from conventional banks use of special purpose vehicles, how often are they used, and more. Thereafter, it aims to examine whether these special purpose vehicle practices are Shari’a (Islamic law) compliant or not, using the results of the first aim (displayed above) as a base for Islamic rulings.

\(^2\) However, it is important to note that as of October 2016, a Shari’a standard for special purpose vehicles was being constructed (AAOIFI, 2015b).
In line with the research aims, the following objectives are developed:

- To explore the *Shari’a* rulings on special purpose vehicles using classical Islamic texts.

- To assess the rationale of special purpose vehicles used in the Islamic banking industry in managing their financial operations.

- To assess the behaviours of Islamic bank managers toward special purpose vehicle structures.

- To examine the practice and attitude of the Islamic banking industry towards special purpose vehicles through secondary data.

- To explore the regulatory requirements of the Central Bank of Bahrain and its attitude towards special purpose vehicles in the Islamic banking industry.

1.5 **Research Methodology**

The research uses a qualitative methodology. It further uses a geographical jurisdiction, the Kingdom of Bahrain, as a case study. The research collects both primary and secondary data for empirical data analysis. The primary data collection method is obtained through forty-four face-to-face semi-structured interviews. The secondary data collection includes annual reports of Islamic banks (which includes financial and *Shari’a* Supervisory Board annual reports), publicised regulatory consultations with the Islamic banking industry pertaining to special purpose vehicles, and a real-life Islamic banking executed special purpose vehicle structure transaction as a unit of analysis. As for the empirical data analysis methods, the research uses a thematic analysis to analyse the primary data, and a content analysis to analyse the secondary data.
1.6 Overview of the Thesis

Chapter one is the current introductory chapter that explains the research background, significance of the study, research gap, research aims and objectives, an introduction to the research methodology, and an overall overview of the thesis.

Chapter two covers the review of literature pertaining to special purpose vehicles. This includes definitions for special purpose vehicles (SPVs) and special purpose entities (SPEs) including the difference between them. It also includes the legal status and different legal forms of special purpose vehicles, corporate governance and administration of special purpose vehicles, bankruptcy benefits through the use of special purpose vehicles, taxation benefits with special purpose vehicles, different types of special purpose vehicles, and accounting treatment of special purpose vehicles. Lastly, it discusses the history and development of special purpose vehicles including its role in the 2008 global financial crises.

Chapter three is the second review of literature chapter that covers two sections: (1) maqāsid al-shari‘a (objectives of Islamic law) and (2) Islamic financial principles. The first section provides definitions for maqāsid al-shari‘a (objectives of Islamic law), in addition to other words related to maqāsid al-shari‘a (objectives of Islamic law) such as maslaha (an interest/benefit) and maʃṣada (that which causes harm). It then specifically explains the maqāsid al-shari‘a (objectives of Islamic law) of māl (wealth). The second section explains main principles underlying the Islamic banking industry, including the prohibition of riba (commonly referred to as usury or interest), prohibition of gharaar (uncertainty), the concept of hila (legal stratagems) to ultimately engage in prohibited activities, and the concept of dharūra (necessity) in Shari‘a (Islamic law).

Chapter four is the third and final review of literature chapter that lists and explains specific Islamic financial products that are, or may be, used in conjunction with special purpose vehicles in Islamic investment structures. These Islamic banking products include tawarruq (monetization), murābaha (cost-plus sale), ijāra (lease), mushāraka (contractual partnership), and sukūk (commonly referred to as Islamic bonds). The chapter includes defining these Islamic financial products with
explanations, explaining their Shari’a (Islamic law) rulings, and listing the different types of a single product, where applicable.

Chapter five is the research methodology chapter. It starts by explaining the paradigm and epistemological stance of the researcher. This includes defining constructivism and critical theory. Thereafter, the chapter explains the research methodology chosen for the research, which is a qualitative methodology, as well as using the Kingdom of Bahrain as a case study. The research uses a “single/holistic” case study design. The research methods for data collection and empirical data analysis are also explained. The chapter concludes by explaining the limitations of the chosen methodology and methods for the research.

Chapter six is the first of the two empirical chapters. It analyses the perception of practitioners and their practice towards special purpose vehicles in the Islamic banking industry. This includes an analysis of responses obtained from forty-four stakeholder interviewees, using a thematic analysis.

Chapter seven is the second and final empirical chapter, which analyses the practice of special purpose vehicles in the Islamic banking industry through secondary data. The secondary data includes annual reports (which includes financial and Shari’a Supervisory Board annual reports), publicised regulatory data, and a contemporary special purpose vehicle structure transacted by an Islamic bank used as a unit of analysis.

Chapter eight is the conclusion chapter. This chapter lists the contribution to knowledge the thesis may have provided, a summary of the research, and the main findings of the research. The chapter also lists the possible various types of Islamic banks (relating to special purpose vehicle practices) that exist in the industry. Potential studies are also discussed, followed by the possible limitations that may have existed on this research. The chapter concludes by providing overall concluding remarks.
The below figure illustrates the full outline of the thesis, and further highlights the position of this introductory chapter in light of the thesis:

**Figure 1 Research Outline (Author’s Diagram)**
2. Chapter Two: Special Purpose Vehicles

The below figure highlights the position of chapter two in light of the research outline:

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Figure 2 Chapter Two Position (Author’s Diagram)
2.1 Introduction

More commonly referred to as a special purpose vehicle (SPV), it is also sometimes referred to as a special purpose entity (SPE). A review of literature revealed that only a few authors referred to it in two different terms in a single text, and a minority of other authors differentiated between the two terms. For clarity purposes, this thesis will generally adopt the term special purpose vehicle (SPV).

This chapter covers five main areas of special purpose vehicles. First, it focuses on the definitions of special purpose vehicles and special purpose entities, and thereafter analyses the difference between both terms. Second, it explains the legal forms of establishing special purpose vehicles. Third, it explains the benefits of special purpose vehicles with regards to bankruptcy and taxation. Fourth, it lists and explores the types of special purpose vehicles. Fifth, it describes the accounting standards and treatments for special purpose vehicles. Sixth, it provides a historical background of the special purpose vehicles history.

2.2 Definitions

In order to attain a better understanding of the research topic, this section provides a better understanding of special purpose vehicles and special purpose entities as explained below:

2.2.1 Special Purpose Vehicles (SPVs) Definition

Literature tends to suggest that special purpose vehicles are generally formed or established to attain a specific purpose (for example: a financial purpose), and may be legally separated from the originator. For example, Topno (2005) explains that a special purpose vehicle is formed for a special purpose. Its power is limited to what might be required to attain such a purpose and its tenor is limited, which ends once the objective (or purpose) has been achieved.

Gorton and Souleles (2007) define a special purpose vehicle as:

"a legal entity created by a firm (known as the sponsor or originator) by transferring assets to the SPV, to carry out some specific purpose or
circumscribed activity, or a series of such transactions. SPVs have no purpose other than the transaction(s) for which they were created, and they can make no substantive decisions; the rules governing them are set down in advance and carefully circumscribe their activities. Indeed, no one works at an SPV and it has no physical location” (Gorton and Souleles, 2007, p. 550).

Abdulla and Chee (2010) define the special purpose vehicle as a separate subsidiary company set up to contain investments, while Price Waterhouse Coopers (PwC) defined it as “an off-balance sheet vehicle (OBSV) comprised of a legal entity created by the sponsor or originator, typically a major investment bank or insurance company, to fulfill a temporary objective of a sponsoring firm” (PwC, 2011, p.5).

Topno (2005) suggests that a special purpose vehicle, which embodies a financial contract, is originally used to isolate financial risk, and is established in order to finance large projects without putting the entire firm at risk.

As seen in the various definitions in this section, special purpose vehicles are generally separate legal entities established by an originator or sponsor to attain a specific (financial) purpose.

2.2.2 Special Purpose Entities (SPEs) Definition

Amoroso and Duchac (2014) described special purpose entities (SPEs) as “business entities that exist for a narrow purpose, such as securitizing a portfolio of receivables or financing the acquisition of a building” (Amoroso and Duchac, 2014, p. 107).

According to Hartgraves and Benston (2002), special purpose entities can be defined as “entities created for a limited purpose, with a limited life and limited activities, and designed to benefit a single company. They may take the legal form of a partnership, corporation, trust, or joint venture” (Hartgraves and Benston, 2002, p. 246). Moreover, Newman (2007) mentions that a special purpose entity “is an entity formed for a discreet and isolated purpose, to adhere to a specific business or economic

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3 PwC is a multinational professional services network, and is one of the “Big Four” auditors, along with KPMG, Ernst & Young, and Deloitte.
objective; a simple premise or starting off point from which the concept builds” (Newman, 2007, p. 99).

In addition, the Bank for International Settlements (BIS)\(^4\) defined a special purpose entity as:

> “a corporation, trust, or other entity organized for a special purpose, the activities of which are limited to those appropriate to accomplish the purpose of the SPE, and the structure of which is intended to isolate the SPE from the credit risk of an originator or seller of exposures. SPE’s are commonly used as financing vehicles in which exposures are sold to a trust or similar entity in exchange for cash or other assets funded by debt issued by the trust” (BIS, 2009).

Another author, Rothman (2012), explains that a special purpose entity is an independent legal entity that can be used to mitigate disruption caused by a bankruptcy filing by all or some members of a corporate group. Rothman (2012) explains that a lender might be more inclined to provide a secured loan to an independent entity rather than a complex corporate group with several creditors. Rothman (2012) also mentions that the special purpose entity’s “corporate documents will generally contain restrictive provisions requiring that the SPE be limited to its stated purpose of holding the collateral assets, therefore restricting it from engaging in outside activities” (Rothman, 2012, pp. 230-231).

Furthermore, Newman (2007) suggests that the idea behind a special purpose entity is to simply narrow the scope of risks to the assets and liabilities held by the special purpose entity. This is done in order for potential investors risk to be based upon what occurs to those assets and liabilities held solely by the special purpose entity, regardless of the risks of the originator (Newman, 2007, Abdulla and Chee, 2010).

\(^4\) The Bank for International Settlements (BIS) is the world's oldest international financial organisation. It has 60 member central banks, representing countries from around the world that together make up about 95% of world GDP. The head office is in Basel, Switzerland.
2.2.3 Difference Between Special Purpose Vehicles (SPVs) and Special Purpose Entities (SPEs)

As witnessed in the definitions for special purpose vehicles (SPVs) and special purpose entities (SPEs), literature tends to suggest that there may not be much difference between both terms, and are sometimes used as having the same meaning. For example, many authors refer to special purpose vehicles (SPVs) also as being special purpose entities (SPEs), or vice versa (for example, please see: Amoruso and Duchac 2014; Rothman 2012; PwC 2011; Gorton and Souleles 2007; Hartgraves and Benston, 2002).

Masoom (2013), however, does differentiate between special purpose vehicles (SPVs) and special purpose entities (SPEs), and therefore included separate definitions for each. He defined a special purpose vehicle (SPV) as:

“an organization constructed with a limited purpose or life. Frequently, these Special Purpose Vehicles serve as conduits or pass through organizations or corporations. In relation to securitization, it means the entity which would hold the legal rights over the assets transferred by the originator” (Masoom, 2013, p. 502).

On the other hand, the author defines a special purpose entity (SPE) as:

“a type of corporate entity or limited partnership created for a specific transaction or business, especially one unrelated to a company’s main business. An SPE may be in the form of a corporation, trust, or partnership. Special purpose entities have been used for several decades for asset securitization, risk sharing, and to take advantage of tax statutes” (Masoom, 2013, p. 502).

In the above definition of special purpose entities (SPEs) mentioned by Masoom (2013), his listing of the legal forms of special purpose entities does not include a limited liability company, which is one form of special purpose entities (SPEs) as argued by Gorton and Souleles (2007).
Stewart (2005) also differentiated between special purpose vehicles (SPVs) and special purpose entities (SPEs). He mentions that special purpose vehicles (SPVs) are most likely used for a facility, account, “which has no separate legal identity” (Stewart, 2005, p. 23). This definition contradicts with those of other authors, who argue that special purpose vehicles may have a separate legal identity, such as Abdulla and Chee (2010). As for special purpose entities (SPEs), Stewart (2005) states that they are formed by an act of incorporation, articles, forming a legal ‘persona’.

To summarise and as evidenced above, special purpose vehicles (SPVs) may be similar to special purpose entities (SPEs), while a number of authors consider both terms as being identical. Regardless of all of the different special purpose vehicle definitions, they may ultimately narrow down to one meaning, which may be defined as a separately created legal entity established for a specific purpose (mainly financial) and to attain a specific objective.

2.3 Legal Status of Special Purpose Vehicles

Legally, a special purpose vehicle can be established in the form of a corporation, trust, partnership, or a limited liability company (Gorton and Souleles, 2007). Special purpose vehicles may also be in a form described as an “Orphan SPV”, which has no owners (Gorton and Souleles, 2007). The differences between these legal structures of special purpose vehicles are explained below:

2.3.1 Corporation

A legal entity that is separate and distinct from its owners (Investopedia, 2015). It is created as an artificial person to carry on the business (Farlex 2015, Gerald and Hill, 2015). The legal person status of the corporation gives the business perpetual life, therefore the deaths of stockholders or officers of the corporation do not alter the corporation structure (Cornell, 2015). Firms may prefer establishing a corporation due to its limited liabilities, since its liability for damages is limited to the assets of the corporation (Farlex, 2015). Therefore, the shareholders and officers of the corporation are protected from any personal claims, unless they commit fraud (Farlex, 2015). The
legal independence of a corporation prevents its shareholders to be personally liable for the debts of the corporation (Cornell, 2015).

2.3.2 Trust

A trust is a legal form where a fiduciary form is created for some property (Gorton and Souleles, 2007). This means that there is a relationship between a sponsoring firm and a trustee. The trustee is the one who holds the title of the trust property, while the beneficiary is the person who received the benefits of the trust (Cornell 2015a, Gerald and Hill, 2015a). Since sponsoring firms want to benefit from certain assets without being the owner of the assets (for legal, regulatory, taxation, or other reasons), a trust legal formation of a special purpose vehicle may be a preferred legal-structure establishment for sponsoring firms, since they would benefit from the assets owned by the special purpose vehicle without legally owning them. A key difference of “trust” compared to other legal structures is that the trustee fully owns the special purpose vehicle and enables different party (for example, the initial sponsoring firm) to benefit from.

2.3.3 Partnership

A partnership is a for-profit business association of two or more persons (Cornell, 2015b, Gerald and Hill, 2015b). In this type of special purpose vehicle, each partner contributes agreed-upon payments or assets for an agreed amount of shareholding or ownership (Gerald and Hill, 2015b). This is a normal partnership where two or more individuals want to conduct business together. The originators therefore incorporate a partnership structure to set about the agreements.

This form of legal structure may be attractive to both Islamic banks and outside investors. Investors may find this form of legal structure attractive because they are able to partner with the Islamic bank to invest in a particular investment or asset without the fear of the negative financial performance of the Islamic bank. As for Islamic banks, when their ‘placement’ team gathers funds from outside investors, it is not retrieved into the account of the Islamic banks; otherwise these investors would legally be partners with the Islamic bank as a whole and would allow outside investors to have shares, board seats, and have a say in the overall activities of the Islamic financial institution. Therefore, by establishing a special purpose vehicle
through a partnership structure, funds obtained from outside investors are deposited into the account of the newly established special purpose vehicle, creating a separate legal entity of a partnership between various investors. The Islamic bank may enter as an investor and become a shareholder (partner) in the special purpose vehicle, or solely act as the fund (SPV) manager. Regardless, the investors are now limited to the shares, board seats, and veto power (where applicable) of solely the special purpose vehicle.

2.3.4 Limited Liability Company

A limited liability company is a form of partnership, in which the maximum amount a partner may lose or be charged in case of claims being made against the company or in the case of bankruptcy is limited to the amount invested by each partner (Gerald and Hill, 2015c). In other words, the owners of the company are legally responsible for its debts only to the extent of the amount of capital they invested (Gerald and Hill, 2015c).

Investors, whether Islamic banks or any other investor, may prefer this legal structure of special purpose vehicle incorporation because they may be able to financially calculate their risk of loss accurately, since any claim made against an investor is limited to the amounts invested.

2.3.5 Orphan Special Purpose Vehicles

An orphan special purpose vehicle is neither owned nor controlled by the person for whom the special purpose vehicle is being established (Chadwick, 2007). Chadwick (2007) explains that:

“There is usually some compelling regulatory or fiscal reason why the SPV should be independently owned and independently controlled: that is to say owned and controlled by someone who is not the sponsor or itself owned or controlled by the sponsor. And there will be compelling commercial reasons why the SPV should carry out its role in a way that fulfills the special purpose of the sponsor: that is to say, in a way, which the sponsor can predict with certainty in advance of the transaction. Those who act as directors or trustees of
such entities are sometimes said to be providing ‘a commercial service of inevitability’” (Chadwick, 2007).

An orphan special purpose vehicle is not consolidated with the sponsoring firm for tax, accounting, or legal purposes (Gorton and Souleles, 2007). However, an orphan special purpose vehicle may be consolidated for some of the mentioned purposes but not others (Gorton and Souleles, 2007). This statement may be arguable, since consolidating an entity completely segregated in terms of ownership and control is questionable, as one of the benefits of orphan special purpose vehicles is the isolation of financial risk. “By structuring the SPV as an ‘orphan company’, the SPV assets may not be consolidated with the firm’s on-balance sheet assets and are ‘bankruptcy remote’ in the event of bankruptcy or a default” (PwC, 2011, p.9).

2.4 Corporate Governance and Administration of Special Purpose Vehicles

As mentioned in the section of the special purpose vehicle definitions, special purpose vehicles neither have a physical office nor actual employees (Topno 2005, Gorton and Souleles 2007). A trustee would act based on pre-specified contracts (Topno, 2005). This is the reason why some law and advisory firms provide independent trustees and other corporate governance services to financial institutions to establish and administer their special purpose vehicles (Wilmington, 2015). Other corporate governance services provided by law and advisory firms include providing independent directors, managers, and officers for the special purpose vehicles, or to hold a nominal share capital (Wilmington, 2015). Since special purpose vehicles do not have physical offices nor employees (Topno 2005, Gorton and Souleles 2007), law and advisory firms also provide the special purpose vehicle administrative processes (Wilmington, 2015). These administrative services include accounting and tax preparation, phone answering service, mail forwarding, office and conference facilities (Wilmington, 2015). The jurisdictions that special purpose vehicles are established in, depends on the needs of the parent company or sponsor. However special purpose vehicles are usually established in tax-free jurisdictions with low levels of supervision (Stewart, 2005). These jurisdictions include the Cayman Islands, Bahamas, Gibraltar, Turks and Caicos (Stewart, 2005), Jersey, Guernsey (Nabarro, 2009), amongst others.
2.5 Main Advantages of Special Purpose Vehicles

2.5.1 Bankruptcy Benefits of Using Special Purpose Vehicles

A special purpose vehicle is also referred to as a “bankruptcy-remote entity” whose operations are limited to the financing and acquisition of specific assets (Topno, 2005). The term “bankruptcy-remote entity” means that when a creditor finances a special purpose vehicle (for example, to acquire an asset) and the parent company goes bankrupt, the special purpose vehicle would still legally be obliged to pay its dues without being protected under bankruptcy laws. This is because legally, the special purpose vehicle is completely separated from the parent company (Topno, 2005). If the creditor financed the parent company directly (without the creation of a special purpose vehicle), the creditor will not legally be able to reclaim its debt if the parent company goes bankrupt and is protected under bankruptcy laws.

To illustrate this matter further and as an example, Arcapita is an Islamic investment company (previously licensed as an Islamic bank) based in the Kingdom of Bahrain (with North American headquarters in Atlanta, United States of America). Arcapita filed for Chapter Eleven Bankruptcy Protection in the United States of America in 2012 after it was not able to refinance a USD 1.1 billion debt, which was due to mature soon after the filing (Truby, 2012). Having filed for Chapter Eleven Bankruptcy Protection, Arcapita protected itself under U.S. laws from the obligation to repay its debt on the due date; and more importantly, protected its assets from being legally claimed as a collateral or compensation to its creditors. The creditors of the outstanding USD 1.1 billion debt facility were now unable to reclaim their dues since the investment firm, Arcapita, was now protected under U.S.A. laws, specifically under Chapter Eleven (United States Courts, 2016). If a different creditor provided credit to Arcapita through a special purpose vehicle, the creditor will still be legally able to claim its debts on the due date, and Arcapita would be obliged to repay its debt through the special purpose vehicle even if it was protected under Chapter Eleven bankruptcy law in the United States of America. This is because, since the special purpose vehicle is a separate legal entity, it would not be subject to United States of America Bankruptcy law protection even though Arcapita obtained legal bankruptcy protection. Therefore, this example may illustrate one of the reasons why creditors may prefer to finance firms through special purpose vehicles rather than
direct financing, since the sponsoring firms’ negative performance would not affect the obligation to repay its debt through the special purpose vehicle.

However, the opposite may also be true. Just as the creditor having protected itself to receive its dues from the special purpose vehicle even if the parent company goes bankrupt, the parent company has also protected its own assets in case the special purpose vehicle goes bankrupt, or fails to pay its dues. This means, that if the special purpose vehicle (which was established by a parent company to obtain credit, for example, to finance an asset) goes bankrupt or fails to pay its dues, the creditor is legally limited to take action solely against the special purpose vehicle, and is not able to legally take action against the parent company or claim any of the parent company’s assets (Abdulla and Chee, 2010). Abdulla and Chee (2010) state that a special purpose vehicle “protects the assets of the parent company even if the subsidiary goes bankrupt (the protection applies the other way as well for the SPV [special purpose vehicle])” (Abdulla and Chee, 2010, p. 84).

It may be important to note that the terminology “bankruptcy-remote” does not mean “bankruptcy proof” (McKune, 2004). In other words, bankruptcy remote does not mean that it is immune from being bankrupt. Rather, it means that the chance of being bankrupt is simply more remote (McKune, 2004).

### 2.5.2 Taxation Benefits of Using Special Purpose Vehicles

Corporations hugely benefit from special purpose vehicles to create tax efficient structures (Forbes and Sharma, 2008). Income tax, for example, differs in different jurisdictions. Therefore, if corporations establish special purpose vehicles in tax havens, they will either eliminate income tax or reduce it magnificently (Forbes and Sharma, 2008). The below illustrates an example:

“Let's take XYZ, the global fashion brand, for example. It sells its ranges of male and female fashion garments through the wholesale channel. Its retail division consists of licensed and owned stores and concessions through which XYZ branded goods are sold. It also licenses its brand for products such as fragrances, watches…and branded mobile phones. It operates in the UK, Europe, US, Middle East, Asia and Australasia through these different channels.
As the brand is owned in the UK the existing royalty income of £5.3 million ($8.9 million) from retail and product licences comes to the UK and is subject to the standard rate of tax, 28%. If, after a restructuring, the XYZ income stream could be treated as due in Luxembourg rather than the UK, the tax rate on that income stream could be as low as 5.9% instead of 28%, resulting in a 30% increase in after-tax return before capital costs compared to a UK location” (Forbes and Sharma, 2008).

The above example clearly illustrates some main advantages in using special purpose vehicles in different jurisdictions. By legally applying a different form of structure, the tax on the income stream may be reduced from 28% to 5.9%, which may be considered as a significant drop.

Another example includes an investment company looking to invest in the real estate market, using a “buy-to-let” strategy. If the company buys the property on its own, all earnings retrieved from the properties may be taxable in its operating country. However, the exact same investment executed through a special purpose vehicle in a tax-free jurisdiction, will enable earnings gained from the investment (to the special purpose vehicle) to be tax-free. In addition, the investing party may also choose when and how to transfer amounts from the special purpose vehicle to the investing company, thereby having more control on paying taxes (Hargreaves, 2014). Some of the advantages of using special purpose vehicles are summarised below:

i. **Tax Saving**: Since the investment company (e.g. bank) controls the amount of income transferred from the special purpose vehicle to the investment company (for example, if the money is not needed, keeping it in the special purpose vehicle would reduce potential income tax liability) (Hargreaves, 2014).

ii. **Easier transfer of ownership**: Adding or removing directors to suit the investment company’s situation would be easier. However, potential inheritance tax liabilities may exist (Hargreaves, 2014).

iii. **Multiple Investments through a single Special Purpose Vehicle**: The same established special purpose vehicle might enter into multiple similar investments (for example, buying more property), to reduce charges and costs. This enables the investment company to build a property portfolio through a single special purpose vehicle (Hargreaves, 2014).
It is important to note that disadvantages also do exist when operating through special purpose vehicles, such as stamp duty taxation\(^5\) (Hargreaves, 2014). However, options for tax statutes for establishing a special purpose vehicle, depending on the jurisdiction, includes a ‘zero-rate’ company. An example for a jurisdiction offering this is Jersey (Carey Olsen, 2016). Other authors who mention the tax advantage when transferring an asset to a special purpose vehicle is Hadnum (2013).

The sophistication of special purpose vehicle structures may be more complex. However, it is evident from the above arguments that although special purpose vehicles can be complex in nature and in structure, the main purpose of establishing a special purpose vehicle remains clear, which is to meet a specific purpose.

### 2.6 Types of Special Purpose Vehicles

According to Newman (2007), special purpose vehicles generally fall into three categories: (i) Joint Venture, (ii) Synthetic Lease, and (iii) Asset Securitization or off-balance sheet financing. These three types are explained below:

#### 2.6.1 Joint Venture

A joint venture is when two or more parties engage in a venture that is separated legally from their respective firms. The channel used for this venture would be a special purpose vehicle (Newman, 2007). This special purpose vehicle may be formed in a number of ways such as a partnership, corporation, trust, and limited liability company (LLC) (Newman, 2007). As an example of a typical joint venture, as suggested by Newman (2007), can be the construction of a gas pipeline to conduct offshore oil drilling. The entire scope of the venture will be transferred into separate business entity – a special purpose vehicle - that would own both the assets and liabilities associated with the project. Since the risks and rewards of the project are now isolated solely with the special purpose vehicle, this creates an attractive incentive for the investors. This is because the investor would be able to assess the risks involved with this project, without the need to worry about the overall financial performance and risks associated with the corporations as a whole (Newman, 2007).

\(^5\) In the UK, changes to the stamp duty rules in the 2014 budget which were brought into force for land transactions on or after 20th March 2014, which means people will pay 15% tax on all purchases over £500,000; while below half a million standard stamp duty applies: 1% for properties up from £125,000 to £250,000, and 3% on properties from £251,000 to £500,000. (Hargreaves, 2014)
In order to avoid a situation where the special purpose vehicle (for example, through its trustee) acts in an unplanned manner after its formation, the chartering documents, such as the articles of incorporation, operating agreement, and partnership agreement, narrows the scope of the special purpose vehicle solely to the pre-planned and pre-determined activities (Newman, 2007).

Therefore, Newman (2007) raises some key observations to the special purpose vehicle joint venture context. The purpose and rationale of the joint venture is clear, transparent, and for the most part makes sense. The design and structure of the joint venture in order to achieve the desired end result and envisaged accomplishment makes sense. Newman (2007) argues that provided proper formation, protocols, and implementations are followed, this type of special purpose vehicle is a legitimate and non-controversial one.

### 2.6.2 Synthetic Leases

This type of special purpose vehicle is not as simple as a joint venture (Newman, 2007). As an example, Newman (2007) argues that if a company wants to use a specific building for twenty years, for example corporate offices, where the land and building purchase price is equivalent to USD 100 million, the company may form a special purpose vehicle to purchase the building. The special purpose vehicle would therefore need to borrow necessary funds to purchase such a building, and the financial institution may loan the special purpose vehicle up to 90 percent of the fair market value of the real estate - which is secured by the real estate, while the remaining 10 percent would be retrieved by the special purpose vehicle from outside equity investors(s). The outside investor(s) owns 100 percent of the shareholder equity in the special purpose vehicle, resulting in a structure where all of the outside equity being owned by someone other than the sponsoring corporation (Newman, 2007). Corporations prefer this structure because these types of transaction, especially with this magnitude, would have a weighty impact on the corporation’s financial statements and tax returns (Newman, 2007). Accordingly, the aim is to structure the transaction in a manner that will be as advantageous as possible for financial and tax reporting purposes.
2.6.3 Asset-securitizations (off-balance sheet financing)

A typical securitization involves a corporation who is referred to as the originator, selecting a group of assets into a special purpose vehicle (Newman, 2007). Assets transferred to the special purpose vehicle are usually account receivables. Theoretically speaking however, the assets may include any type of asset that has a potential inflow of payments. Either in the form of debt or equity, the special purpose vehicle will issue some type of security in exchange for cash (Newman, 2007). These securities would be issued to third party investors, and are backed by the assets that have been transferred to the special purpose vehicle (Newman, 2007). The special purpose vehicle would receive the money from the investors, and transfer it to the originator (Newman, 2007). The debtors, who have an outstanding balance owed to the originator, are informed of the asset transfers and are instructed to send the payments to the special purpose vehicle rather than the originator (Newman, 2007). In turn, the special purpose vehicle would pay the investors (security holders) upon receiving their cash (Newman, 2007).

Similar to the synthetic leases, asset-securitization are also structured in manners to attain a more advantageous financial reporting (Newman, 2007). The balance sheet sensitivity is similar to the synthetic leases, while slight differences exist with regards to financial reporting (Newman, 2007). Because of the off-balance sheet nature of the transaction, the originator is not required to recognise the debt obligation (Newman, 2007). Such a structure may positively improve the results of financial ratios, such as the debt-to-equity ratio.

2.7 Accounting Treatment of Special Purpose Vehicles

The key question to be asked is whether a special purpose vehicle is off-balance sheet or not, in respect to another entity (Gorton and Souleles, 2007). A primary benefit of special purpose vehicles in essence is the possibility for the accounting treatment to be off-balance sheet financing (Amoruso and Duchac, 2014). This is due to many reasons. With an off-balance sheet structure, the sponsor may transfer any of its assets that negatively affect its financial statements, to a separately legal created special purpose vehicle. This would in turn enhance a firms (sponsor) balance sheet.
For this to be possible, the special purpose vehicle must be treated as a separate legal entity for financial reporting purposes, and therefore must meet certain criteria (Amoruso and Duchac, 2014). This accounting issue leads to a different question, which is whether the transfer of receivables from the sponsor to the special purpose vehicle is treated as a sale or as a loan for accounting purposes (Gorton and Souleles, 2007). For the transfer to be treated as a sale, and hence receive off-balance sheet treatment, there are mainly two requirements, which are set out in Financial Accounting Standard No. 140 (FAS 140)⁶ (FASB, 2000). In order for the transfer to be considered as a true sale, the special purpose vehicle must be a qualifying special purpose vehicle, and the sponsor must surrender control of the receivables. A qualifying special purpose vehicle is a very limited scope special purpose vehicle that meets two conditions:

- “It is a trust, corporation, or other legal entity whose activities are limited to
(1) holding title to transferred financial assets, (2) issuing beneficial interests,
(3) collecting cash proceeds from assets held, (4) reinvesting proceeds in
financial instruments pending distribution to beneficial holders, and (5)
distributing proceeds to the holders of its beneficial interests; and
- It has a standing under the law distinct from the transferor” (Hartgraves and

This means that assets and liabilities initially owned by the sponsors may be transferred to the sponsor’s special purpose vehicle, thereby removing assets and liabilities from the sponsor’s (such as a bank) balance sheet (Amoruso and Duchac, 2014). By being legally separated, the special purpose vehicle will generate its own financial statements that are exempt from consolidation by the sponsor (Amoruso and Duchac, 2014).

There are vehicles other than special purpose vehicles that some companies use to avoid recognising assets and liabilities on their financial statements (Hartgraves and Benston, 2002). These include operating leases, take-or-pay contracts, and throughout arrangements, which “enable a company to use something in its future operations in exchange for agreed upon payments” (Hartgraves and Benston, 2002,  

⁶ FAS 140: “Accounting for Transfers and Servicing of Financial Assets”. This issue was initially addressed in FAS 125. However, FAS 140 was later issued to clarify several outstanding questions left ambiguous.
The accounting problem in these situations is determining whether an asset or liability exists, and when they should be reported on the balance sheet (Hartgraves and Benston, 2002).

2.8 Origins and Evolvement of Special Purpose Vehicles

Interestingly, the origins of the concept of special purpose vehicles may be traced back to *Shari’a* (Islamic law) (Makdisi, 1999). This is because the concept of special purpose vehicles is an offshoot of the English “Trust” concept, and as explained earlier, one of the legal forms of special purpose vehicles are in the form of “trust” (Newman, 2007). Meanwhile, other authors such as PwC (2011) refer to this type of special purpose vehicle as a special purpose trust or “SPT”. As cited by Makdisi (1999), Cattan (1955) states that the English “Trust” closely resembled and probably derived from the earlier Islamic institution of “*waqf*”.

The emergence of special purpose vehicles in its modern form can be traced back to the 1970s (Amoruso and Duchac, 2014). Literature tends to suggest that special purpose vehicles began appearing in the portfolio of investment banks and financial institutions in the late 1970s to early 1980s “primarily to help banks and other companies monetize, through off-balance-sheet securitizations, the substantial amounts of consumer receivables on their balance sheets” (Hartgraves and Benston, 2002, p. 246).

The use of special purpose vehicles grew in the 1980s (Amoruso and Duchac, 2014). This growth was driven by a set of accounting standards issued in 1983 that provided the first financial reporting guidance for transactions involving special purpose vehicles (Amoruso and Duchac, 2014). The first of these standards was the Statements of Financial Accounting Standards SFAS No. 76 (FASB, 1983), which dealt with the extinguishment of debt (Amoruso and Duchac, 2014). The second of these standards was the Statement of Financial Accounting Standard (SFAS) No. 77 (FASB, 1983a). Prior to these standards, financial reporting did not allow a company

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Makdisi (1999) raises many other interesting claims regarding the Islamic origins in the Common Law. For example, he identifies the royal English contract protected by debt as having its origins in the Islamic *‘aqd* (contract), while the English Jury system having its origin in *Lajif* (a concept in the Maliki school of thought stating that when no evidence is presented, a group of twelve trusted individuals will state the ruling).
to record a transfer as a sale, if the seller yet had some sort of continuing obligation, which was uncertain at the time of the sale. When the Statement of Financial Accounting Standard (SFAS) No. 77 was issued, it allowed companies to record transfers as a sale even though the seller had some sort of continuing obligation, such as delivering the assets sold, provided this obligation could be estimated, for accounting purposes (Amoruso and Duchac, 2014). Amoruso and Duchac (2014) are of the view that this change in accounting rule was critical in the evolution of the market, because “it opened the door for companies to remove financial assets from their balance sheets, even if these assets were sold into a trust with recourse” (Amoruso and Duchac, 2014, p.110).

Later, in 1989, an Emerging Issues Task Force (EITF) in the United States of America addressed the issue of when sponsors should consolidate their special purpose vehicles (Amoruso and Duchac, 2014). Three criteria were set out for this, where the guidance allowed the sponsor to avoid consolidation if there was: (1) A substantive equity investment by an independent third party who (2) has control of the special purpose vehicle, and (3) has the substantive risks and rewards of owning the special purpose vehicle (Amoruso and Duchac, 2014). This guidance was significant, as it provided the framework for determining when a special purpose vehicle could be treated as a separate financial reporting entity, with its assets and liabilities reported separately from the sponsor (Amoruso and Duchac, 2014).

Until the end of the twentieth century, although the special purpose vehicle market was continuously expanding, special purpose vehicles were not yet widely known, nor were a main concern or problems being witnessed in its practice (Amoruso and Duchac, 2014).

According to McMillen (2013), it was during this time, prior to Mid-1990s, that special purpose vehicles started to be used in the Islamic financial industry for Shari’a (Islamic law) compliance purposes. The use of special purpose vehicles (for example, at locations such as the Cayman Islands and Bermuda), are used by Middle Eastern investors because of prevalent investment and transaction structures such as joint

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8 Topic D-14 “Transactions Involving Special-Purpose Entities” (EITF, 2002)
ventures, corporate restructurings, private equity and real estate acquisitions (Elmalki and Stone, 2009).  

Until a scandal known as the “Enron Scandal”\textsuperscript{10}, which is a scandal that led the Enron Corporation from having a market capitalisation of USD 60 billion in the beginning of 2001, to being bankrupt by the end of 2001 (SEC, 2005)\textsuperscript{11}, special purpose vehicles were not under any major criticism or scrutiny (Amoruso and Duchac, 2014). The Enron Scandal, and later the 2008 global financial crises, massively increased special purpose vehicle awareness to the public, questioning their usage and accuracy in terms of financial reporting, regulation, and transparency (Amoruso and Duchac, 2014). This is because, one of the reasons for the failure of Enron Corporation was USD 14 billion off-balance sheet debts, which were incurred through structured financing transactions involving the use of special purpose vehicles (SEC, 2005). The Enron Corporation was able to hide enormous amounts of debt through accounting frauds by using special purpose vehicles (Amoruso and Duchac, 2014 and Dharan, 2002). This scandal evidences that special purpose vehicles may be used to hide debt from investors, auditors, regulators, and other stakeholders. Therefore, these huge business failures focused attention on the shortcomings of rule-based accounting standards that addressed off-balance sheet accounting and special purpose vehicle reporting (McKee et al, 2006). However, Newman (2007) argues that it was not the lack of accounting guidance that resulted in the special purpose vehicle scandal by Enron, rather a dishonest and fraudulent behaviour of Enron’s management.

After the Enron Scandal, special purpose vehicles have come under major criticism and scrutiny in the financial industry (Newman, 2007). The line between the use and abuse of special purpose vehicles has become extremely thin, where the two are considered almost the same (Newman, 2007). It is almost as if special purpose vehicles are established solely for manipulative, fraudulent, obfuscate, and inherently negative purposes (Newman, 2007).

\textsuperscript{9} The timeline and reasons why the Islamic financial industry started operating through special purpose vehicles (SPVs) during the 1990s is further explained in chapter four.  
\textsuperscript{10} The “Enron Scandal” was revealed late 2001 that led to the bankruptcy of the Enron Corporation, an American energy company based in the United States of America, and the de facto dissolution of Arthur Andersen, a major multi-international audit and accountancy firm.  
\textsuperscript{11} The Securities and Exchange Commission (“SEC”) in the United States submitted a report and recommendations (Pursuant to Section 401(c) of the Sarbanes-Oxley Act of 2002) on arrangements with off-balance sheet implications, SPEs, and transparency of filings by issuers. As part of this SEC (2005) report, a historical context of the study included “Enron Corp”.
In 2007, concerns began to emerge regarding the possible impacts of special purpose vehicles on the financial system (Amoruso and Duchac, 2014). These off-balance sheet vehicles were described by McCulley (2007) as a “shadow banking system” that provided liquidity to the financial markets without transparency or regulation. Problems started to arise where the default rate on loans held by the special purpose vehicles increased, and in turn caused the value of debt securities issued by special purpose vehicle securities to deteriorate (Amoruso and Duchac, 2014). Although this did not have a huge impact on special purpose vehicles, this deterioration in the value of securities heavily impacted structured investment vehicles (SIVs) holding these securities (Amoruso and Duchac, 2014). The structured investment vehicle crises began to emerge and spread out by late 2007 (Amoruso and Duchac, 2014).

It is apparent from the Enron Scandal as well as other bailouts of major corporations that special purpose vehicles played a huge role in leading to the 2008-2009 global financial crises. However, it should be noted that special purpose vehicles are merely separate legal entities and therefore, it may logically be claimed that those who establish and manage the special purpose vehicles are the real action players in the market.

Lastly, in 2016, a set of confidential documents that was disclosed to the public, known as the “Panama Papers”, led to a media erupt, which provided detailed information of countless offshore companies with directors and links to politicians, government representatives, business institutions, and wealthy individuals who benefit from offshore companies (such as special purpose vehicles) for tax evasion/avoidance purposes as reported by the Guardian (2016), the New York Times (2016), British Broadcasting Corporation - BBC (2016), Reuters (2016), amongst others. This contemporary concern indicates that the issues faced by these offshore type companies still pose challenges to those parties who may be negatively affected by it.

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12 A pool of investment assets that attempts to profit from credit spreads between short-term debt and long-term structured finance products such as asset-backed securities (ABS).

13 HSBC bailed out two SIVs at roughly $45 billion in assets (Amoruso and Duchac, 2014). Citigroup bailed out $49 billion in assets from SIVs, while Bear Steams loaned one SIV $3.2 billion (Connolly, 2007; Kelly & Ng, 2007; Weil, 2007). Bear Steams ended up failing due to its SIV crisis, and the Federal Reserve set up a separate fund to absorb the company’s unhealthiest assets (Federal Reserve, 2013).
2.9 Conclusion

After the 2008 global financial crisis, special purpose vehicles “have received negative publicity and faced heightened scrutiny from regulators” (Amoruso and Duchac, 2014, p.116). Special purpose vehicles are frequently used to hide debt from shareholders and investors, and used to “conceal responsibility for these entities behind contractual arrangements that conflict with underlying economic reality” (Amoruso and Duchac, 2014, p.116).

Negativity towards special purpose vehicles is also witnessed throughout literature related to special purpose vehicles. Some journalistic literatures officially include negative wording proving that the initial intentions some originators of special purpose vehicles were to deceive those with the right to know. For example, Stewart (2005), mentions that the establishment of special purpose vehicles “...very easily develops in to a sustained policy of deceiving or depriving those with a right to know…which have to compound their deceit in order to remain intact and to sustain the lie” (Stewart, 2005, p.23). Another negative trait is the “proliferation - or domino-effect procreation - of such entities is a typical effect of complex circumstances in which lies have to be compounded and expanded to retain theoretical credibility” (Stewart, 2005, p.24). Stewart (2005) considers the link between special purpose vehicles and money laundering as being “almost automatic” (Stewart, 2005, p.24), which is why money-laundering laws have been partly developed in a way to detect and discourage the formation of special purpose vehicles (Stewart, 2005).

However, Stewart (2005) argues that the term “special purpose vehicle” does not in itself indicate any illegality such as fraud or scam. Although Stewart (2005) does indicate the intended deception by the originators being done through the usage of special purpose vehicles who end up having to compound their deceit in order to remain intact and to sustain the lie, he nevertheless mentions that special purpose vehicles yet remain a possible perfectly acceptable designation. This is because special purpose vehicles do not, in and off themselves, indicate any sort of illegality. Others who hold this view are Forbes and Sharma (2008), who stated:

“Special purpose vehicle (SPV) is often considered a series of dirty words. The assumption being that something devious is going on to hide a potential
liability. But this simply is not the case. All financial instruments are exposed to misuse so of course special purpose vehicles are no exception, but they can be used for legitimate business advantage, especially regarding intangible assets”. (Forbes and Sharma, 2008)

Also, Newman (2007) notes that evidence suggests that special purpose vehicle abusers represent a small pool of companies relative to the total population of public companies. This is worthy of note because Newman (2007) argues that it was not the accounting standards set that was the core of the problem, nor normal special purpose vehicle practices in the industry, rather, it was “SPV abuse”. Lastly, in terms of regulation, Amoruso and Duchac (2014) are of the view that the evolution of these entities and their relationship with structured investment vehicles posed a systematic challenge for regulating and developing a robust financial reporting model for special purpose vehicles.
3. Chapter Three: *Maqāsid Al-Shari’ā* (Objectives of Islamic Law) and Islamic Financial Principles

The below figure highlights the position of chapter three in light of the research outline:

![Figure 3 Chapter Three Position (Author’s Diagram)](image)
3.1 Introduction

Islamic banking is a banking system that operates according to the principles of Shari’a (Islamic law) (Abdul-Raheem 2013, Kettel 2011, Abdul-Rahman 2010, Abdulla and Chee 2010, Soumare 2008, and Ayub 2007). The Shari’a (Islamic law) consists of rulings derived from four main sources, which are the Qur’an, sunna (Prophetic sayings and tradition), ijma’ (consensus), and qiyas (analogy) (Possami et al. 2015, Ahdar and Arony 2010, Auda 2008, Jokisch 2007, Ayub 2007, and Prince 1986). Each ruling in Shari’a (Islamic law), whether general or specific, has a meaning and wisdom behind it (Ash-Shubaili 2015 and Auda 2008). The study of maqāsid al-shari’a (objectives of Islamic law) looks into specific and general rulings of Shari’a (Islamic law), and is concerned with learning the meaning and wisdom behind specific legislated rulings (Ash-Shubaili, 2015). This field of study (maqāsid al-shari’a) is based on both usul al-fiqh (fundamentals of Islamic jurisprudence) and fiqh (Islamic jurisprudence) (Ash-Shubaili, 2015).

Main Sources of Shari’a (Islamic Law)

The Holy Qur’an

Sunna (Prophetic Sayings and Traditions)

Ijma’ (Consensus)

Qiyas (Analogy)

Figure 4 - Main Sources of Shari’a (Author's Diagram)

Also, one of the main objectives of an Islamic economy is to achieve the maqāsid al-shari’a (objectives of Islamic law) (Ginena and Hamid 2015, AlSerhan 2015, Al-
Enezi 2015, and Chapra 2006). Islamic banks are considered a significant component in achieving a successful Islamic economy (Al-Enezi, 2015). Islamic financial principles serve *maqāsid al-shari‘a* and therefore, since Islamic banks operate according to the *Shari‘a* (Islamic law), Islamic banks should obviously follow Islamic financial principles (Ayub, 2007).

It may be concluded from the above, that in order to understand Islamic financial principles, it is imperative to understand two things: (1) The field of study and concept of *maqāsid al-shari‘a* (objectives of Islamic law) in relation to Islamic finance; and (2) the main Islamic financial principles. These two matters are important to understand because they are linked to special purpose vehicles in Islamic banking. Do special purpose vehicles serve *maqāsid al-shari‘a* (objectives of Islamic law)? Does the special purpose vehicle practice act according to Islamic financial principles? Understanding the study of *maqāsid al-shari‘a* (objectives of Islamic law) and Islamic financial principles may help in understanding and answering these questions, which are therefore explained in this chapter.

### 3.2 *Maqāsid Al-Shari‘a* (The Objectives of Islamic law)

Generally, there are specific *maqāsid* (objectives) and general *maqāsid* (objectives) (Ash-Shubaili, 2015). The *maqāsid* (objectives) for each *hukm taklīfi* (injunctive ruling) in Islamic law is known as the specific *maqāsid* (objectives) (Ash-Shubaili, 2015). Ash-Shubaili (2015) uses “fasting” as an example for a specific objective, who argues that the objective or wisdom behind this legislation is to remember the poor, and curb the self-desires of an individual (Ash-Shubaili, 2015). As for the general *maqāsid* (objectives), an example would be that the *Shari‘a* (Islamic law) came to prevent harms and uphold interests (Ash-Shubaili, 2015).

This section defines *maqāsid al-shari‘a* (objectives of Islamic law), in addition to two other terminologies related to *maqāsid al-shari‘a* (objectives of Islamic law), which are *maslaha* (interest/benefit) and *mafsada* (harm). Second, it will specifically identify how *maqāsid al-shari‘a* (objectives of Islamic law) relates to *māl* (wealth) and Islamic finance.
3.2.1. Definitions

The term “Shari’a” involves all the creeds and acts legislated by Allāh (God) (Ibn Taymiyah, 2005). “Maqāsid al-shari’ā” (objectives of Islamic law) refers to the meaning and wisdom the Legislator was concerned with, both generally and specifically, to achieve the interests of mankind (Ash-Shubailī, 2015). This meaning is confirmed by a number of Shari’a jurists including Al-‘Izz Bin Abdel-Salām, Imam Al-Shātibī, and Imam Al-Ghazālī who state that it is known from the derived sources of Shari’a (Islamic law) that the objective of Shari’a is the well being of humans, both in their religion and their worldly affairs (Abdel-Salām 2008, Al-Shātibī, 2008, Ibn Āshūr 2004, Khallāf 1993, Al-Āmidī 1981, and Al-Ghazālī 1971).

Shari’a jurists unanimously agree that a main maqāsid (objective) of Shari’a (Islamic law) is to protect the interests of mankind, which can be rightfully called a “maslaha (interest/benefit)”, and not the desires, short-term pleasures, or deviant lusts of mankind (Abu Zahra 2010, Al-Fawzān 2015, Khallāf 2008, and Sattam 2015). “Maslaha (interest/benefit)” is the preservation of maqāsid al-shari’ā (objectives of Islamic law) (Al-Ghazālī 2008, Al-Zarkashi 1992, and Al-Shawkānī, 1909).

According to Imam Al-Ghazālī, maqāsid al-shari’ā (objectives of Islamic law) with respect to the creation are five, which is to protect and preserve for them their: (1) deen (religion/faith), (2) nafs (oneself, lives), (3) ‘aql (mind/intellect), (4) nasl (posterity/decedents), and (5) māl (wealth) (Al-Ghazālī 2008 and Al-Būtī 2009).

Anything that repels what causes harm to these five categories is considered a “maslaha” (an interest/benefit), while anything that causes harm to these five categories is the opposite of maslaha (interest/beneficial), which is considered as a “mafsada” (that which causes harm) (Al-Ghazālī, 2008).

14 The linguistic meaning of “Shari’a” refers to a place from which water descends (Ibn Mandhūr, 2003).
15 Linguistically, “maqāsid” refers to “qasd”, a word with three meanings: (1) the determination and undertaking something, (2) straightness on the path, and (3) moderation in matters (Al-Zamakhshari, 1998).
16 There are differences amongst scholars regarding whether the masālih (benefits) were initially intended by the Lawgiver or not, which is debated in great length amongst ahl al-sunna, mu’tazilites, ash’arites (different denominations of Islam with regards to aqeedah (creed), while the issue was also addressed by scholars of kalam (theology). However, these are philosophical differences and they are in unanimous agreement that the laws of Shari’a (Islamic law) are comprised of masālih (benefits) for mankind (Al-Fawzān, 2015).
As for the masālih (interests/benefits), with respect to its: importance, significance, people’s need for them, their effect on the well-being of mankind, and providence of its security and stabilizing its existence - they are not all considered to be of the same level of importance (Al-Fawzān, 2015). There are some masālih (interests/benefits) that are less important than others (Al-Fawzān, 2015). The highest level of masālih (interests/benefits) with respect to its significance is al-dhārūriyāt (necessities), followed by hājiyyāt (needs) and tāhsīniyyāt (complementary) (Al-Fawzān, 2015). The above five categories mentioned by Al-Ghazālī (2008) are all considered as dhārūriyāt (necessities) (Al-Fawzān, 2015). Therefore, this means that the protection and perseverance of lawful māl (wealth), is considered a “dharūra (necessity)”, holding the highest rank of al-masālih (interests/benefits) in maqāsid al-shari‘a (objectives of Islamic law).

Since Islamic finance mainly deals in financial transactions, it may be concluded that the relationship between maqāsid al-shari‘a (objectives of Islamic law) and Islamic finance is mainly in the fifth category, which is māl (wealth). It may also be
concluded that the protection and perseverance of Islamic banks capital and financial transactions also holds a high ranking of importance and significance according to maqāsid al-shari‘a (objectives of Islamic law), and may be considered a dharūra (necessity). The Shari‘a (Islamic law) concept of dharūra (necessity) is further discussed later in this chapter.

3.2.2. **Maqāsid Al-Shari‘a (Objectives of Islamic law) of Māl (Wealth)**

Islamic finance is a system of finance that is in line with Shari‘a (Islamic law) rules and principles (Abdulla & Chee 2010 and Ayub 2007). It was also previously concluded that each Shari‘a ruling (al-ahkām al-taklīfiyya) has a specific maqsad (objective) (Ash-Shubailī, 2015). Therefore, it may be concluded that Islamic finance in essence, should fulfill many of maqāsid al-shari‘a (objectives of Islamic law) (Al-Qura-Dāghī, 2011). It was also concluded that the link between Islamic finance and maqāsid al-shari‘a (the objectives of Islamic law) is mainly in māl (wealth), where protecting and persevering māl (wealth) may be considered a dharūra (necessity), which is the highest rank of masālih (interests/benefits) (Al-Ghazālī, 2008).

According to Al-Qaradhāwī (2008), there are a number of different types of maqāsid (objectives) that are related to māl (wealth) (Al-Qaradhāwī, 2008). This includes maqāsid (objectives) with respect to māl (wealth) (1) value and structure, (2) link with faith and morality, (3) production, (4) consumption, (5) circulation; and (6) distribution (Al-Qaradhāwī, 2008).

3.2.3. **Maqāsid Al-Shari‘a (Objectives of Islamic Law) and the Islamic Economy**

Since the Islamic economy includes Islamic banking and finance within it, understanding the main maqāsid al-shari‘a (objectives of Islamic law) relating to an Islamic economy may be useful to understand. According to Al-Qura-Dāghī (2011), the maqāsid al-shari‘a (objectives of Islamic law) of an Islamic economy includes the following:
1. The achievement of succession and empowerment of the earth, which is done through developing the land and making it upright for the whole of humanity (Al-Qura-Dāghī, 2011).

2. The (general) development of the human being and the society economically, socially, culturally, and intellectually (Al-Qura Dāghī, 2011).

3. Protection of wealth along with its enhancement through investments and engagement in (business) contracts with risk management (Al-Qura-Dāghī, 2011). Also, to manage māl (wealth) in a balanced manner, without extravagant spending, stinginess, or miserliness (Al-Qura-Dāghī, 2011).

3.2.4. *Maqāsid Al-Shari’ā* and Special Purpose Vehicles

A question that may be significant to address is whether the theoretical concept of special purpose vehicles serves or goes against *maqāsid al-shari’ā* (the objectives of Islamic law). It may be concluded from the previous section(s), that whether special purpose vehicles serve or go against *maqāsid al-shari’ā* (objectives of Islamic law) is dependent on whether the activities undertaken through a special purpose vehicle in Islamic finance is in accordance with *Shari’ā* (Islamic law) requirements or not. The following may clarify this understanding:

1. If the special purpose vehicle fulfills *Shari’ā* (Islamic law) requirements, engage in lawful activities, and/or abstain from prohibited activities, its activities are serving *maqāsid al-shari’ā* (objectives of Islamic law). This is because the *Shari’ā* (Islamic law) rulings by default serve the philosophy of *maqāsid al-shari’ā* (objectives of Islamic law).

2. If the special purpose vehicle does not fulfill a *Shari’ā* (Islamic law) requirement, without a valid reason, and/or engages in activities that are prohibited in *Shari’ā* (Islamic law), then this special purpose vehicle practice goes against *maqāsid al-shari’ā* (objectives of Islamic law).

The below provides arguments relating to whether or not special purpose vehicles serve *maqāsid al-shari’ā* (objectives of Islamic law):
A. Arguments supporting the notion that Special Purpose Vehicles serve *Maqāsid Al-Shari‘a* (Objectives of Islamic law):

i. Removing Hardship

Evidence for removing hardship and facilitating ease being considered as a *maqsad* (objective) is found in the *Qur’an*\(^\text{18}\): “Allah intends for you ease, and He does not want to make things difficult for you”\(^\text{19}\) (Al-Hilali & MuhsinKhan, 1996, p.57) and “Allah does not want to place you in difficulty”\(^\text{20}\) (Al-Hilali & MuhsinKhan, 1996, p.216)\(^\text{21}\).

Therefore, it may be argued that special purpose vehicles serve the general *maqsad* (objective) of *Shari‘a* (Islamic law), which is “removing hardship and facilitating things for people” (Ash-Shubaili, 2015). This is because special purpose vehicles, in essence, are established because of their practicality and to make things easy, as evidenced in chapter two. If strictness was practiced by those with the authority of approvals, such as the *Shari‘a* body or regulator, who disallow special purpose vehicles to be used as a tool in an investment structure, this may oblige banks to pay higher taxes, reduce the financial performance of their balance sheets, increase establishment fees and other costs, reduce the legal benefits for the transaction, and complicate the transactions due to certain jurisdiction bureaucracies. Thus, logically, this may inflict hardships on Islamic banks managements when dealing with their financial operations.

ii. Protecting *Māl* (Wealth)

Protecting and preserving peoples *māl* (wealth) is a significant *maqsad* (objective) of *Shari‘a* (Islamic law), which also holds the highest ranking of *masālih* (interests/benefits) (Al-Ghazālī 2008 and Al-Fawzān 2015). Since one of the benefits for special purpose vehicles is to protect its shareholders funds even if the sponsoring entity goes bankrupt, and will not be affected by the poor financial performance of the sponsoring entity (Abdulla and Chee, 2010), this by extension means that the legal

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\(^{18}\) The Qur’an is the first and primary source of *Shari‘a* (Islamic law)

\(^{19}\) Interpretation of the meanings of the Qur’an, Chapter 2: Verse 185

\(^{20}\) Interpretation of the meanings of the Qur’an, Chapter 5: Verse 6

\(^{21}\) This is also evidenced by the second source of *Shari‘a* (Islamic law), the Prophetic *Sunna*, when he (pbuh) said “Treat people with ease and do not be hard on them; give them glad tidings and don’t fill them with aversion” (Bukhari and Muslim).
structures of special purpose vehicles may protect the māl (wealth) of shareholders. Therefore, it may be concluded that the special purpose vehicle legal structure serves as a maslaha (interest/benefit), as it protects and preserves individuals’ māl (wealth) (Al-Ghazālī 2008 and Al-Būṭī 2009).

iii. Promoting Economic Development

It may be argued that special purpose vehicles serve the economic well being of an economy. Since special purpose vehicle structures reduce tax obligations, regulatory requirements, and other hardships, this may increase trade in the market. Therefore, more business contracts will be entered into and in turn help the economy grow. A growth in business transactions will also help Islamic banks attain business opportunities that will enhance shareholder wealth, which is one of the objectives of maqāsid al-shari’a (objectives of Islamic law) (Al-Qura-Dāghī, 2011).

B. Arguments supporting the notion that Special Purpose Vehicles does not serve Maqāsid Al-Shari’a (Objectives of Islamic Law)

i. Lack of Transparency

Shari’a (Islamic law) prohibits illusory practices and considers it to be one of the detestable sins, which is a statement accepted by the unanimity of Shari’a scholars or jurists (Al-Nawawi, 2015). Chapter two concluded that the establishment of special purpose vehicles “…very easily develops in to a sustained policy of deceiving or depriving those with a right to know…which have to compound their deceit in order to remain intact and to sustain the lie” (Stewart, 2005, p.23). If these actions mentioned by Stewart (2005) were true, it may be concluded that the misleading practices involved with special purpose vehicles are not acceptable according to Shari’a (Islamic law).

The question that arises is whether Shari’a (Islamic law) jurists should prohibit or discourage special purpose vehicles, in order to annihilate the means and method that lead to such disingenuous practices, called as sad al-tharāʾi (prohibition of evasive legal devices) in Shari’a (Islamic law), which is further discussed in section 3.3.4.
ii. Spread of Mafāsid (Harms)

It may be assumed that if Islamic banks engaged in misleading practices through special purpose vehicles, similar to the claims put forth by Stewart (2005), those in charge of such practices may be the respected individuals who are in charge of planning and initiating such special purpose vehicle transactions, such as Islamic banking managers. If these bank managers mislead those with a right to know, such as the board of directors, shareholders, regulators, Shari’a Supervisory Boards, auditors, or other stakeholders, these disingenuous practices may lead to the following:

1. Board of Directors may approve special purpose vehicle transactions harmful to them and the shareholders, if bank managements lack transparency when displaying the investment structures for approval. This is because a possible lack of transparency may lead to a hidden detail(s) not known to the board of directors, which might have affected their decision. Also, this may further have a negative impact on the māl (wealth) of shareholders as capital contributors, and therefore may be considered as a mafsada (harmful) (Al-Ghazālī 2008 and Al-Būṭī 2009).

2. Board of Directors rationale in their decisions may further be affected due to possible lack of transparency by management. For example, if financial statements presented to the board lack transparency (i.e. hidden debts or financial deals executed through special purpose vehicles that are not clearly presented in financials) where it portrays a positive financial performance rather than the realistic performance, this may lead the board to approve compensations and bonuses to management that would have otherwise not been the case. This negative affect on the māl (wealth) of shareholders may also be considered a mafsada (harmful) (Al-Ghazālī 2008 and Al-Būṭī 2009).

3. Shari’a Supervisory Boards of Islamic banks may issue Shari’a (Islamic law) rulings on special purpose vehicle structures that do not necessarily reflect the underlying economic reality of the transaction. For example, if a Shari’a Supervisory Board unknowingly approves a special purpose structure that includes an element of riba (i.e. which were hidden through the layering of special purpose vehicles), in reality, all the mafāsid (harms) associated with riba (commonly referred to as interest or usury) would exist in the transaction. This by extension
means that if many similar structures were approved in various Islamic banks, all the mafāsid (harms) associated with riba (commonly referred to as interest or usury) may spread across the Islamic banking industry. If the mafāsid (harms) pertaining to riba (commonly referred to as usury or interest) spreads throughout the Islamic banking industry, then this would serve against maqāsid al-shari’ā (objectives of Islamic law) (Al-Qaradhāwī, 2008).

4. Regulators may not regulate efficiently, nor hold the Islamic banks accountable, to protect the stakeholders and economy due to possible mismanagements by Islamic banks. This will lead to a mafsada (harm) where the regulator will not be able to protect the māl (wealth) of the shareholders, and may inefficiently regulate the tadāwul (circulation) of māl (wealth) - both of which are considered as mafāsid (harms) and go against maqasid al-shari’ā (objectives of Islamic law).

5. Auditors (whether internal or Shari’a) may not spot or report necessary findings in their reports, and therefore the bank would not rectify mistakes and cause mafāsid (harms) to the economy, even when a proper corporate governance and auditing infrastructure is set into place.

3.2.5. Summary of Special Purpose Vehicles and Maqāsid Al-Shari’ā (Objectives of Islamic Law)

Special purpose vehicles serve and go against maqāsid al-shari’ā (the objectives of Islamic law), depending on the practice of Islamic banks. Special purpose vehicles may serve maqāsid al-shari’ā (objectives of Islamic law) by removing hardships such as legal, regulatory, and taxation. The removal of these hardships further increases economic activities and development, which is one of the maqāsid (objectives) in Shari’ā (Islamic law). Lastly, special purpose vehicles may further serve the maqāsid al-shari’ā (objectives of Islamic law) by protecting the māl (wealth) of shareholders, through its various forms of legal structures.

However, special purpose vehicles may not serve maqāsid al-shari’ā (objectives of Islamic law) since it may be considered as a gateway to non-transparent practices by banks (Stewart, 2005). This in turn would lead to a variety of mafāsid (harms) that may negatively impact the maqāsid al-shari’ā (objectives of Islamic law) in the
Islamic banking industry. It is imperative to note, that these *mafāsid* (harms) being spread out the banking industry may not be a result of special purpose vehicles as a concept nor its legal framework, however may be a result of the abuse of special purpose vehicles by the Islamic banking industry. This is similar to Stewart (2005) statements, as described in chapter two.

### 3.3 Islamic Financial Principles

The *Shari’a* (Islamic law) does not recognise transactions that constitute an element or object that is considered illegitimate (Ayub, 2007). Therefore, the *Shari’a* (Islamic law) has identified particular elements that need to be avoided while engaging in transactions (Ayub, 2007). These prohibitions include *riba* (commonly referred to as usury or interest) and *gharar* (uncertainty) (Ayub 2007 and Al-Enezi 2015). The *Shari’a* (Islamic law) also prohibits actions that lead to prohibitive activities, such as *hila* (legal stratagem or ruse) to ultimately engage in prohibited activities, and *thari’a* (means and method) that leads to a prohibited activity (Al-Enezi, 2015). This section explains the main concept of Islamic financial principles pertaining to these four prohibitions, because they are related and may be used in special purpose vehicle structures.

#### 3.3.1. Prohibition of *Riba* (commonly referred to as Usury or Interest)

In *Shari’a* (Islamic law), the term “*riba* (commonly referred to as usury or interest)” means an addition, however low in number, over and above the principal of a loan or debt (Ayub, 2007). “Riba means and includes any increase over and above the principal amount payable in a contract obligation, not covered by a corresponding increase in labour, commodity, risk or expertise” (Ayub, 2007, p. 53).

There is no difference of opinion regarding the prohibition of *riba* (commonly referred to as usury or interest) in *Shari’a* (Islamic law) according to Islamic scholars (Ayub, 2007). This is due to the fact that the two main sources of *Shari’a* (Islamic law) – the *Qur’an*\(^\text{22}\) and *sunna*\(^\text{23}\) – both strictly prohibit *riba* (commonly referred to as usury or interest (Ayub, 2007). However, differences exist regarding the meaning of

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\(^{22}\) Please See Qur’an: Surah Al-Baqara, verse 275-281; Surah Al-Imran, verse 130; Surah Al-Nisa’, verse 161; Surah Al-Rum, Verse 29.  
\(^{23}\) Examples: *Muslim*, *Al-Tirmidhi*, and *Imam Ahmed*.  

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riba (commonly referred to as usury or interest) or what constitutes riba (commonly referred to as usury or interest) in modern transactions (Ayub, 2007). For example, Al-Tantawi (2001), the rector of Al-Azhar\textsuperscript{24} claimed that compensations made by the banks to its depositors (known today as interest) do not constitute an element of the forbidden riba (commonly referred to as usury or interest). However, this view is held by Al-Tantawi (2001) only in the context where the depositor/banker relationship should be viewed as savers giving their funds to banks as investment managers (which would be a mudhāraba\textsuperscript{25}). If the relationship is viewed (or under contractual terms) as a lender/borrower relationship, then Al-Tantawi (2001) himself also holds the view that interest in these transactions does constitute the element of the forbidden riba (commonly referred to as usury or interest). Therefore regardless of this debate, all contractual lender/borrower relationships with interest do constitute an element of the forbidden riba (usually referred to as usury or interest) even according to Al-Tantawi (2001).

Also, the majority of Shari`a (Islamic law) scholars argue that modern interest-based transactions include an element of riba (Al-Enezi, 2015). The researcher accepts this view mainly for the following reasons:

1. The Qur’an, being the first and primary source of Shari`a (Islamic law), explicitly states\textsuperscript{26} that if a lent amount is returned to the creditor, it should equal the principal amount, to avoid oppressing or being oppressed (Al-Hilali and MuhsinKhan, 1996). This means that demanding an increase in return for a lent amount constitutes oppression and is forbidden according to Shari`a (Islamic law).

2. The Qur’an elaborates\textsuperscript{27} that Allah has permitted trade but prohibited riba (Al-Hilali and MuhsinKhan, 1996), which indicates that an increase in a sale price (e.g. profit) is permissible since it is actual trade, opposed to an increase for a lent amount.

3. There are many hadiths (Prophetic traditions and sayings) that prohibits dealing with riba (commonly referred to as riba or interest).\textsuperscript{28}

\textsuperscript{24} Al-Azhar is one of the oldest and most authentic Islamic universities in the world, headquartered in Egypt.

\textsuperscript{25} Mudhāraba is a type Islamic business explained in chapter four.

\textsuperscript{26} Please see Qur’an, Surah Al-Baqarah, verse 279 (2:279)

\textsuperscript{27} Please see Qur’an, Surah Al-Baqarah, verse 275 (2:275)

\textsuperscript{28} Examples: Muslim, Al-Tirmidhi, and Imam Ahmed.
4. If it was assumed that interest does not constitute the prohibited *riba* (commonly referred to as usury or interest) mentioned in the *Qur’an* and *hadith* (Prophetic traditions and sayings), then the third source of *Shari’a* (Islamic law), which is *ijma’* (consensus), would still prove that interest is forbidden and does constitute an element of the forbidden *riba* (commonly referred to as riba or interest).

Therefore, it may be concluded that interest-based activities include an element of *riba* (commonly referred to as usury or interest), which is prohibited in *Shari’a* (Islamic law). Khan (1986) states that this prohibition is largely due to its negative distributive justice and equity effects (Visser & McIntosh, 1998). Choudhury and Malik (1992) further comment that due to this prohibition, it perhaps developed the most sophisticated and complete theoretical systems of an interest-free economy in the world (Visser & McIntosh, 1998). As discussed in chapter four, this development includes the concept of establishing multiple special purpose vehicle structures that either avoids interest-based transactions, or separates interest-based transactions from Islamic banks (McMillen, 2013).

3.3.2. **Prohibition of *Gharar* (Uncertainty)**

*Gharar* (uncertainty) generally means that in which the outcome is unknown (Ibn Taymiyah 2001, Al-Sarkhāi 1989, and Ibn Taymiyah 2005), or that whose nature and consequences are hidden (Al-Shirāzī, n.d.). Ibn Hazm (n.d.) defines *gharar* (uncertainty) as being: when the buyer does not know what he bought, or the seller does not know what he sold. For example, selling an asset to be delivered in the future without providing specifications of the asset (for example, selling an apartment without revealing the size or location of the apartment) contains an element of *gharar* (uncertainty). Al-Zuhaily (n.d.), who lists and analyses all the various definitions of *gharar* (uncertainty) of many classical *fuqaha* (Islamic jurists), believes that Al-Sarkhāi’s (1989) definition is the most accurate one, which is “that whose outcome (or consequences) are hidden”.

*Gharar* (uncertainty) is prohibited in *Shari’a* (Islamic law) (Ibn Majeh n.d., Muslim n.d., Al-Tirmidhi 1998, Al-Nisā’ī 1986, and Abu Dawūd n.d.) and therefore, according to *Shari’a* (Islamic law), the existence of *gharar* (uncertainty) nullifies a
contract (Sultan 2007, Ramadan 2006, and Buang 2000). According to El-Gamal (2001), Al-Darīr (1997) lists four conditions for gharar (uncertainty) to nullify a contract:

1. “It must be major. [...]”
2. The potentially affected contract must be a commutative financial contract. [...]”
3. The gharar must affect the principal components of the contract (e.g. the price and object of sale, language of the contract, etc.). Thus, the sale of a pregnant cow is valid, even though the status of the fetus calf may not be known.
4. That there is no need met by the contract containing gharar which cannot be met otherwise.” (El-Gamal, 2001, p.4)

3.3.3. **Prohibition of using Hīla (Legal Stratagems) to engage in prohibited activities**

Initially, hīla (legal stratagem or ruse) and makhārīj (Shari’a solutions) have the same meaning in Shari’a (Islamic law) (Al-Enezi, 2015). With reference to classical Islamic texts, many Shari’a (Islamic law) scholars referred to this section of Shari’a (Islamic law) as “the book of hiyal (legal stratagems, ruse, legal tricks, etc.)”, while others referred to the same section as “the book of makhārīj” (Ibn Najim, 1999). However, the term “hiyal” throughout history prevailed as being the prohibited action of developing tricks that lead to prohibited activities, while the term “makhārīj” prevailed as being seeking alternative solutions that is permissible in Shari’a (Islamic law) (Al-Enezi, 2015). It is now common between the fuqahā (Islamic jurists) that when the term “hiyal” is used, it refers to an action or trick to make lawful what is actually not lawful (Ibn Taymiyah 1998 and Ibn Al-Qayyim 2002). Therefore, engaging in hiyal (legal stratagems or ruse) in order to engage in prohibited activities is prohibited in Shari’a (Islamic law) (Al-Qaradhbū 1978 and Al-Enezi, 2015). Ibn Taymiyah (2005) argues that the same mafāsid (harms) included within these prohibited activities are also included within this type of hiyal (legal stratagems or ruse), except that this type of hiyal (legal stratagems) additionally includes an element of deception.
As explained in the introduction of this chapter, one of the main objectives of an Islamic economy is to achieve the *maqāsid al-shari’a* (objectives of Islamic law), while the Islamic banking industry is considered a significant component in achieving a successful Islamic economy (Al-Enezi, 2015). Therefore, in order to achieve such objectives, Islamic banks started using what is known as *fiqh al-hiyal wal makhārij* (Islamic jurisprudence of *hiyal* (legal stratagems) and *makhārij* (*Shari’a* solutions)) (Al-Enezi, 2015). However, Islamic banks (whether intentionally or not) started adopting the prohibited type of *hiyal* (legal stratagems), which ultimately leads to engaging in prohibited activities (Al-Enezi, 2015). For example, this may include Islamic banks using *hiyal* (legal stratagems) to ultimately indirectly engage in prohibited activities or industries. Al-Enezi (2015) argues that the list below may have acted as reasons for engaging in this prohibited type of *hiyal* (legal stratagems):

1. The Islamic banking industry is a young industry and therefore not sophisticated as the conventional banking industry.
2. Islamic banks want to compete with conventional banks.
3. Islamic banks co-mingled prohibited *hiyal* (legal stratagems) with lawful *makhārij* (*Shari’a* solutions), where the distinction became not always clearly recognizable.
4. Many Islamic financial engineers do not have *Shari’a* (Islamic law) educational backgrounds.
5. Islamic banks persist on attaining profitability without taking risk (avoiding the risk-reward factor of Islamic banking).

Engaging in *hiyal* (legal stratagems) to engage in unlawful activities exists in the Islamic banking industry (Al-Enezi, 2015). Al-Enezi (2015) claims that this is true despite the fact that many contemporary *fiqh* (Islamic jurisprudence) scholars, Islamic *fiqhi* (jurisprudence) infrastructure organizations, and *Shari’a* Supervisory Boards are exhorting effort to cleanse the industry from these misleading practices, and rather find *makhārij* (*Shari’a* compliant solutions or alternatives) to these prohibited practices.

As mentioned in chapter two, special purpose vehicles are separate legal entities created for a specific (financial) purpose. Due to being able to structure transactions
with a tool that is legally separated from an Islamic bank, Islamic banks may use special purpose vehicle structures as one of the main methodologies to engage in *hila* (legal stratagem) in order to engage in conventional (or prohibited) activities or transactions. The empirical chapters further discuss this matter.

### 3.3.4. **Sad Al-Tharā’i (Prohibition of Evasive Legal Devices)**

In many cases, a specific activity is not considered prohibited itself, however it may act as the cause that leads to prohibited activities. A *thari’a* is the means and method to arrive of something (e.g. engage in an activity) (Ibn Taymiyah 1998 and Ibn Al-Qayyim 2002). Therefore, eradicating the *thari’a* (means and method) that lead to engaging in prohibited activities is known in *Shari’a* (Islamic law) as *sad al-tharā’i* (prohibition of evasive legal devices) (Al-Qaradhāwī 1978 and Al-Enezi 2015). However, if a *thari’a* (means and method) no longer leads to a prohibited activity, it may be deemed permissible and re-used, known as *fat’h al-tharai’* (approval of evasive legal devices) (Al-Enezi, 2015).

To clarify this concept and as an example, if an Islamic bank leases a building to a company who continues to operate a prohibited business (for example, in the gambling industry), the renewal of the lease would indicate that this prohibited business will continue to operate so long as the lease agreements are renewed. The Islamic bank may therefore, avoid renewing the lease agreement to this company, as a way of eradicating the *thari’a* (means) that led to the opening of the prohibited businesses. This is because this business may lead to the spread of *mafāsid* (harms). This practice may be referred to as *sad al-thari’a* (prohibition of evasive legal devices).

### 3.3.5. **Exceptions in Shari’a (Islamic law) Rulings: Al-Dharūriyyāt (Necessities)**

*Al-dharūriyyāt* (necessities) is the plural of *dharūra* (necessity). It may be useful to understand this branch of *Shari’a* (Islamic law), since it may provide a justification to engage in what is initially considered unlawful in *Shari’a* (Islamic law), considered as an exception (Al-Qaradhāwī, 1978).
The types of masālih (interests/benefits) intended by Shari’a (Islamic law) are three: (1) Necessities (Al-Dharūriyāt), (2) Needs (Hājiyyāt), and (3) Amenities (Tahsiniyyāt) (Al-Fawzān, 2015). It was previously explained that not all masālih (interests/benefits) are considered to be in the same level of importance, where some masālih (interests/benefits) are less important than others (Al-Fawzān, 2015). It was also previously explained that with respect to its significance, al-dharūriyāt (necessities) is considered to be the highest level of masālih (interests/benefits) (Al-Fawzān, 2015).

Al-dharūriyāt (necessities) refers to a thing, which without it, the welfare of the religion and/or worldly life cannot be established (Al-Shatibi 2008 and Al-Fawzān 2015). In other words, it is the matter that is needed to establish and sustain the well being of religion and the worldly life (Al-Shatibi 2008). Al-Shatibi (2008) explains that if a dharūra (necessity) is missing, the welfare of the world will be impacted negatively that would spread corruption in this world.

As explained in section 3.2.1, the dharūriyāt (necessities) are limited to five necessities: (1) deen (religion), (2) nafs (oneself, lives), (3) ‘aql (intellect), (4) nasl (posterity/decedents), and (5) māl (wealth) (Al-Ghazālī 2008 and Al-Būtī 2009). However, these are comprehensive necessities, meaning that anything falling into a category of repelling what causes harm to these five comprehensive necessities may be considered a maslaha (interest/benefit), while anything causing harm to these five comprehensive categories may considered as a mafsada (harm) (Al-Ghazālī 2008). Thus, what may be considered a dharūra (necessity) is not limited to the above five terminologies.

For example, the consumption of pork is initially considered prohibited in Shari’a (Islamic law)29 (Al-Hilali and MuhsinKhan, 1996). However, the same verse where the Qur’an30 prohibits pork consumption explicitly provides an exception for those who are forced by necessity to engage in what was initially prohibited (Al-Hilali and MuhsinKhan, 1996). Therefore, if an individual finds no other food to consume except for pork, it is completely acceptable to consume pork according to Shari’a

29 Please see Qur’an: Surah Al-Baqarah, verse 173 (2:173)
30 Please see Qur’an: Surah Al-Baqarah, verse 173 (2:173)
(Islamic law), since it was done out of dharūra (necessity) and not intentional transgression (Al-Qaradhāwī, 1978).

Likewise and using analogical methods, it may be concluded that engaging in initially prohibited interest-based transactions may be acceptable in Shari‘a (Islamic law) if it was done out of dharūra (necessity) (Al-Qaradhāwī, 1978). For example, shelter is considered a dharūra (necessity) and therefore, if an individual finds no other means to house or shelter his family except through an interest-based loan, then this would be considered acceptable according to Shari‘a (Islamic law). This is because the masālih (interests/benefits) of housing outweighs the mafāsid (harms) in obtaining an interest-based loan.

By understanding this concept of dharūra (necessity), it may be imperative to understand Islamic banking structure and transactions on a case-by-case basis, in order to understand whether the concept of dharūra (necessity) exists, where the Shari‘a (Islamic law) rulings may provide exceptions (Al-Qaradhāwī, 1978). This may further be important to understand since two identical special purpose vehicle transactions may have different rulings, depending on the dharūra (necessity) of each individual case. It also clarifies that Islamic banks may not replicate Islamic investment structures adopted by other Islamic banks since the details of the approval may not be available nor clarified to them.

3.4 Conclusion

The Shari‘a (Islamic law) is derived from four main sources, which are the Qur‘an, sunna (Prophetic sayings and traditions), ijma‘ (consensus), and qiyas (analogy). There is a higher objective and wisdom behind each Shari‘a (Islamic law) ruling (Ash-Shubailī, 2015). The maqāsid al-shari‘a (objectives of Islamic law) in respect to the creation is five, which is to preserve and protect for them their deen (religion/faith), nafṣ (oneself/lives), ‘aql (mind/intellect), nasl (posterity/descendants), and māl (wealth).

Islamic banking includes main prohibitions, such as riba (commonly referred to as usury or interest) and gharar (uncertainty). Also, since hila (legal stratagem) and
makhārij (Shari’a solutions) closely resemble each other (Al-Enezi 2015), the ability to accurately distinguish whether a certain practice is a hila (legal stratagem or ruse) or makhraj (Shari’a solution) becomes specifically important.

Also, whether a certain situation is considered a dharūra (necessity) or not, determines whether an Islamic bank can directly engage in (initially) prohibited activities according to Shari’a (Islamic law). However, if special purpose vehicles are considered separate legal entities, can Islamic banks indirectly engage in prohibited activities through special purpose vehicles regardless of whether a circumstance was considered a dharūra (necessity) or not?

Al-Enezi (2015) argues that there are Islamic banks that engage in hila (legal stratagem) in order to ultimately engage in prohibited (e.g. interest-based) activities. However, it is unclear how Al-Enezi (2015) derived to this conclusion, but what may be apparent is that the ability to engage in hila (legal stratagem or ruse) through the use of special purpose vehicles may easily be possible. The empirical chapters further discuss the practice of special purpose vehicles by Islamic banks.
4. Chapter Four: Islamic Financial Products

The below figure highlights the position of chapter four in light of the research outline:

- Introduction
- Review of Literature No. 1: Special Purpose Vehicles
- Review of Literature No. 2: Maqasid Al-Shari’a and Islamic Financial Principles
- Review of Literature No. 3: Islamic Financial Products
- Research Methodology
- Empirical No. 1: Perspective of Practitioners regarding Special Purpose Vehicles
- Empirical No. 2: Practice and Behaviour of the Islamic Banking Industry towards Special Purpose Vehicles
- Conclusion

Figure 6 Chapter Four Position (Author’s Diagram)
4.1 Introduction

This chapter will explain the main Islamic financial products that are (or may be) used in conjunction with special purpose vehicles, which are: (1) *tawarruq* (monetization), (2) *murābaha* (cost-plus sale), (3) *ijāra* (lease), (4) *mushāraka* (contractual partnership) (5) *mudhāraba* (another form of partnership) and (5) *sukūk* (commonly referred to as Islamic bonds). This is because these five Islamic products are the main products related to Islamic banking (Ayub, 2007). These five Islamic banking products may be used in conjunction with special purpose vehicles for financing and investment transactions or structures. Therefore, it is imperative to understand the concept of these Islamic products in order to gain a better understanding of how special purpose vehicles may operate in the Islamic banking industry.

4.2 Islamic Financial Products

4.2.1 *Tawarruq* (Monetization)

A. *Tawarruq* (Monetization) Definitions

The Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI) defines *tawarruq* (monetization) as: “the process of purchasing a commodity for a deferred price determined through Musawamah (Bargaining) or Murabahah (Mark-up Sale), and selling it to a third party for a spot price so as to obtain cash” (AAOIFI 2015c, p.758).

*Tawarruq* (monetization) means to buy a commodity on credit, then sell it to a third party for cash (spot payment) for a price that is less than the original price the commodity was purchased for, in order to obtain instant cash or liquidity (Al-Qura-Dāghī, 2009 and Kuwait-Awqaf, 1988). In *fiqh* (Islamic jurisprudence), the *Hanbali* doctrine of Islamic law is the only doctrine that uses the term “*tawarruq* (monetization)” as a distinct product (Al-Bahūtī, 2000 and Ibn Muflih, 2003). The other doctrines of Islamic law explain the concept of *tawarruq* (monetization) as a division within their explanation of *tānah* (a type of sale that involves selling a commodity on credit, thereafter re-purchasing the same commodity on spot payment for a lower price) (Kuwait-Awqaf, 1988).
The Organization of Islamic Cooperation (OIC) Fiqh Academy (2009) defines *tawarruq* (monetization) as:

“A person (mustawriq) who buys a merchandise at a deferred price, in order to sell it in cash at a lower price. Usually, he sells the merchandise to a third party, with the aim to obtain cash. This is the classical tawarruq, which is permissible, provided that it complies with the Shari’ah requirements on sale (bay’)).” (OIC, 2009)

If the word “usually” in the definition implies that a *tawarruq* (monetization) transaction may not involve a third party, the accuracy of this definition may be questioned since the lack of involvement of a third party is considered a “‘īnah” and not a “tawarruq” (Al-Qura-Dāghī, 2009 and Kuwait-Awqaf, 1988). It may be significant to note here that the main difference between *tawarruq* and ‘īnah is the existence of a third party in *tawarruq*, whereas in ‘īnah - the original seller will repurchase the commodity at a lower price without the existence of a third party (Kuwait-Awqaf, 1988 and Al-Qura-Dāghī, 2009).

**B. Shari’a (Islamic law) Ruling of Tawarruq (Monetization)**

The permissibility of *tawarruq* (monetization) under *Shari’a* (Islamic law) has been an issue of debate amongst both classical and contemporary *Shari’a* (Islamic law) jurists. The majority of classical *Shari’a* (Islamic law) jurists consider the practice of *tawarruq* (monetization) - whether being referred to in the term of “*tawarruq* monetization)” or otherwise - to be permissible under *Shari’a* (Islamic law) (Kuwait-Awqaf, 1988). These include classical *Shari’a* (Islamic law) jurists from *Hanafi*, *Mālikī*, *Shāfi’i*, and *Hanbali* doctrines of *Shari’a* (Islamic law) (Ibn Al-Hamām 2010, Ibn Rushd 1998, Al-Shāfi’i 2001, and Al-Mardawi 1956, respectively). Some classical *Hanafi* and *Mālikī Shari’a* (Islamic law) scholars consider *tawarruq* (monetization) as *mākrūḥ* (discouraged or disliked) under *Shari’a* (Islamic law) (Al-Zaylā’ī 1896 and Al-Hattāb 2010, respectively), where one narration in the *Hanbali* doctrine of *Shari’a* (Islamic law) supports this view (Ibn Muflih, 2003). However, there is also a narration in the *Hanbali* doctrine of *Shari’a* (Islamic law) that considers *tawarruq* (monetization) to be prohibited under *Shari’a* (Islamic law) (Al-Mardawi
1956 and Ibn Taymiyah 1998a). This view of tawarruq (monetization) being prohibited is also supported and held by two classical and accomplished Shari’a (Islamic law) jurists, who are Ibn Taymiyah (1987) (according to one of his two opinions) and Ibn Al-Qayyim (2002).

The views of contemporary Shari’a (Islamic law) jurists pertaining to tawarruq (monetization) are similar to the abovementioned opinions of classical Shari’a (Islamic law) jurists, claiming that tawarruq (monetization) is either permissible, mākrūh (discouraged or disliked), or prohibited, according to each independent opinion. However, a heavy debate amongst contemporary Shari’a (Islamic law) jurists is not regarding the tawarruq (monetization) concept described by the classical Shari’a jurists, which is also known as “al-tawarruq al-fardi (individual tawarruq)” (Bouheraoua, 2009). Rather, the debate amongst the contemporary Shari’a (Islamic law) jurists is regarding modern (Islamic) banking application of tawarruq (monetization), referred to and known as “al-tawarruq al-masrafi (banking tawarruq)”. The key difference between tawarruq al-fardi (individual tawarruq) and al-tawarruq al-masrafi (banking tawarruq) is that al-tawarruq al-masrafi (banking tawarruq) involves a concept of “al-tawarruq al-munadham (organized tawarruq)” (Bouheraoua, 2009). Al-Tawarruq al-munadham (organized tawarruq) is when the seller, buyer who intends to sell to a third party, and the third party all intend and execute the transaction simultaneously, referred to as “organized tawarruq” (OIC, 2009). The Organization of Islamic Cooperation (OIC) Fiqh Academy (2009) defined “organized tawarruq” as:

“When a person (mustawriq) buys a merchandise from a local or international market on deferred price basis. The financier arranges the sale agreement either himself or through his agent. Simultaneously, the mustawriq and the financier execute the transactions, usually at a lower spot price”. (OIC, 2009)

This concept is one of the key additions to contemporary Shari’a (Islamic law) and fiqhi (Islamic jurisprudence) literature relating to tawarruq, where contemporary Islamic fiqhi (jurisprudential) literature includes the term and concept of “al-tawarruq al-munadham (organized tawarruq)”. This terminology, “al-tawarruq al-munadham (organized tawarruq)”, does not exist in classical Shari’a (Islamic law) texts and
literature probably due to the possibility of it being a contemporary phenomenon, and therefore was not commented on by classical Shari’a (Islamic law) jurists.

i. **Shari’a (Islamic law) Ruling on Al-Tawarruq Al-Masrafi (Banking Tawarruq)**

Although the Organization of Islamic Cooperation (OIC) Fiqh Academy views *tawarruq al-fardi* (individual *tawarruq*) as being permissible according to Shari’a (Islamic law), it however ruled that the practice of *al-tawarruq al-masrafi* (banking *tawarruq*) is prohibited under Shari’a (Islamic law) due to it being *munadham* (organized) (OIC, 2009). The specific ruling regarding its prohibition of *tawarruq al-munadham* (organized *tawarruq*) practices by Islamic banks is:

“It is not permissible to execute both tawarruq (organized and reversed) because simultaneous transactions occur between the financier and the mustawriq, whether it is done explicitly or implicitly or based on common practice, in exchange for a financial obligation. This is considered a deception, i.e. in order to get the additional quick cash from the contract. Hence, the transaction is considered as containing the element of riba” (OIC, 2009).

The researcher believes that this view may be stringent since it does not provide an alternative to a *tawarruq* (monetization) nor a conventional loan, and is considering two lawful sale agreements (which may have met the conditions of *bai’* (sales) in Shari’a (Islamic law)) as prohibited without providing sufficient evidence. If *tawarruq al-munadham* (organized *tawarruq*) practiced by modern Islamic banks is considered plainly prohibited by the Organization of Islamic Council (OIC) Fiqh Academy (2009), this implies that customers who want to adhere to Shari’a compliant products for cash financing might as well obtain conventional loans rather than a *tawarruq* (monetization). Therefore, even if *tawarruq al-munadham* (organized *tawarruq*) was actually prohibited, it should serve as a temporary substitute for a conventional loan, until another acceptable substitute to a cash loan is made available (Al-Qura-Dâghî, 2009).

However, there are quite a few of influential contemporary Shari’a (Islamic law) jurists who consider *al-tawarruq al-munadham* (organized *tawarruq*) as lawful according to Shari’a (Islamic law) (Al-Enezi, 2015). These include Sh. Abdulla Al-
Menea, Sh. Mohammed Uthmani, and Sh. Mohammed Al-Qarri (Al-Enezi, 2015) - who argue that there is no difference between al-tawarruq al-fardi (individual tawarruq) and tawarruq al-masrafi (banking tawarruq). This may be a more acceptable view, since it serves as a substitute to a conventional loan under actual sales (of commodities) agreements, whether it was a normal or organized tawarruq (monetization). The question that may arise here is if a sufficient alternative Shari’a compliant financial product comes into existence, should this view or the continuous use of tawarruq (monetization) still be acceptable? In any case, this issue remains a debate amongst contemporary Shari’a (Islamic law) jurists.

C. Islamic Banks and Tawarruq (Monetization)

As discussed in chapter three, a creditor providing a cash-based loan in order to retrieve an amount that is higher than the lent amount includes an element of riba (commonly referred to as usury or interest) (El-Enezi, 2015). The conventional banking loan system is based on this structure, which is known as interest-based banking or interest-based loans (Al-Qaradhāwī, 2008). The concept of riba (commonly referred to as usury or interest) is prohibited in Shari’a (Islamic law) and therefore, interest-based loans are considered prohibited under Shari’a (Islamic law) (Al-Qaradhāwī, 2008). The substitute used by individuals or institutions wanting to adhere to Shari’a (Islamic law) principles in their financial dealings is tawarruq (monetization), considering it to be the suitable substitute (Al-Qura-Dāghī, 2009 and Ayub, 2007). This product (tawarruq) enables parties to obtain liquidity or credit without the need to enter into riba-based transactions, but rather through the above-described sale agreement (Al-Qura-Dāghī, 2009).

However, tawarruq (monetization) practiced by modern (Islamic) banks are “tawarruq al-masrafi (banking tawarruq)”, which are structured as a tawarruq al-munadham (organized tawarruq). The debates by contemporary Shari’a (Islamic law) jurists explained in the previous section displayed that the majority of Shari’a (Islamic law) jurists view tawarruq al-munadham (organized tawarruq) as prohibited, while a minority of influential Shari’a (Islamic law) jurists consider it to be lawful (OIC, 2009). Differences in branches of fiqh (Islamic jurisprudence) exist because Shari’a (Islamic law) is a broad chain where these differences are allowed in Shari’a
(Islamic law) within the same law. Despite these heavy debates regarding *tawarruq al-munadham* (organized *tawarruq*), in addition to its prohibition by the Organization of Islamic Council (OIC) Fiqh Academy (OIC, 2003), it is interesting to note that many Islamic banks nevertheless use *tawarruq al-munadham* (organized *tawarruq*) as their methodology of financing (Ayub, 2007). This is probably due to the fact that Islamic banks are not obliged to follow *Shari’a* (Islamic law) rulings pronounced by international Islamic or *fiqh* (Islamic jurisprudence) organizations, but rather are subject to the rulings and interpretations of their *Shari’a* Supervisory Boards (Abdulla and Chee, 2010). Therefore, if the *Shari’a* Supervisory Boards at Islamic banks consider *tawarruq al-munadham* (organized *tawarruq*) permissible or approve it on an exceptional basis by considering the transaction as a *dharūra* (necessity), Islamic banks would be able to use *tawarruq al-munadham* (organized *tawarruq*) as their main method of financing without any regulative difficulty.

The below diagram is a simple illustration for how Islamic banks are able to finance customers through the use of *tawarruq* (monetization) without engaging in interest-based lending:

---

**Tawarruq (Monetization) Transaction**

1. Purchase commodity with spot payment (principal amount)
2. Transfer of commodity ownership
3. Purchase commodity with deferred payment (principal + profit)
4. Transfer of commodity
5. Sell commodity with spot payment
6. Customer Receives cash (while still indebted to the Islamic bank)

---

Figure 7 *Tawarruq* (Monetization) Transaction (Author’s Diagram)
Having diagrammatically understood the concept of *tawarruq* (monetization), this product may be used in special purpose vehicle transactions where Islamic financing(s) is included. Below illustrates this example:

**Example of a Tawarruq (Monetization) in an SPV Transaction**

Figure 8 *Tawarruq* (Monetization) in an SPV Structure (Author’s Diagram)

### 4.2.2 Murābahā (Cost-Plus Sale)

“Murābahā (cost-plus sale)” is a term that is included in classical *Shari’a* (Islamic law) literature that refers to a sale, where the seller would sell a product for an amount equivalent to its initial purchased amount, in addition to a known profit (Al-Murghayāni 1936, Ibn Al-Hamām 2010, Al-Nawawi 2003, and Ibn Qudāmah 1994). In a *murābahā* (cost-plus sale) transaction, the seller is required to convey to the buyer the initial price he (seller) purchased the commodity for, whereby the exact profit may also be accurately calculated by the buyer (Ibn Qudāmah, 1997).
In a murābaha (cost-plus sale) transaction, the ultimate purpose is that the buyer will get a (physical) hold and benefit from the asset bought (contrary to tawarruq (monetization), where the buyer sells the asset to a third party to attain the ultimate purpose of obtaining cash or liquidity). Like many other Islamic sale agreements, there are specific conditions that must be met to execute a valid murābaha sale (Ayub, 2007). In a murābaha (cost-plus sale), as well as all other Islamic sale agreements, one of the main conditions is that the seller needs to legally own the asset prior to selling it (Ayub, 2007).

A. Murābaha (Cost-Plus Sale) Transactions in Islamic Banks

Islamic banks use Murābaha (cost-plus sale) as a method of offering finance to its customers (Ayub, 2007). To simplify this understanding, an Islamic bank would purchase an asset for a spot payment; thereafter sell it to the customer on credit (for an amount equivalent to its principal plus a conveyed profit) (Ayub, 2007). This provides opportunities for customers to buy an asset from a bank (on credit) rather than obtaining an interest-based loan to buy an asset (Ayub, 2007). Islamic banks use this tool when they want to finance customers who wish to attain specific assets for beneficiary purposes (Ayub, 2007). Therefore, this also leads to the necessity of explaining a specific type of murābaha used by Islamic banks, which is the ‘bai’ al-murabaha lil āmir bil shirā (murābaha to purchase orderer or MPO)’. Islamic banks are aware of which assets to purchase because the customer informs the Islamic bank of his intention to buy a specific asset.

B. Al-Murābaha lil Āmer bil Shirā (Murābaha to Purchase Orderer)

Al-Murābaha lil āmer bil shirā (murābaha to purchase orderer or MPO) is “an arrangement wherein the bank, upon request by the customer, purchases an asset from a third party and sells the same to the customer on a deferred payment basis” (Ayub, 2007, p.222). Ayub (2007) further explains “this variant is being widely used by almost all Islamic banks operating in various parts of the world and by the Islamic Development Bank for its foreign trade-financing operations” (Ayub, 2007, p.222).

A difference of opinions between classical Shari‘a (Islamic law) jurists exists regarding the Shari‘a (Islamic law) ruling for al-murābaha lil āmir bil shirā
(murābaha to purchase orderer). The debate mainly exists regarding whether or not the customer - referred to as ‘al-āmir (the orderer)’ – is obliged to purchase the asset in which he initially expressed his intention to purchase (therefore considered as a promise and binding), or solely an expression of intention that may change (considered non-binding). If the customer’s expression of intention is non-binding, then the murābaha lil āmir bil shirā (murābaha to purchase orderer) is considered lawful in Shari’ā (Islamic law) according to the Hanafi (Al-Sarkhasi, 1989) and Shāfi’i (Al-Shāfi‘i, 2001 and Al-Nawawi, 2003) doctrines of Islamic law (Al-Enezi, 2015). It is however considered prohibited according to the Mālikī doctrine of Islamic law (Ibn Rushd, 1988), as well as an acknowledged recent contemporary Shari’ā (Islamic law) jurist Ibn Othaimīn (2004), who considered it prohibited and whose literature indicates that it as a type of bai’ al-īnah (Ibn Othamīn, 2004, p.211). However, Qassās (2010) explains that when a customer’s (orderer) expression to purchase the asset is not a promise (therefore non-binding), then al-murābaha lil āmir bil shirā (murābaha to purchase orderer) is considered lawful in Shari’ā (Islamic law) according to the unanimous agreement of contemporary Shari’ā (Islamic law) jurists. Below is an example of a murābaha (cost-plus sale):
4.2.3 **Ijāra (Lease)**

*Ijāra* (lease) is a contract that involves one party providing a certain (lawful) benefit to a beneficiary, for a pre-specified duration and compensation, to be paid by the beneficiary (Ibn Al-Najjār 1999, Al-Bahūṭi 2000, Al-Murghayānī 1936, and Al-Hattāb 2010). Ayub (2007) defines *ijāra* as “a contract of a known and proposed usufruct of specified assets for a specified time period against a specified and lawful return or consideration for the service or return for the benefit proposed to be taken, or for the effort or work proposed to be expended” (Ayub, 2007, p.279). In other words, *ijāra* (lease) refers to leasing agreement/transaction that adheres to conditions prescribed by *Sharī‘a* (Islamic law) (Ayub, 2007). According to these definitions, Ayub (2007) lists five essentials of *ijāra* (lease): (1) It is a contract (2) for a known usufruct to be transferred (3) of a specific asset (4) for a specified time (5) and an agreed pre-specified rent amount.

**A. Ijāra (Lease) and Islamic Banking**

“According to contemporary jurists and experts on Islamic finance, *Ijarah* has great potential as an alternative to interest in respect of evolving a *Sharī‘ah*-compliant financial system” (Ayub, 2007, p.279). In the *murābaha* (cost-plus sale) section, it was evident that Islamic banks purchasing the asset had the ultimate purpose of selling it to a customer for profit, through a *murābaha* (cost-plus sale) contract (Ayub, 2007). In *ijāra* (lease) contracts, rather than selling the asset to its customer, the bank leases the asset to the customer for periodic payments (Ayub, 2007). However, this does not mean that in all *ijāra* (lease) contracts, the customer would not end up owning the asset (Ayub, 2007). There are different types of *ijāra* (lease) contracts, one of them being *ijāra muntahia bil tamlīk* (lease-to-own), which enables the customer (beneficiary) to own the asset at the end of the lease period (Ayub, 2007).

**i. Ijāra Muntahia bil Tamlīk (Lease to Own)**

*Ijāra muntahia bil tamlīk*’ (lease-to-own) is a contract that involves the Islamic bank purchasing and legally owning a lawful asset in order to lease it to a potential customer for an agreed tenure and rental amount, where the lessee would end up owning the asset at the end of the lease period (Al-Hāfi, 2000).
B. *Ijāra* (Islamic leasing) Diagram

The below diagram simply displays how an *ijāra* (lease) transaction may be structured using a special purpose vehicle:

![Diagram of Ijara in an SPV Structure](image)

**Figure 10 Ijara in an SPV Structure (Author’s Diagram)**

The reasons for establishing a special purpose vehicle rather than directly obtaining finance to purchase and lease the asset, are similar to the reasons mentioned in chapter two (e.g. regulatory, legal, accounting, and taxation benefits). The above diagram displays a simple *ijāra* (lease) transaction structure that includes Islamic financing (for example, a *tawarruq* (monetization) transaction). However, in many cases, conventional financings are included in Islamic special purpose vehicle structures (McMillen, 2013). This raises a key question: how can Islamic banks, whose essence is based on the prohibition of interest-based transactions, structure transactions through the use of special purpose vehicle structures to obtain conventional financing? This issue is further examined and discussed later throughout this research.
4.2.4 Mushāraka (Contractual Partnership)

Sharikat al-‘aqd, known today as “mushāraka (contractual partnership)” refers to an agreement between two or more parties to combine their assets, labour or liabilities for the purpose of making profits” (AAOIFI, 2015d, p.326). It is a simple concept of a partnership agreement with rules and regulations that needs to comply with Shari’a (Islamic law). Modern corporations that are considered as a mushārakas (contractual partnerships) include:

1. “Stock company
2. Joint-liability company
3. Partnership in commendum
4. Company limited by shares
5. Allotment (Muhassah) partnership
6. Diminishing partnership (this partnership that originated from sharikat al ‘inan)” (AAOIFI, 2015d, p.327)

The above types of corporations may be incorporated as special purpose vehicles.

4.2.5 Mudhāraba (A form of Partnership)

A mudhāraba (a form of partnership) is a type of partnership, where one party provides the capital (known as rub il mal), while the other party provides labour (known as the mudhārib) (AAOIFI, 2015e). Islamic banks are able to use this type of partnerships with partners through the use of special purpose vehicles, since the Islamic bank can act as the capital contributor (rub il mal) to a special purpose vehicle, while the partner managing the special purpose vehicle investments is the investment manager (mudhārib), or vice versa. The definition evidences that mudhāraba (a form of partnership) may act as a tool for Islamic financial engineers to use when Islamic investments are structured.

4.2.6 Sukūk (Commonly referred to as Islamic bonds)

The term “sukūk (commonly referred to as Islamic bonds)” refers to title deeds of shares owned by sukūk holders, the shares of which represent ownership in a specific benefit, assets, services, or investment activities, that provide the sukūk holders the entitlement of rights retrieved from these sukūk (commonly referred to as Islamic bonds) (Al-Qura-Dāghī, 2009a). The Accounting and Auditing Organization for
Islamic Financial Institutions (AAOIFI) defined *sukūk* (commonly referred to as Islamic bonds) as: “certificates of equal value representing undivided shares in ownership of tangible assets, usufruct and services or (in the ownership of) the assets of particular projects or special investment activity, however, this is true after the receipt of the value of the Sukūk, the closing of subscription and the employment of funds received for the purpose for which the sukūk were issued” (AAOIFI, 2015f, p.468). AAOIFI (2015f) refers to the *sukūk* standard as “investment *sukūk*”. This is in order to distinguish it from shares and bonds (AAOIFI, 2015f). The below diagram is an example illustration of how a *sukūk* structure may operate:

![Diagram of Sukūk Structure](image)

In the above diagram, the shares the investors own in the special purpose vehicle represent actual ownership of the asset. Therefore, the percentage each investor owns represents an ownership percentage in the actual asset. Each share is known as a “*sakk*”, which is the singular of “*sukūk*” (*sukūk* is plural). Therefore, the investors own *sukūk* that pay them dividends through Islamic forms of businesses (e.g. in this case, *ijāra* [leasing] *sukūk*).
4.3 Conventional Financing(s) in Islamic Special Purpose Vehicle Structures

It was previously explained (in the *i*jära (lease) section) that Islamic special purpose vehicle structures may include conventional financing within their structures (McMillen, 2013). The below is an example of how conventional financing is included in an Islamic special purpose vehicle structure that may be considered *Shari’a* compliant, subject to meeting several specific conditions (detailed in the empirical chapters):

![Diagram of Conventional Financing in an (Islamic) SPV Structure](image)

Figure 12 Conventional Financing in an (Islamic) SPV Structure

The key information in the above diagram is the legal separation of the special purpose vehicle obtaining conventional financing, and the Islamic bank. This is because legally, the special purpose vehicle (SPV 1) established by the Islamic bank is solely leasing an asset from a different legal entity. The Islamic bank, does not own the special purpose vehicle that obtained a conventional loan and purchased the asset (SPV 2). Rather, the special purpose vehicle owned by the Islamic bank (SPV 1) is solely leasing the asset from a separate legal entity that was established by an external party (SPV 2), and sub-leases it to a third party company. Therefore, as far as the
Islamic bank is concerned, it is solely engaging in an *ijāra* (lease) transaction business.

Although actual structures may be more sophisticated, the concept is yet similar. The above-like structures may have understandably been heavily criticised by Islamic finance critiques (McMillen, 2013). However, before generalizing a criticism on the Islamic banking industry as a whole, it is imperative to first understand the history of when, why, and how these structures were brought into existence:

1. *Shari’a* Supervisory Boards who have approved this structure indicated (as shown in chapter six) that this is not an approved “mother-structure” that Islamic banks can use freely. Rather, it is approved on a case-by-case\(^{31}\) basis as a solution to a current challenge in the global market that the Islamic banking industry faces. Furthermore, there are numerous necessary conditions that need to be met for the structure to be *Shari’a* (Islamic law) compliant.\(^{32}\)

2. One of the greatest hurdles to the expansion of Islamic finance is the fact that the world is dominated by interest-based financing systems (McMillen, 2013). The majority of the world’s financial instruments and transactions are interest-based (McMillen, 2013). “The legal, regulatory, tax, accounting, and other regimes, principles and procedures are constructed to support and maintain these interest-based instruments, transactions, analytical techniques and processes, assumptions and institutions. There are no Islamic banks in many jurisdictions” (McMillen, 2013, p.189).

3. Prior to mid-to-late 1990s, investments from the Middle East into secular states (for example, the United States of America) were made without considering *Shari’a* compliance. The leverage for real estate acquisitions, private equity transactions, investment in equipment, and all other investments were provided by U.S. banks with interest-based loans. No other alternatives existed in the market (McMillen, 2013).

4. Mid-to-late 1990s, a group of Middle Eastern investors, from the State of Kuwait, Abu Dhabi, the Kingdom of Bahrain, amongst other countries, sought to develop

\(^{31}\) Depending on the type of business, jurisdiction, whether it is considered a necessity, amongst many other conditions.

\(^{32}\) The conditions are discussed in detail in chapter six.
structures in order to invest in the United States of America in a Shari’a compliant manner (McMillen, 2013).

5. U.S. lawyers worked closely with theirs clients (Middle Eastern investors and their Shari’a Supervisory Boards) to develop alternative Shari’a compliant structures (McMillen, 2013). Leverage financing had to be obtained from U.S. banks that had no knowledge or experience with Shari’a compliant banking practices, and were not motivated to modify their existing practices (for example, the underwriting, credit review, and standardised transactional structures and documentation, and more) to enable investors to adhere to Shari’a-compliant banking practices - that were relatively insignificant in size at the time (McMillen, 2013).

6. U.S. Banks and their lawyers (with rare exceptions by one or two banks) were not willing to consider analysing Shari’a compliant transactions (due to having an existing established risk evaluation and risk protection measures, including standardised practices, procedures and documentation – all of which were developed and have been highly refined in a system unaware of Shari’a (Islamic law) and its financial practices (McMillen, 2013).

7. The lawyers of the Shari’a compliant investors were innovative in coming up with solutions to face this challenge by developing a structure that would be familiar to (i) U.S. banks and their lawyers, and (ii) may be deemed Shari’a compliant according to the investors Shari’a Supervisory Boards (McMillen, 2013).

Understanding the above occurrences and timeline may be imperative to comprehend since it shows that the development of Islamic special purpose vehicle structures with the use of conventional finance was created as a makhraj (Shari’a solution to a current problem) and not hila (legal stratagem or ruse) to engage in conventional activities. This is apparent due to the fact that effort was being exhorted to innovate a Shari’a solution as an alternative to global modern conventional financial practices. Being fully Shari’a compliant, or establishing a structure without conventional financings, was not an option due to the global frameworks underlying the international financial industry. For clarification purposes and as an example, the below diagram illustrates a more sophisticated ījāra (lease) transaction:
4.4 Conclusion

The main Islamic banking products that may be used in conjunction with special purpose vehicles is tawarruq (monetization), murābaha (cost-plus sale), ījāra (lease), mushāraka (contractual partnership), and sukūk (commonly referred to as Islamic bonds). Generally, all of these products are considered Shari‘a compliant except for tawarruq (monetization), in which a debate exists. The contemporary debate mainly relates to one type of tawarruq (monetization), known as al-tawarruq al-masrafi (banking tawarruq), which includes an element of al-tawarruq al-munadham (organized tawarruq). The majority of contemporary Shari‘a (Islamic law) scholars, including the Organization of Islamic Cooperation (OIC), consider al-tawarruq al-munadham (organized tawarruq) to be prohibited in Shari‘a (Islamic law). However, a minority but influential contemporary Shari‘a (Islamic law) scholars consider this
type of *tawarruq* (monetization) as perfectly acceptable according to *Shari’a* (Islamic law).

Islamic special purpose vehicle structures may include conventional financings, if the special purpose vehicles engaged in conventional transactions were legally separated from the Islamic bank. This is subject to several *Shari’a* (Islamic law) conditions that should be met. Criticisms regarding these types of special purpose vehicle structures exist (McMillen, 2013). However, it was concluded that understanding the timeline and how these Islamic special purpose vehicle structures that includes conventional financings came into existence was imperative prior to opining on similar structures. In short, these structures were established in order to simultaneously meet U.S. laws in addition to *Shari’a* (Islamic law) requirements, to meet the needs of a group of Middle Eastern investors who preferred to invest in the United States of America in a *Shari’a* compliant way (McMillen, 2013). Therefore, the efforts into initiating this structure may be considered a *makhrjaj* (*Shari’a* solution) rather than *hila* (legal stratagem), since the ultimate purpose of the structure was to engage in a *Shari’a* compliant manner in a jurisdiction that made it very difficult to do so.

This is not to say however, that engaging in *hila* (legal stratagem or ruse) to obtain conventional financing (for invalid reasons) through the use of special purpose vehicles by Islamic banks does not exist. According to Al-Enezi (2015), *hila* (legal stratagem) does exist within the Islamic banking industry. Furthermore, it may be that Islamic banks are able, through *hiyal* (legal stratagems), to engage in interest-based financings through the use of special purpose vehicles without valid reasons. To state that this occurs as a fact however requires accompanied evidence. To generalise and claim that all Islamic special purpose vehicle structures that include conventional financings are *hiyal* (legal stratagems) may prove to be inaccurate. However, since the empirical chapters (six and seven) investigate special purpose vehicle practices by the Islamic banking industry, this issue may be further investigated and clarified in those chapters.
5. Chapter Five: Research Methodology

The below figure highlights the position of chapter five in light of the research outline:

- Introduction
- Review of Literature No. 1: Special Purpose Vehicles
- Review of Literature No. 2: Maqasid Al-Shari’a and Islamic Financial Principles
- Review of Literature No. 3: Islamic Financial Products
- Research Methodology
- Empirical No. 1: Perspective of Practitioners regarding Special Purpose Vehicles
- Empirical No. 2: Practice and Behaviour of the Islamic Banking Industry towards Special Purpose Vehicles
- Conclusion

Figure 14 Chapter Five Position
5.1 Introduction

Bryman (2008) defines methodology as practices and techniques that are used to gather, process, manipulate and interpret information that may be used to test theories and ideas about social life. A research methodology is the means by which individuals collect data to answer research questions, or to test hypotheses (Munro, 2006).

The research methodology is the philosophy or general principal that guides this research, while the research methods are the tools used to gather data needed for the research (Dawson, 2002). The research methods also include tools used to gather, analyse, and interpret data obtained that are guided by the research methodology (Gray et al., 2007). As a term, “research methodology” refers to specific procedures undertaken to accomplish the specific aims for a research project (Munro, 2006).

The research methodology and methods chosen for this research are dependent on the research aims and objectives mentioned in chapter one, in addition to being influenced by the epistemological stance of the researcher. This chapter first explains the paradigm and epistemological stance of the researcher. Thereafter, the chapter identifies the research methodology and methods used for the research.

5.2 Research Philosophy

5.2.1 Research Paradigm

Paradigm comes from the Greek word that means an example or pattern (Paradigm, 2005). It has been used in science since the 1960s to refer to a theoretical framework (Paradigm, 2005). A paradigm is a conceptual tool that differentiates the theoretical perspectives within a discipline (Paradigm, 2001).

Constructivism is a theory of knowledge that has roots in philosophy and psychology (Husen and Postlethwaite, 1989). It is considered a proposed “theory of knowing”, an alternative to a different epistemological position known as objectivism (Hardy and Taylor, 1997). In short, constructivism is a philosophical view of how individuals come to understand or know (Savery and Duffy, 2001). The researcher is inclined to a constructivist paradigm, rather than an objectivist or subjectivist paradigm.
“Constructivism suggests that reality is more in the mind of the knower, that the knower constructs a reality, or at least interprets it, based upon his or her apperceptions” (Jonassen, 1991). The below table provides a clearer understanding of constructivism by distinguishing it from objectivism:

<table>
<thead>
<tr>
<th>Reality (real world)</th>
<th>Objectivism</th>
<th>Constructivism</th>
</tr>
</thead>
<tbody>
<tr>
<td>External to the knower</td>
<td>Determined by the knower</td>
<td></td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Mind</th>
<th>Objectivism</th>
<th>Constructivism</th>
</tr>
</thead>
<tbody>
<tr>
<td>Mirror of nature</td>
<td>Perceiver of interpreter of nature</td>
<td></td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Thought</th>
<th>Objectivism</th>
<th>Constructivism</th>
</tr>
</thead>
<tbody>
<tr>
<td>Represents (or mirrors)</td>
<td>Beyond the mirroring of reality</td>
<td></td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Meaning</th>
<th>Objectivism</th>
<th>Constructivism</th>
</tr>
</thead>
<tbody>
<tr>
<td>External to the understander</td>
<td>Determined by the understander</td>
<td></td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Symbols</th>
<th>Objectivism</th>
<th>Constructivism</th>
</tr>
</thead>
<tbody>
<tr>
<td>Represent reality and are internal representations of external realities</td>
<td>Are tools for constructing reality and are representations of internal reality</td>
<td></td>
</tr>
</tbody>
</table>

Table 1 Objectivism vs. Constructivism (Author’s Diagram, theories extracted from Jonassen (1991))

The researcher views knowledge to have the need of involving interpretive characteristics, combined with a constructivist way of thinking. However, this does not mean that the researcher claims that the objectivist assumptions should be discarded in favor of the constructive assumptions. Rather, the researcher believes that the different paradigms and epistemological stances that exist are debatable, and may be subject to other factors. The favoring of the constructivist paradigm is solely to display the cognitive psychology of the researcher, in order to understand the mind interpreting the results of this research.

“Constructivism does not preclude the existence of an external reality; it merely claims that each of us constructs our own reality through interpreting perceptual experiences of the external world” (Jonassen, 1991). The researcher believes that knowledge should not be passive, and that the responsibility for learning may be placed more upon the learner rather than external factors. This view is acceptable in constructivism, which claims learners are not submissive to knowledge as portrayed by the world or mirroring knowledge passed to them as reality (Glasersfeld, 1989). Rather, learners construct their own understanding, trying to find meaning
These beliefs by extension mean that individuals should exhort effort into seeking knowledge, authenticating information and interpreting knowledge to find out the wisdom or meaning behind the knowledge, rather than accepting the external world as a reality without understanding the objectivity behind it.

5.2.2 Critical Theory

According to Bohman (2005), theorists differentiate between “critical” from a “traditional” theory according to a specific practical purpose: which is that a theory is critical to an extent that it seeks “emancipation from slavery” (Horkheimer, 1972, p.246 cited in Bohman, 2005). It also acts as a “liberating”, “influence”, and works “to create a world which satisfies the needs and powers of humans” (Horkheimer, 1972, p.246 cited in Bohman, 2005). The researcher favours critical theory due to its formulation of emancipatory strategies that enhance the social conditions of society (Corradetti, 2011). These strategies fit within maqāsid al-shari’a (objectives of Islamic law) explained by Al-Ghazālī (2008).

The Frankfurt School began with Horkheimer, extended to Marcuse (1969) and Habermas (1971), who have authored literature in these philosophical subject matters (Bohman, 2005) that include views held by the researcher. The reason why this research may be considered as following a critical theory approach is because, according to Bohman (2005), any philosophical approach with similar practical aims could be called a critical theory. This is particularly significant to the researcher since the type of organizations being examined in the empirical study are Islamic banks, which should be the type of organizations that should have a moral and just approach (Ayub, 2007).

Examples of other literature relating to critical theory include Chambers (2004), Couzens (1994), Geuss (1981), Honneth (2004), and Ingram (1990). However, what may be extracted from critical theory to a culture relating to the banking industry is the sense of liberation, employee emancipation in conditions of oppression, eradication of self-interests, problem identification and proposed solutions to those with the ability to change.
Furthermore, literature tends to suggest that the concept of Islamic critical theory is a new phenomenon that has not been written about by many scholars. For example, Gilani-Williams (2014) claims that only three scholars mentioned the concept of Islamic critical theory, who are Kazmi (2000), Sharify-Funk (Bahi, 2008), and Sadek (2012). Each author discusses the concept of Islamic critical theory from a different angle. For example, the Kazmi (2000) discussion relating to Islamic critical theory comes from an angle arguing that Muslims should be proactive after saying the declaration of faith (known as shahāda), while Sadek (2012) tries to enhance the concept of Islamic critical theory in relation to Islamic politics and democracy. However, the main reason why this research touches upon the concept of Islamic critical theory is because according to the review of literature relating to Western critical theory and maqāsid al-shari’ā (objectives of Islamic law), there are many similarities between the objectives of both concepts. For example, Western critical theory and maqāsid al-shari’ā (objectives of Islamic law) share the ideas of supporting emancipatory strategies such as emancipatory from slavery, achieving social justice, helping the poor, amongst others. According to Bohman (2005), any philosophical approach with similar aims may be referred to as critical theory. Therefore, in accordance with the argument put forth by Bohman (2005), any subdivisions of maqāsid al-shari’ā (objectives of Islamic law) that have similar aims with Western critical theory may also be namely referred to as critical theory. The difference that may arise between critical theory and Islamic critical theory, is that the roots of Western critical theory has Marxist roots (Corradetti, 2011), while Islamic critical theory has Islamic roots (Kazmi, 2000) and/or is currently being enhanced based on Islamic philosophical roots (Gilani-Williams, 2014).

5.3 Research Methodology

Generally, there are three types of research methodologies, which are the qualitative, quantitative, and mixed-methods methodologies (Aliaga and Gunderson, 2000). Qualitative research involves the exploration of diverse attitudes, behaviours, and experiences through methods similar to interviews (Dawson, 2002). On the other hand, a quantitative research methodology involves explaining a phenomenon by collecting numerical data, which are analysed using mathematically based methods (Aliago & Gunderson, 2000). “Quantitative research emphasizes ordinal measures
and number” (Gray et al., 2007, p.61). Furthermore, mixed methods is when the researcher “collects, analyses, mixes, and draws inferences from both quantitative and qualitative data in a single study or a program of inquiry” (Cameron, 2011). This research uses a qualitative methodology due to its aims and objectives illustrated in chapter one. The next section discusses the concept of a qualitative methodology in more detail.

5.3.1 Qualitative Methodology

Qualitative research involves a holistic or all-inclusive approach that involves discovery (Creswell, 1994). Qualitative research is not necessarily based on a unified theory or a methodological approach (Flick, 2006), where more than one method can be adopted within a qualitative research project, such as interviews and document analysis (Gray, 2009). Gray (2009) suggests that qualitative data can be a powerful source of analysis, even though criticisms exist which considers qualitative research to be (in some areas) less valid and less reliable than quantitative research (Gray, 2009). The qualitative research community includes individuals who intend to implement a critical interpretive approach, and may adopt a constructivist and/or critical theory (Denzin and Lincoln, 2005).

“The qualitative research community consists of groups of globally dispersed persons who are attempting to implement a critical interpretive approach… These individuals employ constructivist theory, critical theory…” (Denzin and Lincoln, 2005, p.xiv)

Furthermore, according to Gray (2009), Miles and Huberman (1994) list a number of characteristics that is involved in most qualitative research:

- “It is conducted through intense contact within a ‘field’ or real life setting.
- The researcher’s role is to gain a ‘holistic’ or integrated overview of the study, including the perceptions of participants.
- Themes that emerge from the data are often reviewed with informants for verification.
- The main focus of research is to understand the ways in which people act and account for their actions” (Gray, 2009, p.166-167)
5.3.2 Case Study as a Methodology

A common way to engage in a qualitative enquiry is to use a case study (Denzin and Lincoln, 2005). According to Denzin and Lincoln (2005), a “case study is not a methodological choice but a choice of what is to be studied” (Denzin and Lincoln, 2005, p.443). Furthermore, using a case study approach on a constructive paradigm is not a new phenomenon. According to Baxter and Jack (2008), both Stake (1995) and Yin (2003) base their approach to case study on a constructive paradigm. Yin (2003) defines a case study as:

“an empirical inquiry that
1. Investigates a contemporary phenomenon within its real-life context, especially when
2. The boundaries between phenomenon and context are not clearly evident”
(Yin, 2003, p.13).

A case study enables the researcher to analytically generalise theories (Yin, 2003). Case study research consists of investigating primary and secondary data relating to the phenomena within the context of this research, similar to the definition of case study research put forth by Hartley (2004). Hartley (2004) further explains that this is done in order “to provide an analysis of the context and processes which illuminate the theoretical issues being studied” (Hartley, 2004, p.323).

Generally, there are four types of case study designs, which are: (1) single case study, holistic, (2) single case, embedded, (3) multiple case, holistic, and (4) multiple case, embedded (Gray 2004 and Flick 2006). This is further illustrated below:
Main Types of Case Study Designs

<table>
<thead>
<tr>
<th>Holistic (Single Unit of Analysis)</th>
<th>Single Case Designs</th>
<th>Multiple Case Designs</th>
</tr>
</thead>
<tbody>
<tr>
<td>Type 1 Single/Holistic</td>
<td>Type 3 Multiple/Holistic</td>
<td></td>
</tr>
<tr>
<td>Type 2 Single/Embedded</td>
<td>Type 4 Multiple/Embedded</td>
<td></td>
</tr>
<tr>
<td>Embedded (Multiple Units of Analysis)</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

Within a single case study, there may only be one unit of analysis, referred to as holistic, or multiple units of analysis, referred to as embedded (Gray, 2004). To clarify this matter further, this research uses the Kingdom of Bahrain as a single case study, by holistically analysing one special purpose vehicle transaction structure. This structure includes a single case study design and one unit of analysis, referred to as single/holistic. The research may have analysed multiple special purpose vehicle transaction structures, which would have been multiple units of analysis, referred to as single/embedded. The reason for selecting a holistic approach rather than an embedded one is because qualitative research generally involves a holistic or all-inclusive approach that involves discovery (Creswell, 1994).

The concept of holistic (unit of analysis) and embedded (multiple units of analysis) may also apply to a multiple case study design. For example, if this research were using three geographical jurisdictions as case study, the Kingdom of Bahrain, the State of Dubai, and Malaysia, this would be considered a multiple case study design. The research may have included a single unit of analysis for each case study.
jurisdiction (holistic), or multiple units of analysis (embedded) for each case study jurisdiction. However, the research uses a single case study design, by using the Kingdom of Bahrain as a case study. Details pertaining to the reasons for selecting the Kingdom of Bahrain as the jurisdiction for the case study are explained in the following section.

5.3.2.1 The Kingdom of Bahrain as a Case Study

The Kingdom of Bahrain may arguably be considered a suitable Islamic financial centre to use as a case study. The Kingdom of Bahrain may be considered as one of the global leaders in Islamic finance, and according to the Central Bank of Bahrain is “host to the largest concentration of Islamic financial institutions in the Middle East” (CBB, 2012). The growth of the Islamic banking industry in the Kingdom of Bahrain may statistically be witnessed as its assets grew from USD 1.9 billion in 2000 to USD 24.9 billion in 2014 (CBB, 2015). This asset growth from the year 2000 to 2014 evidences a growth exceeding 1000%. The market share of the Islamic banking industry in the Kingdom of Bahrain has also increased from 1.8% of total banking assets in the year 2000, to 13.3% in August 2012 (CBB, 2012). Thus, these statistics signal a growth of the market share of the Islamic banking industry in the Kingdom of Bahrain. Furthermore, the Bahraini banking system as a whole (including conventional banking but excluding the Central Bank of Bahrain) as of 2014 had an aggregate total asset of USD 189.3 billion (CBB, 2015).

By 2012, Bahrain had seven takaful (Islamic insurance) and two re-takaful companies (CBB, 2012). Furthermore, the Kingdom of Bahrain has been on the forefront of the sukūk (commonly referred to as Islamic bonds) market, including leasing securities and short-term government sukūk (commonly referred to as Islamic bonds) (CBB, 2012). The Kingdom of Bahrain is home to multiple international organizations central to the development of Islamic finance (CBB, 2012), such as the Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI), International Islamic Financial Market (IIFM), International Islamic Rating Agency (IIRA), Liquidity Management Centre (LMC), Shariya Review Bureau, amongst others (CBB, 2012).
Furthermore, the regulator of the banking industry in the Kingdom of Bahrain is the Central Bank of Bahrain (CBB). The Central Bank of Bahrain has played a significant role in the country where it installed comprehensive prudential and reporting frameworks for the Islamic finance industry. The Central Bank of Bahrain rulebook for Islamic financial institutions (Volume II) covers areas such as licensing requirements, capital adequacy, risk management, business conduct, financial crime and disclosure/reporting requirements. Furthermore, evidence of the CBBs keenness for the development of the Islamic financial industry is the “Waqf Fund”33 which was established under the auspices of the CBB in partnership with the Islamic banking industry, playing a key role in the development of the Islamic and Shari’a industry (CBB, 2012a).

Lastly, as of July 2015, there were a total of 403 banks and financial institutions in the Kingdom (CBB, 2015a). This includes 79 conventional banks, 24 Islamic banks, 140 Insurance companies, 52 investment firms, 82 financial institutions with specialized licenses, and 26 capital market licenses. This indicates that the Bahraini market may be a huge and rapidly growing financial centre, with an arguably competitive role as an Islamic financial hub.

The abovementioned statistics helped guide this research to use the Kingdom of Bahrain as a case study.

5.4 Research Methods

The research methods are the tools used to gather, analyse, and interpret the obtained data, which is guided by the research methodology (Gray et al., 2007). Within the realm of using a qualitative methodology, the research uses various research methods that are explained in this section. In particular, this section explains two types of research methods, which are the research methods used for data collection, and the research methods used for empirical data analysis.

33 The waqf fund was established by the Central Bank of Bahrain to promote and help the Islamic banking industry through various activities.
5.4.1 Research Methods for Data Collection

Both primary and secondary data are collected for the research. The primary data collection tool is semi-structured interviews. As for the secondary data, this includes annual reports (which includes financial and Shari’a Supervisory Board annual reports), publicised regulatory data pertaining to special purpose vehicles in the Islamic banking industry, and a real-life executed special purpose vehicle structure obtained as a unit of analysis. The methods of using these data collection tools are explained below:

5.4.1.1 Primary Data: Semi-Structured Interviews

An interview involves a conversation between people where at least one person is a researcher (Gray, 2009). By engaging in conversations with Islamic banking stakeholders, the researcher will be able to obtain information that may not necessarily exist in literature. Since this data may offer important information, interviews arise as a data collection method that may be useful for the research. Furthermore, interviews may also be useful since it is more likely that individuals “may enjoy talking about their work rather than filling questionnaires” (Gray, 2009, p.370). Also, interviews allow the Islamic banking stakeholders to “reflect on events without having to commit themselves in writing, often because they feel the information may be confidential” (Gray, 2009, p.370).

Semi-structured interviews are usually used in qualitative research, where the interviews are not standardised (Gray 2009 and Dawson 2002). In a semi-structured interview, the researcher wants to obtain knowledge on specific information, which can be used in comparison and to contrast with information gained in other interviews (Dawson, 2002). Therefore, the researcher is required to ask the same questions to each interviewee (Dawson, 2002). Yet, the researcher should be able to remain flexible, due to the fact that significant information may arise during an interview (Dawson, 2002). To ensure continuity, the researcher produces an “interview schedule” (e.g. list of specific questions or topics) to organize the discussion (Dawson, 2002).
The chosen method for collecting primary data for this research is semi-structured interviews. The following list summarises the reasons for choosing interviews as a method for data collection:

• More realistic feedback was expected to be obtained through this type of interviews, since interviewees may be more open to talk about their work rather than filling in questionnaires (Gray, 2004).

• Semi-structured interviews may allow interviewees to reflect upon on events, and may consequently provide more descriptive answers, rather than solely committing themselves to writing (Gray, 2004).

• In line with the research methodology and as explained in section 5.3.1, most qualitative researches involve intense contact with a field or real life setting, where the role of the researcher is to gain a holistic overview of the study that includes the perception of participants (Gray 2009, Miles and Huberman 1994).

A. Interview Questions

During the review of literature for this research, a set of questions was raised in relation and in significance to the research topic. As such, the following list of set of questions were developed by the researcher that was asked to interviewees:

1. Do you (Islamic Bank) use SPVs in your transactions/investments?
2. Which of your (Islamic Bank) investments include SPVs in its structure? What is the percentage?
3. What is the reason for using SPVs in your transactions/structures? (legal, taxation, *Shari’a*, regulation, etc.?)
4. Do you believe that SPVs are essential in your work as a Bank?
   a. (If answer is Yes): Why?
      i. What are the reasons for their significance
   b. (If answer is No): Why not?

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34 Please refer to Appendix II (Conceptual Framework Summary Table) for more details and indications to understand how certain questions were being developed throughout the research.
i. Then why is it used in many structures and % of your investments?

5. Do (and which of) your SPV structures include conventional financing within them?
   a. (If yes: how do you reconcile this with Islamic finance?)

6. Where conventional financing exists within an SPV structure, what does the Conventional Bank obtain as a financial guarantee?

7. How do you treat SPVs from an accounting point of view?

8. What is the difference between your (Islamic bank) SPV practices and conventional banks?

9. Do you think that your (Bahraini Islamic Banks) SPV practices are similar to those of other countries, such as Malaysia and Dubai?

10. When is the Shari’a Supervisory Board (or SSB) exposed to a (SPV) structure or a transaction, and when do they approve/disapprove it.

11. Where an SSB has approved a mother-structure (i.e. SPV structure), can the bank use the same structure for other transactions without SSB approval?
   a. (If answer yes): Although the structure is the same, who reviews the different details for the transaction?
      i. (If it is the Shari’a auditor): How often does the Shari’a auditor review transactions? Does the Shari’a auditor review transactions on a case-by-case basis?
      ii. Where a structure being used is similar to what has been previously approved by the SSB, does the Shari’a auditor have the authority to approve/disapprove the structure after having looked at the details?
      iii. How often does a Shari’a auditor conduct a periodic audit on these investments or transactions?
      iv. What is the procedure of Shari’a auditing on such investments?
   b. (If answer is no): Does this mean the SSB reviews all transactions on a case by case basis, even though the bank will use a structure that has been previously approved by the SSB?

12. Do all transactions go through the Shari’a Compliance Department prior to execution?
   a. (If yes): Are all of the transactions circulated to the SSB?
b. (If no): How do you determine which transactions need to be submitted to the SCD prior to execution?

13. Since interest-bearing loans are largely the main prohibition in Islamic banking, how do the SSB justify the permissibility of SPV structures with conventional financing?

   a. (If answer is that SPV is a separate legal entity having nothing to do with the bank): Does that mean Islamic banks can deal freely with conventional financiers provided that it is done through SPVs?

      i. (If answer yes: then does Islamic banking differ from conventional banking by having SPVs in the middle?)

   b. (If answer is that SPVs are used for conventional facilities when these conventional facilities need to be used as a basis of necessity): Does that mean it is prohibited in Shari’a to deal with conventional financing through SPVs if there was no necessity?

      i. If yes: how do you determine necessity?

What is the specific SSB fatwa regarding the SPV structures for your investments?

14. “Following a round table discussion with the Waqf Fund involving several notable Shari’a scholars, it was observed that some SPVs associated with locally incorporated Islamic banks were not subject to Shari’a compliance review which has resulted in some SPVs to undertake activities that were not Shari’a compliant, or at least their activities had not been reviewed as Shari’a compliant.” CBB Circular EDBS/KH/238/2013

“The governance of special purpose vehicles (SPVs) in the Islamic banking industry has been occupying the minds of key stakeholders, it has emerged” (Gulf Daily News – March 2013)

   a. What do you think of the above circular and article?
   b. What do you think prompted the CBB to issue such a circular?
   c. What do you think of the proposed changes to the CBB Rulebook regarding SPVs for Islamic banks?
The application of the semi-structured interviews was designed by dividing it into three segments:

B. Interview Segments

The interview process involves three segments. The first segment was designed by interviewing five practitioners in the Islamic banking industry in the Kingdom of Bahrain. This included two Shari’a managers, two investment managers, and one risk manager. The five interviewees were asked the questions displayed in the previous section. This was in order to obtain knowledge on specific information that can be used in comparison and contrast to other interviewees, which is a subset of the semi-structured interviews (Dawson, 2002). The researcher then undertook a pilot study (Appendix I) in order to (1) test the questions (2) obtain an initial understanding of the industry’s feedback (3) to practice and enhance the interviewers interview skills. This preliminary analysis helped determine the empirical data analysis research method for the interview analysis, which as described later, is a thematic analysis. Having tested the interview questions in the first segment, the interviewer viewed the type of interview and questions to be informative, serving the research questions and obtaining data through interviewee responses. However, there were four questions that were removed as the result of the pilot study:

- Section (a) of question four, where it asks “why” the interviewer believes special purpose vehicles are essential (if the interviewer mentioned it as being essential in question four). This is because each time an interviewee responds to special purpose vehicles as being essential, question (4a) turned out to be a repetition of question three (what are the reasons for using special purpose vehicles). Therefore all five interviewee answers were “it is essential due to the reasons mentioned in my answer for question three”. This question (4a) was therefore considered a repetition and unneeded.

- Question six asks what would act as the financial guarantee for the conventional financier. All interviewees indicated that the asset being purchased as used as a collateral from the conventional financiers. This answer was viewed as being the same answer to all interviewees and an obvious phenomenon, and therefore not needed.
• The answer to question twelve was always answered along with question ten.
• Although paraphrased differently, question thirteen was removed because each time the fifth question was asked, the answer to question thirteen would be answered along with it. This researcher viewed question five sufficient to obtain the answer to question thirteen as well.

The pilot study also revealed that practitioners-interviewees view recorded interviews as being a sensitive issue, since an accidental leak of the voice recordings may place them in unwanted situations and similar to Gray (2009) statements regarding confidentiality preferences of interviewees. A practical test was also conducted when two practitioner-interviewees\textsuperscript{35} agreed for their interviews to be recorded to test possible interview outcomes. The results revealed that interviewees in recorded interviews were very formal and guarded each word being uttered, which limited the information given by the interviewees, as opposed to openness and transparency in unrecorded interviews. Furthermore, without recording and with note taking, the interviewees felt free in expressing themselves openly. This approach was viewed as being more suitable for the research as it was imperative to obtain unlimited informative information to the extent possible, for the empirical data analysis.

The second segment of interviews involved interviewing thirty interviewees, who were largely practitioners in the Islamic banking industry in the Kingdom of Bahrain\textsuperscript{36}. Lastly, the third segment of interviews consists of nine elite interviewees, which mainly includes chief executive officers and Shari’a Supervisory Board members. The Shari’a Supervisory Board member interviewees largely consist of highly experienced Shari’a (Islamic law) scholars who serve on numerous Shari’a Supervisory Boards globally.

The following table summarises the interviews conducted that includes the dates and durations of the interviews, as well as the positions of interviewees:

\textsuperscript{35} Practitioner-interviewees does not include Shari’a Supervisory Board members, where four Shari’a Supervisory Board members agreed for the interviews to be recorded without limitations

\textsuperscript{36} Segment II of the interview process also includes two board members and two Shari’a Supervisory Board members of Islamic banks.
## Interview List

<table>
<thead>
<tr>
<th>Interviewee No.</th>
<th>Interview Date</th>
<th>Position as of the Interview Date</th>
<th>Interview Duration (Minutes)</th>
</tr>
</thead>
<tbody>
<tr>
<td>001</td>
<td>Aug. 2. 2015</td>
<td>Shari'a Manager</td>
<td>70</td>
</tr>
<tr>
<td>002</td>
<td>Aug. 3. 2015</td>
<td>Director, Private Equity</td>
<td>70</td>
</tr>
<tr>
<td>003</td>
<td>Aug. 3. 2015</td>
<td>Ex-Acting Risk Manager</td>
<td>115</td>
</tr>
<tr>
<td>004</td>
<td>Aug. 4. 2015</td>
<td>Ex-Chief Investment Officer</td>
<td>55</td>
</tr>
<tr>
<td>005</td>
<td>Aug. 4. 2015</td>
<td>Head of Shari'a &amp; SSB Member</td>
<td>60</td>
</tr>
<tr>
<td>006</td>
<td>Aug. 4. 2015</td>
<td>Head of Shari'a</td>
<td>65</td>
</tr>
<tr>
<td>007</td>
<td>Aug. 5. 2015</td>
<td>Director, Compliance Officer</td>
<td>105</td>
</tr>
<tr>
<td>008</td>
<td>Aug. 5. 2015</td>
<td>Shari'a Reviewer</td>
<td>30</td>
</tr>
<tr>
<td>009</td>
<td>Aug. 5. 2015</td>
<td>Head, Compliance &amp; AML</td>
<td>45</td>
</tr>
<tr>
<td>010</td>
<td>Aug. 5. 2015</td>
<td>Head of Shari'a</td>
<td>45</td>
</tr>
<tr>
<td>011</td>
<td>Aug. 9. 2015</td>
<td>Group Head of Shari'a</td>
<td>60</td>
</tr>
<tr>
<td>012</td>
<td>Aug. 9. 2015</td>
<td>Head of Shari'a &amp; SSB Member</td>
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<tr>
<td>013</td>
<td>Aug. 10. 2015</td>
<td>Head of Compliance</td>
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<td>014</td>
<td>Aug. 10. 2015</td>
<td>Head of Shari'a</td>
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<tr>
<td>015</td>
<td>Aug. 12. 2015</td>
<td>Shari'a Scholar</td>
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<tr>
<td>016</td>
<td>Aug. 13. 2015</td>
<td>Shari'a Scholar</td>
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<tr>
<td>017</td>
<td>Aug. 13. 2015</td>
<td>Head of Islamic Finance</td>
<td>70</td>
</tr>
<tr>
<td>018</td>
<td>Aug. 16. 2015</td>
<td>Director, Investment RM</td>
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<tr>
<td>019</td>
<td>Aug. 16. 2015</td>
<td>Financial Management</td>
<td>60</td>
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<td>020</td>
<td>Aug. 16. 2015</td>
<td>Global Head, Financial Management</td>
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<td>Aug. 17. 2015</td>
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<td>Aug. 18. 2015</td>
<td>Head of Investment Management</td>
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<td>023</td>
<td>Aug. 18. 2015</td>
<td>Secretary General</td>
<td>40</td>
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<tr>
<td>024</td>
<td>Aug. 22. 2015</td>
<td>Shari'a Manager</td>
<td>35</td>
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<tr>
<td>025</td>
<td>Aug. 24. 2015</td>
<td>Board Member</td>
<td>90</td>
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<tr>
<td>026</td>
<td>Aug. 25. 2015</td>
<td>Chief Investment Officer</td>
<td>60</td>
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<tr>
<td>027</td>
<td>Aug. 26. 2015</td>
<td>Investment Officer</td>
<td>95</td>
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</table>
### Segment III Interview List

<table>
<thead>
<tr>
<th>No.</th>
<th>Interview Date</th>
<th>Position</th>
<th>Duration</th>
</tr>
</thead>
<tbody>
<tr>
<td>028</td>
<td>Aug. 27. 2015</td>
<td>Investment Manager</td>
<td>45</td>
</tr>
<tr>
<td>029</td>
<td>Aug. 27. 2015</td>
<td>Executive Director</td>
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</tr>
<tr>
<td>030</td>
<td>Aug. 30. 2015</td>
<td>Head of Investment Administration</td>
<td>60</td>
</tr>
<tr>
<td>031</td>
<td>Sep. 1. 2015</td>
<td>Vice Chairman</td>
<td>75</td>
</tr>
<tr>
<td>032</td>
<td>Sep. 2. 2015</td>
<td>Head of Islamic Finance School</td>
<td>120</td>
</tr>
<tr>
<td>033</td>
<td>Sep. 13. 2015</td>
<td>Lawyer and Professor</td>
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<tr>
<td>034</td>
<td>Sep. 16. 2015</td>
<td>Head of Islamic Finance</td>
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<tr>
<td>035</td>
<td>Nov. 23. 2015</td>
<td>Lawyer</td>
<td>55</td>
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<tr>
<td>036</td>
<td>Feb. 27. 2016</td>
<td>Shari'a Scholar</td>
<td>70</td>
</tr>
<tr>
<td>037</td>
<td>Mar. 9. 2016</td>
<td>Chief Executive Officer</td>
<td>60</td>
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<tr>
<td>038</td>
<td>March 10. 2016</td>
<td>Shari’a Scholar</td>
<td>120</td>
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<td>042</td>
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### Table 2 List of Interviewees

#### C. Interview Durations

Table No. 2 demonstrates the duration for each interview conducted. The table reveals that the total duration of interviews conducted in the interview process amounted to 2791 minutes, which is around forty-seven hours. Therefore, the average duration per interview is equivalent to 63.6 minutes.
D. Interview Coverage: By Departments

The below table presents the percentage of interviewees relative to their respective departments for Segments I and II:

<table>
<thead>
<tr>
<th>Department</th>
<th>Total</th>
<th>Percentage (Rounded)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Internal Shari’a Review</td>
<td>9</td>
<td>26%</td>
</tr>
<tr>
<td>Investment</td>
<td>8</td>
<td>23%</td>
</tr>
<tr>
<td>Compliance and Regulator</td>
<td>5</td>
<td>14%</td>
</tr>
<tr>
<td>Board of Directors and Shari’a Board Members</td>
<td>4</td>
<td>11%</td>
</tr>
<tr>
<td>Risk and Financial Management</td>
<td>3</td>
<td>9%</td>
</tr>
<tr>
<td>Legal</td>
<td>3</td>
<td>9%</td>
</tr>
<tr>
<td>Others</td>
<td>3</td>
<td>9%</td>
</tr>
<tr>
<td>Total</td>
<td>35</td>
<td>100%</td>
</tr>
</tbody>
</table>

Table 3 Segment II Interview Coverage: By Departments
As illustrated above, the internal Shari’a and investment departments represent the majority coverage relative to other departments. Collectively, they cover 49% of the department coverage of the Islamic banking industry. This is mainly due to the fact that the investment managers are the investment decision-making body, while the internal Shari’a review department is responsible for ensuring Shari’a compliance internally. Therefore, these two functions were considered crucial departments due to the research area. The remaining 51% collectively include departments that also play key roles in structuring or regulating special purpose vehicle transactions in their respective banks.

Furthermore, the interview process in Segment II largely included interviewing several practitioners for each bank. This was in order to verify consistencies of knowledge, adherence to process, policy and procedures, practice, and whether differences of understandings and opinions existed between practitioners within a single Islamic bank, which may affect the behaviour of special purpose vehicle practices.
E. Interview Coverage: By Islamic Banking Sector

The interviewees selected represented ten Islamic banks in the Kingdom of Bahrain. This includes six Islamic investment (wholesale) banks and four Islamic retail banks. Due to the analysis of interview responses, it may be important to classify the four Islamic retail banks as follows:

- **Islamic Retail Bank One**: Is heavily involved in international Islamic investment activities.
- **Islamic Retail Bank Two**: Is heavily involved in local (Bahraini market) Islamic investment activities.
- **Islamic Retail Bank Three**: Was formerly a conventional investment bank that converted into an Islamic retail bank.
- **Islamic Retail Bank Four**: Does not engage in investment activities. Rather, it was established and remains to offer solely Islamic banking retail services.

Thus, these ten Islamic banks represent around 42% of the Islamic banking industry in the Kingdom of Bahrain, since the total Islamic banks in the Kingdom of Bahrain are twenty-four banks (CBB, 2015a).

![Interview Coverage of the Islamic Banking Industry in the Kingdom of Bahrain](image)

*Figure 18 Interview Coverage: By Islamic Banking Sector*
Since the Kingdom of Bahrain has one regulator for its banking (including Islamic banking) industry, which is the Central Bank of Bahrain (CBB), it was included to understand the regulatory perspective regarding special purpose vehicle practices in the Islamic banking industry. Also, two Islamic infrastructure organizations were included: (1) the Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI), and (2) the International Islamic Financial Market (IIFM), due to their significance and contribution to the industry. Interviewees also included individuals who represent three law firms, two of which are international law firms that deal with Islamic special purpose vehicle transactions on a continual basis.

In order to diversify the sample, the researcher included one conventional wholesale bank in the Kingdom of Bahrain, one Islamic bank in a GCC\(^{37}\) country outside of the Kingdom of Bahrain, and two independent financial experts, all of which who are included under “others” in the below table. The below table displays the sectors represented in the interview process of Segment I and II:

<table>
<thead>
<tr>
<th>Sector</th>
<th>Total</th>
<th>Percentage (Rounded)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Islamic Investment Banks</td>
<td>6</td>
<td>27%</td>
</tr>
<tr>
<td>Islamic Retail Banks</td>
<td>4</td>
<td>18%</td>
</tr>
<tr>
<td>Regulator</td>
<td>1</td>
<td>5%</td>
</tr>
<tr>
<td>Islamic Infrastructure Organizations</td>
<td>2</td>
<td>9%</td>
</tr>
<tr>
<td>Law Firms</td>
<td>3</td>
<td>14%</td>
</tr>
<tr>
<td>Education</td>
<td>1</td>
<td>5%</td>
</tr>
<tr>
<td>Others</td>
<td>5</td>
<td>23%</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td>22</td>
<td><strong>100%</strong></td>
</tr>
</tbody>
</table>

Table 4 Interviewee Sectors: Percentage

The pie graph below illustrates the percentage of sectors engaged in the interview process of Segment II:

---

\(^{37}\) Gulf Cooperation Council
It was previously explained that the third segment of the interview process consisted of nine interviewees. Although the second segment of interviews largely consisted of practitioner-interviewees, footnote 36 mentioned that two Shari’a scholars and two board members of Islamic banks were also included in Segment II. In addition to the nine elite interviewees interviewed in Segment III, this leads to a total of thirteen elite interviewees that were included in the research. Collectively, the elite interviewees consist of two board members, two chief executive officers, and nine Shari’a Supervisory Board members, as illustrated below:
Secondary Data

Secondary data refers to information or data that was collected by a party other than the researcher or user (Schutt, 2006). As explained earlier, the research uses secondary data to analyse the Islamic banking industry practice towards special purpose vehicles. This mainly includes annual reports (which includes financial statements and Shari’a Supervisory Board annual reports); regulatory consultations relating to Islamic banking special purpose vehicle transactions, and a real-life Islamic banking executed special purpose vehicle Islamic transaction structure.

A. Annual Reports

The annual reports of Islamic banks include the financial and Shari’a Supervisory Board annual reports. The researcher uses annual reports to investigate how many Islamic banks use special purpose vehicles. On the other hand, the financial statements are mainly used to identify which transactions or industry includes the usage of special purpose vehicles by an Islamic bank.
Although Shari’ā (Islamic law) audit points are usually mentioned in internal Shari’ā audit reports that are confidential, rather than a publicised Shari’ā Supervisory Board annual report, major Shari’ā (Islamic law) violations may be reported by Shari’ā Supervisory Board members in their Shari’ā Supervisory Board annual report. This is in order for the Shari’ā Supervisory Board to enable transparency to be practiced by the Islamic bank with its shareholders. Therefore, the researcher examines if any Shari’ā Supervisory Board annual reports specifically includes special purpose vehicle practices or violations that may be analysed.

B. Regulatory Consultation(s) relating to Special Purpose Vehicles

Prior to amending the regulatory rulebook by the Central Bank of Bahrain, the regulator first consults with Islamic banks by circulating newly proposed changes along with an introductory letter. Thereafter, the Islamic banking industry responds to the circular by providing their feedback regarding the proposed changes by the regulator. Finalised regulatory consultations with Islamic banks usually include a reference to the draft directive, comments by the Islamic banking industry, and the response of the Central Bank of Bahrain to industry comments. The research uses regulatory consultations pertaining to special purpose vehicles in the Islamic banking industry, since it may provide evidence relating to the behaviour of the regulator towards special purpose vehicles, in addition to the official opinions of the Islamic banking industry.

The second regulatory consultation in which the rhetoric are analysed relates to the protection of control functions at Islamic banks. This is because without regulatory protection, the internal Shari’ā and other control functions may not perform effectively, which may lead to Islamic banks having additional abilities to abuse special purpose vehicle transactions.

C. Executed Special Purpose Vehicle Transaction Structure as a Unit of Analysis

The interview process revealed the most common structure used for Islamic special purpose vehicle transactions. Thus, the researcher obtained a similar real-life contemporary special purpose vehicle structure transacted by an Islamic bank in the
Kingdom of Bahrain to use for the research. This type of secondary data was collected for analysis as a specific case study as a unit of analysis (Yin, 2003). As explained previously, according to Gray (2009) and Flick (2006), there are mainly four types of case study designs, which are:

1. Type 1: Single Case Study, Holistic
2. Type 2: Single Case, Embedded
3. Type 3: Multiple Case, Holistic
4. Type 4: Multiple Case, Embedded

The idea behind choosing a case study design is to understand a special purpose vehicle structure, in a jurisdiction where Islamic banking arguably plays an imperative global role. Chapter one revealed that the Bahraini (and perhaps other) Islamic banking industry includes Islamic banks that indirectly obtain conventional loans through the use of special purpose vehicles. Yin (2003) explains that a case study design should be considered when a research focuses on answering “why” and “how” questions. Moreover, chapter one explains that the research partially aims to answer why, and how, Islamic banks engage in interest-based transactions, if the main principal underlying the philosophy of Islamic banking is a strict and unanimous prohibition of *riba* (commonly referred to as usury or interest). Therefore, in line with the research aims and objectives, the research uses a special purpose vehicle structure as a unit of analysis, which includes conventional financings. This would help the research investigate and analyse the concept underlying these practices. The research obtained one unit of analysis to holistically analyse, because chapter one revealed that some Islamic banks engage in similar practices. Therefore, an all-inclusive or holistic view may enable the analysis to focus on the core research questions rather than a divided attention for a comparative or multiple units of analysis. The primary data collection through interviews may reveal how many Islamic banks engage in similar transaction structures. The case study design adopted by this research is illustrated below:
5.4.2 Research Methods for Empirical Data Analysis

5.4.2.1 Primary Data Analysis Tool: Thematic Analysis

The first empirical chapter uses a thematic analysis to analyse the interview responses. The thematic analysis approach may have originated in the 1960s by the recognition of Gerald Holton (Holton, 2000). It involves a categorization strategy for qualitative data (Boyatzis, 1998). Thematic analysis as a technique may be used in a wide range of research methodologies; it tends to be particularly used in research with an interpretivist approach (Thematic Analysis, 2011). “Thematic analysis is the process of looking over data in order to identify recurrent, salient and self-evident points, issues, words, terms, events, language, discourse, images, allusions and so on and so forth. These noticeably repetitive pieces of data can be clustered together under a label (that may also emerge from the respondent data or be allocated by the researcher) for the theme” (Thematic Analysis, 2011).
A thematic analysis involves the researcher reviewing the data, making notes, and sorting them into categories (Boyatzis, 1998). This is the strategy the research uses to analyse interview responses. The researcher, initially through the pilot study, analysed the responses obtained from interviewees by reviewing the data several times. Similar language, terms, points, and ideas existed between different interviewees depending on the question. As such, each question or set of questions was/were placed under one theme where a thematic analysis was chosen as the empirical data analysis tool for the primary data.

The generated themes was a result of the pilot study conducted after the first segment of interviews, displayed below:

<table>
<thead>
<tr>
<th>Theme</th>
<th>Derived from Answers for Interview Question No.</th>
</tr>
</thead>
<tbody>
<tr>
<td>1. Special Purpose Vehicle Market Share</td>
<td>One and Two</td>
</tr>
<tr>
<td>2. Reasons for Using Special Purpose Vehicles</td>
<td>Three</td>
</tr>
<tr>
<td>3. Special Purpose Vehicles and Conventional Financings</td>
<td>Five</td>
</tr>
<tr>
<td>4. Accounting of Special Purpose Vehicles</td>
<td>Seven</td>
</tr>
<tr>
<td>5. Difference between Islamic and Conventional banks Practices towards Special Purpose Vehicles</td>
<td>Eight</td>
</tr>
<tr>
<td>6. Difference between Special Purpose Vehicle Practice in the Kingdom of Bahrain relative to the International Islamic Banking Industry</td>
<td>Nine</td>
</tr>
<tr>
<td>7. Shari’a Approval Structure</td>
<td>Ten</td>
</tr>
<tr>
<td>8. Non-existence of a Shari’a approved Islamic Special Purpose Vehicle “Mother-Structure”</td>
<td>Eleven</td>
</tr>
<tr>
<td>9. Industry Feedback Relating to Regulatory Circular regarding Shari’a Compliance and Special Purpose Vehicle Transactions</td>
<td>Fourteen</td>
</tr>
</tbody>
</table>

Table 5 Linking developed themes with interview questions

Note: As explained earlier, the interview questions four, six, twelve, and thirteen are not included in the above table because it was removed after the pilot study.
5.4.2.2 Secondary Data Analysis Tool: Qualitative Content Analysis

According to Titscher et. al (2000), content analysis is considered the longest method of text analysis, relative to the other empirical methods of social investigation (Kohlbacher, 2006). Titscher et. al (2000) mentions that the term content analysis originally referred to methods that concentrated on direct quantifiable aspects of text content, “and as a rule on absolute and relative frequencies of words per text or surface unit” (Kohlbacher, 2006 and Titscher et al., 2000, p.55) Babbie (2001) defines content analysis as the study of recorded human communications, which is a coding operation that acts as the process of transferring raw data into a standardised form (Kohlbacher, 2006). Classical content analysis includes techniques for reducing texts to a “unit by variable” matrix, thereafter analyse that matrix quantitatively to test a hypothesis (Kohlbacher 2006, and Ryan & Bernard 2000).

Content analysis, which was initially solely quantitative, was criticised as a research tool from various perspectives (Kohlbacher, 2006). For example, Ritsert (1972) criticised (quantitative) content analysis when he stated that the context regarding the components of the text, distinctive individual cases, and the things that do not appear in a text, are all not taken into account in a quantitative content analysis. As a result, the qualitative content analysis has been developed to try and overcome the shortcomings of a classical quantitative content analysis (Kohlbacher, 2006). According to Titscher et al. (2000), one of the most popular developed qualitative content analysis includes an approach taken by Marying (2002). Marying (2002) qualitative content analysis applies a “systematic, theory guided approach to text analysis using a category system” (Kohlbacher, 2006). A qualitative content analysis may be similar to a thematic analysis in the sense where both research tools involve a categorization strategy. Bryman (2004) defines a qualitative content analysis as being:

“An approach to documents that emphasizes the role of the investigator in the construction of the meaning of and in texts. There is an emphasis on allowing categories to emerge out of data and on recognizing the significance for understanding the meaning of the context in which an item being analyzed (and the categories derived from it) appeared” (Bryman, 2004, p.542).
This research uses a qualitative content analysis by qualitatively analysing the secondary data. In line with the Bryman (2004) definition of qualitative content analysis, categories emerged out of the data during the review of secondary data. The categorization strategy involves analysing special purpose vehicle usage or market share through the annual and financial reports. On the other hand, the Shari’a Supervisory Board annual report enabled the emergence of a category relating to analysing the behaviour of Shari’a Supervisory Boards towards special purpose vehicle abuse, especially in terms of reporting. Two categories emerged out of analysing the regulatory consultations regarding special purpose vehicles and Shari’a compliance, the first being analysing the regulatory behaviour towards special purpose vehicle abuse, and the second being the reaction of the Islamic banking industry regarding the proposal in the regulatory consultation. The regulatory behaviour towards protecting control functions at Islamic banks emerged as a result of a second regulatory consultation. As for the special purpose vehicle structure transaction obtained as a case study (unit of analysis), the main category is to determine whether the structure is Shari’a compliant or not. The below table summarises the categories that emerged by analysing the secondary data:

<table>
<thead>
<tr>
<th>Secondary Data</th>
<th>Emergent Category</th>
</tr>
</thead>
<tbody>
<tr>
<td>Annual Reports</td>
<td>SPV usage in the Islamic banking industry</td>
</tr>
<tr>
<td>• Financial Report</td>
<td>• Same as above</td>
</tr>
<tr>
<td>• <em>Shari’a</em> Supervisory Board Report</td>
<td>• Behaviour of <em>Shari’a</em> Supervisory Board towards SPV abuse</td>
</tr>
<tr>
<td>Regulatory Consultations regarding:</td>
<td>Regulatory behaviour towards SPV abuse</td>
</tr>
<tr>
<td>• SPV and Shari’a Compliance</td>
<td>• Industry reaction towards new SPV regulatory proposals</td>
</tr>
<tr>
<td>• Protecting Control Functions</td>
<td>• Regulator action to protect control functions at Islamic banks</td>
</tr>
<tr>
<td>Real-life executed SPV Transaction Structure</td>
<td>Is the structure <em>Shari’a</em> compliant?</td>
</tr>
</tbody>
</table>

Table 6 Categories Emerged from Content Analysis

The details pertaining to the analysis of the real-life executed special purpose vehicle transaction is explained in the following section.
5.4.3   Criterion for Shari’a Compliant Special Purpose Vehicle Transactions

Prior to using content analysis as a tool to the first two categories of secondary data (annual reports and regulatory consultations), a content analysis summary table was constructed (Appendix IV) to determine the Shari’a (Islamic law) ruling of selected subject matters in a special purpose vehicle structure. The subject matters selected were dependent on the review of literature chapters, conceptual framework (Appendix II), and a summary content analysis table specifically relating to the Shari’a compliance of selected special purpose vehicle subject matters (Appendix IV). This analysis was conducted in order to help understand and analyse a real-life executed special purpose vehicle structure, and to understand possible Shari’a (Islamic law) rulings for each product, industry, type of financing, or other subject matters in a special purpose vehicle structure.

Furthermore, this initial content analysis\(^{39}\) helped to create the following standards, displayed as test questions, which may be used to generally and indicatively analyse the overall Shari’a compliance of a special purpose vehicle structure. The following qualitative test questions are used to analyse the third category of secondary data, which is the real-life executed special purpose vehicle structure transaction:

I.  Test Question One: Is the business the Islamic bank is investing in Shari’a compliant?

This encompasses the ultimate industrial business or service the bank is investing in. For example, the aircraft, shipping, telecommunications, or information technology (IT) industries are generally Shari’a compliant\(^{40}\). On the other hand, gambling and alcoholic beverage industries are prohibited under Shari’a (Islamic law). This question is not about whether the special purpose vehicle in the investment structure obtains conventional loans or engages in prohibited activities.

\(^{39}\) A content analysis summary is displayed in Appendix IV

\(^{40}\) Subject to meeting certain conditions (e.g. ratios relating to existing conventional debts of the company)
II. Test Question Two: Is there a Special Purpose Vehicle in the structure that will engage in non-Shari’a compliant activities or transactions?

This involves the special purpose vehicle(s) in an investment structure, whether directly owned by an Islamic bank or through other relationships. This is because a special purpose vehicle may not be directly owned by an Islamic bank but may still be included in the investment structure as a partner. The activity or this special purpose vehicle relating to the transaction needs to be known in order to understand the relationship between the Islamic bank and the special purpose vehicle.

III. Test Question Three: Does the Islamic Bank legally own the Special Purpose Vehicle that will engage in a conventional/non-Shari’a compliant transaction(s)?

This question determines whether the Islamic bank owns the special purpose vehicle(s) in an investment transaction or not. The legal ownership of a special purpose vehicle by an Islamic bank may place Shari’a (Islamic law) restrictions on the activities the special purpose vehicle may engage in. However, restrictions may differ depending on the percentage of ownership. For example, generally, the Islamic bank owning more than 50% would be the majority shareholder, with veto and / or voting powers. Another example would be if an Islamic bank owned 33% or less (≥ 33%), its power over the control of the special purpose vehicle is limited, and therefore the restrictions would differ (McMillen, 2013).

IV. Test Question Four: Does the Islamic bank have any sort of control, whether direct or indirect, through proxies for example, on non-Shari’a compliant separately owned the Special Purpose Vehicle?

The answer to this question may determine whether the Islamic bank influences a special purpose vehicle owned by an external party or not. Islamic banks may not legally own special purpose vehicles but simultaneously have control or influence over the special purpose vehicles.
V. Test Question Five: Is there evidence for hiyal (legal stratagems) taken place by an Islamic bank after executing the special purpose vehicle structure or transaction?

The answer to this question may determine whether an Islamic bank took advantage of the use of special purpose vehicles as separate legal entities by abusing them to engage in non-Shari’a compliant activities or transactions.

Answering the above questions may generally help in analysing whether a special purpose vehicle transaction is Shari’a compliant or not. These qualitative test questions are applied in chapter seven to a contemporary special purpose vehicle structure transacted by an Islamic bank in the Kingdom of Bahrain as a case study to partially conduct the empirical data analysis.

5.5 Conclusion

The philosophical research assumptions held by the researcher relate to ideas derived from constructivism and critical theory. The research methodology adopts a qualitative methodology. The research further uses a case study methodology, by using the Kingdom of Bahrain as a case study. The research methods for data collection relating to primary data are semi-structured interviews. Data collection for secondary data includes (1) annual reports of Islamic banks (which includes financial and Shari’a Supervisory Board annual reports), (2) publicised regulatory consultations with the Islamic banking industry relating to special purpose vehicles, and (3) a real-life executed special purpose vehicles structure transaction by an Islamic bank. For empirical data analysis, the research uses a thematic analysis for the primary data (interviews), and a content analysis for the secondary data.

The limitations to the research methodology chosen were considered during the course of the research. For example, qualitative research is considered as less valid than a quantitative research (Gray, 2009). On the other hand, one of the criticisms relating to case studies is that it tends to focus on collecting information that is up to date and therefore, may involve using solely contemporary documentation with direct
observation and/or systematic interviewing (Gray, 2009). Yin (2003) also claims that a case study approach is not universally accepted nor is considered as reliable by researchers. One of the reasons Gray (2009) mentions regarding this lack of reliability is that it is difficult to generalise from a single case study. Furthermore, it may be argued that using a “single/embedded” case study design may be more useful than a “single/holistic” case study design.

However, limitations and criticisms may exist for almost all methodologies and/or methods. For example, a criticism of the quantitative methodology is that it can involve either none or little interaction with people or field settings (Gray, 2009). It was however important to particularly display the methodological limitations pertaining to this research in order to apprehend possible limitations that may have been placed upon this study.
6. Chapter Six: Perspective of Practitioners regarding Special Purpose Vehicles

The below figure highlights the position of chapter six in light of the research outline:

![Chapter Six Position (Author’s Diagram)](image_url)

**Figure 22 Chapter Six Position (Author’s Diagram)**
6.1 Introduction

This chapter analyses the perception of Islamic banking practitioners towards special purpose vehicles in the Islamic banking industry, using the Kingdom of Bahrain as a case study. The analysis includes analysing primary data by qualitatively analysing the interviewee responses using a thematic analysis. The interviews were divided into three segments, the first being five interviewees, the second thirty interviewees, and the third nine interviewees. Therefore, the total number of interviewees was forty-four.

The thematic analysis involves placing each interview question, or set of questions, under a theme that is used for analysis (Boyatzis, 1998). As explained in the research methodology chapter, the selected themes and which questions represent such themes have been determined as a result of the pilot study (Appendix I).

6.2 Industry Feedback of Islamic Banking Industry in the Kingdom of Bahrain

This section analyses the interviewee responses in the first and second segment of interviews using a thematic analysis, which includes responses from thirty-five interviewees.

6.2.1 Special Purpose Vehicle Market Share

Out of thirty-five interviews, thirty-two interviewees indicated that their respective banks use special purpose vehicles in their investment structures and transactions. The question did not apply to the remaining three interviewees because:

- One of the interviewees represented a fully-fledged Islamic retail bank (referred to in the research methodology chapter as “Islamic Bank Four”) that does not engage in investment transactions. However, this interviewee indicated that the bank once established a special purpose vehicle in order to distribute shares as bonuses, due to newly introduced regulatory requirements.
- The second interviewee, whom although works in an Islamic retail bank that was previously a conventional investment bank (that engaged in special purpose vehicle transactions), indicated that he/she joined the respective bank
after the conversion of this bank (Islamic Bank three) from a conventional investment bank to a fully-fledged Islamic retail bank. This question therefore did not apply to this interviewee.

- The third interviewee this question did not apply to is because the interviewee represented an Islamic infrastructure organization that did not engage in investment transactions.

The above indicates that Islamic investment banks - or Islamic retail banks engaging in investment transactions - all use special purpose vehicles as a part of their investment operations and/or transactions. Islamic retail banks solely engaged in retail activities generally do not use special purpose vehicles. Thus, it may be safely claimed that the majority of Islamic banks that engage in investment transactions use special purpose vehicles. Below is a bar graph that illustrates the interviewee answers:

![Special Purpose Vehicle Usage in the Islamic Banking Industry](image)

*Figure 23 SPV Usage in the Islamic Banking Industry*

Having established that the majority of Islamic banks engaged in investment transactions use special purpose vehicles, it was imperative to understand how often (or which of the transactions) Islamic banks use special purpose vehicles. Twenty-eight interviewees indicated that special purpose vehicles are used in 90% - 100% of their investment transactions. The remaining seven interviewees are as follows:
The question was not applicable to four interviewees, because they either represented an Islamic infrastructure organization or an Islamic retail bank that does not engage in investment transactions.

One interviewee divided the answer into two sections over the past decade. From 2005 – 2010, the Islamic investment bank used special purpose vehicles in 100% of their transactions. However, from 2010 – 2015, special purpose vehicles were used solely in around 50% of investment transactions executed by the bank. The interviewee explained that this decrease in the usage of special purpose vehicles was due to many factors, including: (1) business decreased post the global financial crises, (2) taxation either decreased or was removed in many jurisdictions which did not require the creation of special purpose vehicles, (3) regulatory rules were altered in a way that the reasons for Islamic banks to establish special purpose vehicles was not as significant, (4) a substitute now exists (i.e. project companies - which are similar to special purpose vehicles, however have real offices and employees).

One interviewee indicated that special purpose vehicles are used in less than 50% of the banks investments. This is due to the fact that the bank this interviewee represents was a conventional investment bank that converted into an Islamic retail bank. This conversion from an investment to a fully-fledged retail bank eradicated the use of special purpose vehicles and decreased existing special purpose vehicles by selling existing investments.

One interviewee who represents an Islamic retail bank that is heavily engaged in investment activities in the local (Bahraini) market, explained that special purpose vehicles are used in around 10-15% of the banks investments. This is because most investments were local investments, while special purpose vehicles are needed when investments were made internationally.

The below bar graph illustrates the above answers:
As the question applied to thirty-one interviewees, while twenty-eight interviewees indicated that special purpose vehicles are used in 90% - 100% of their investment transactions, this indicates 90.3%\(^{41}\) of these Islamic banks use special purpose vehicles in the majority (around 90% - 100%) of their investment transactions.

The exceptions for an Islamic bank not using special purpose vehicles are either Islamic retail banks that do not engage in investment transactions, or an Islamic bank that does not engage in international investments (solely local). There are no international investment transactions that do not use special purpose vehicles in its structure. This may suggest that special purpose vehicles may be deemed as an essential tool for Islamic investment structures, and that the practice of establishing special purpose vehicles is spread throughout the industry. The below bar graph combines both figures numbers twenty-three and twenty-four:

---

\(^{41}\) \[\frac{28}{31} = 0.903 \times 100 = 90.3\%\]
“Without a doubt, SPVs are used in 100% of Islamic [international] investment transactions… Why don’t you check [Islamic bank name]? The judge\textsuperscript{42} recently ruled in favor of [Islamic bank name] by drawing all the banks investment structures in front of him, he realised these transactions were all fiduciary-based, and found some 20,000 to 22,000 SPVs within one Islamic bank!”

– Shari’a Scholar

The Islamic bank referred to in the above quotation has its full documentation publicised, because it filed for Chapter Eleven bankruptcy in the United States of America and as a result, was obliged to publicise all its documentation. In relation to special purpose vehicles, this revealed that this one Islamic bank had established more than 20,000 special purpose vehicles. This may further indicate that the establishment of special purpose vehicles may be widely spread as a practice in the Islamic banking investment industry. The interview process revealed that the establishment of special purpose vehicles was almost necessary each time an international investment was being structured. In this regard, an interviewee simply mentioned:

“An SPV is merely a tool [used in investment transactions]…” – Board Member

\textsuperscript{42} The interviewee is referring to a judge ruling in favor of a bank who filed for Chapter 11 (Bankruptcy) in the United States of America. Although this is public data, the name of the bank was removed for anonymity purposes.
6.2.2 Reasons for Using Special Purpose Vehicles

A thematic analysis has been conducted for this section on its own. This is because the reasons for using special purpose vehicles varied in which the researcher viewed the requirement of categorizing the diverse reasons to use for analysis. The thematic analysis narrows down answers delivered by the thirty-five interviewees (Segment I and II) for the third interview question: “What is the reason for using special purpose vehicles in your transactions/structures?” into specific themes. This is also because many of the reasons mentioned by the interviewees were similar to those of others, and analysing patterns on interviewees answers to generic reasons may be imperative to understand (Thematic Analysis, 2011). The themes for the main reasons why special purpose vehicles are created are:

Main Reasons why Islamic Banks use Special Purpose Vehicles
(According to Interviewee Responses)

- Shareholding Structure
- Limiting Liability and Creating Bankruptcy Remote Structures
- Taxation
- Regulatory and Compliance
- Legal
- Shari'a Compliance
- Confidentiality
- Sukuk (Islamic Securities) and Syndication

As explained, the above themes have been created as a result of the answers obtained from the interviewees for the third question. The below explains the reasons for
Islamic banks using special purpose vehicles according to the interviewees with a constructivist or interpretivist approach, but also slightly shows a quantitative aspect in relation to interviewees answers or repetitions. This is not to switch the initial constructivist paradigm to a positivist paradigm. “A common error in … qualitative research is switching from a critical or constructivist paradigm back to a materialistic, positivist paradigm part of the way through the research process, most often at the interpretive moment” (Crabtree and Miller, 1999, p.132). Rather, it is in order to be able to display interviewee answers through diagrammatic figures for the reader to identify possible patterns (for example, taxation as a reason for using special purpose vehicles was mentioned by the highest number of interviewees).

6.2.2.1 Shareholding Structure

Islamic investment banks may be required to allocate voting and other decision-making powers to certain investors, such as placing them as members of the Board of Directors. The Islamic investment bank do not want to take the risk of placing investors of one investment, on the board of directors of the bank as a whole with board power. Therefore, the Islamic bank creates a separate legal entity (special purpose vehicle) structured in a pre-agreed manner in terms of Board representation, distribution of control of power and decision making (veto) for that specific investment. Twelve out of thirty-five interviewees mentioned this reason.

“… How can I allow outside investors become partners in my bank as a whole when they’re investing in one investment? That’s a huge risk. Imagine them (outside investors) having equal shareholding or voting rights in the bank as a whole? … [Rather,] we create a separate entity, [and] then all of us become partners in that entity … and then we control [allocation of investment] return, [the] investment process, [etc.]” – Investment Manager

The above quote indicates that investment managers establish special purpose vehicles in order to be able to orchestrate the shareholding structure of a specific investment, which makes sense, especially from a risk management perspective. This practice may represent efficiency in terms of investment risk and legal management. However, each party may have different preferences according to their interest. For example, another interviewee mentioned that investors have started requesting Islamic
banks to have direct shares in the Islamic banks themselves rather the separate special purpose vehicles.

“Now… investors are starting to say: ‘no [we don’t want] SPVs, we want to be partners with the bank’… which is difficult. That must be difficult. Of course, very difficult” - Board Member

This represents the viewpoint of investors rather than investment managers. It reflects the opposite view of the investment managers’ preference, where investors might have realised that owning shares directly with the bank places them at a stronger position in terms of decision making to protect their wealth. According to Al-Ghazālī (2008) and Al-Būṭī (2009), protecting such wealth is considered as one of the highest level of maqāsid al-shari’a (objectives of Islamic law). This also makes sense from the perspective of investors. This is because if the bank mismanaged the investment that possibly led to irregularities or disputes, investors would only be able to sue the special purpose vehicle in offshore jurisdictions, such as the Bahamas or the Cayman Islands, which may be difficult for investors. This indicates that the preference of a specific structure highly depends on the perspective of the stakeholder.

Lastly, establishing special purpose vehicles for the orchestration of shareholding and ownership structures may also be required when certain jurisdictions have placed limitations on foreign ownership. The below quote clarifies this statement:

“Sometimes, certain jurisdictions don’t allow foreign ownership above a certain percentage. So we create an SPV and nominate a local owner [to own a certain percentage on our behalf] and protect ourselves through a murābaha agreement”. – Chief Investment Officer

The above indicates that special purpose vehicles may solve challenges that businesses may face. In chapter three, it was explained that one of the arguments supporting the notion that special purpose vehicles serve maqāsid al-shari’a (objectives of Islamic law), is that they remove hardship and make things easy (Al-Hilali & MuhsinKhan, 1996). The above responses indicate that special purpose vehicles removes hardship and facilitates things for people, which is considered as a
general *maqṣad* (objective) in *Shari‘a* (Islamic law) (Ash-Shubailī, 2015). If it is assumed that special purpose vehicles did not exist; does this mean that all the problems solved as a result of special purpose vehicles would still exist? Does this indicate that all types of investment companies, including Islamic banks, would have to take more risks to obtain outside investors by allocating shares to them within the company (i.e. Islamic bank) as a whole? Furthermore, would the absence of special purpose vehicles disable Islamic banks from investing, or establishing companies, in jurisdictions where foreign ownership is either not allowed or limited? Does all the benefits that come along with special purpose vehicles disappear in the absence of special purpose vehicles?

### 6.2.2.2 Limiting Liability and Creating Bankruptcy Remote Structures

Similar to a statement put forth by Topno (2005), Abdulla and Chee (2010), ten interviewees indicated that their respective Islamic banks legally structure their investments in a manner where the bank will not be held liable for any default or damages. Rather, the special purpose vehicle is the sole entity that would be responsible for liabilities. This enables banks to manage their risk of loss effectively that are able to enter into investments without putting the Islamic bank at risk. This further indicates that special purpose vehicles assist investment managers in protecting the *māl* (wealth) of an investment, which according to Al-Ghazālī (2008) and Al-Būṭī (2009), is considered as one of the main *dharūriyāt* (necessities) in *Shari‘a* (Islamic law) that holds one of the highest ranks in *maqāsid al-shari‘a* (objectives of Islamic law).

According to these ten interviewees, limiting the liability of the Islamic banks is one of the key reasons for establishing special purpose vehicles. Most of the interviewees who mentioned this reason are either the Islamic banks’ investment managers or lawyers.

Similar to the response of the ten interviewees and as displayed in chapter two, creating a bankruptcy-remote structure being one of the main reasons for establishing special purpose vehicles was mentioned by many authors, including Topno (2005), Abdulla and Chee (2010), and McKune (2004). One of the ten interviewees added
that just as the Islamic bank distancing itself from any liability, the establishment of special purpose vehicles also distance investors from the Islamic banks’ risks of loss, similar to the arguments put forth by Abdulla and Chee (2010). Below is the quotation if this interviewee’s statement:

“…[By establishing and SPV, you] distance the Bank and its shareholders from the risks of the SPV… but you also distance the investors of the SPV from the Bank’s risks”. – Compliance Officer

Investment managers seemed to have the same attitude, response, or pattern when asked why they thought special purpose vehicles was established. Many of them without elaborating on different reasons, simply explained that special purpose vehicles are created to limit the liability of the bank. The below quote is an example of the full response given by a chief investment officer when asked why special purpose vehicles are established:

“How purely limiting your liability”. – Chief Investment Officer

An Islamic finance lawyer further elaborated that direct ownership may pose threats to the owners. The below quote elaborates on this matter:

“The simplest reason for establishing an SPV, is because it’s a separate entity… if [the SPV] is sued, it’s separate [from the bank]… You take an asset out of a legal person - to another person… the reason for this is because you want someone else to hold it (the asset), because maybe it (the asset) causes a legal threat to them (the bank)... There is also what we call ‘jurisdiction shopping’, which is finding out where is the best jurisdiction to establish your SPV in. I think it was Richard Branson, who is one of the richest people in the world, but he doesn’t prefer to have direct ownership. No one wants to own nowadays”

– Islamic Finance Lawyer

The question that arises here, is that if no one wants to have direct ownership because of the possible threats this legal structure may have on the owner, then who owns the special purpose vehicles on behalf of the initial originators (i.e. Islamic banks)? Are they not placed in risky positions? Or are they legally protected? One interviewee
mentioned that the Islamic bank/investors, as the initial originator of the special purpose vehicles, are protected through legal tools that make it impossible for the direct/legal owners to “walk away with the Islamic bank’s assets”. However, if the special purpose vehicle is sued, who is responsible? Is it the legal owners or initial originator? Multiple questions arise with these types of fiduciary-based relationships and structures that yet remain unclearly answered. There seems to be lack of a complete transparency, which supports the notion discussed in chapter three that special purpose vehicles may serve against maqāsid al-shari’a (objectives of Islamic law) due to transparency issues. This is because the Shari’a (Islamic law) encourages transparency and either discourages or prohibits purposeful non-transparent practices (Al-Nawawi, 2015).

6.2.2.3 Taxation

Twenty-four interviewees mentioned taxation as one of the main reasons for establishing special purpose vehicles, similar to arguments put forth by various authors such as Hargreaves (2014), Hadnum (2013), Forbes and Sharma (2008), amongst others. This represents the highest number of interviewees who mentioned a single reason for why special purpose vehicles were established.

Amongst the different categories of interviewees such as investment managers, academics, lawyers, and Shari’a managers, there seems to be a debate regarding the acceptability of tax avoidance (and not the illegal type of tax ‘evasion’) from a moral viewpoint. The main points of views are: is it efficient to create tax-efficient structures for profitability purposes that are considered legally acceptable? Or is there an issue of morality, where large corporations are able to legally avoid tax, while the mass population does not have the ability or capacity to do the same. Firstly, because the Kingdom of Bahrain was used as a case study (an individual tax-free country), where the majority of interviewees do not necessarily pay or realise individual or income tax affects, the issue of tax-efficient structures was not raised as a negative reason or from a negative moral standpoint. It was seen as either being legally acceptable or a fraud. If it was legal, then tax efficient structures were required to protect the māl (wealth) of the bank from extravagant spending on unnecessary loss of profits. However, this was argued by some academics that do not necessarily work in
the Kingdom of Bahrain. Although this issue remains to be a point of debate, it is first important to understand the details of the interviewee responses relating to taxation as a main reason for creating special purpose vehicles.

All twenty-four interviewees stated that special purpose vehicles are usually established in what is known as “tax haven” jurisdictions. Therefore, Islamic banks prefer using special purpose vehicles in certain jurisdictions to benefit from their taxation laws and in turn are used as a strategy to enhance their investment performance. The below two quotes are examples for this view:

“Certain jurisdictions have tax treaty agreements with other jurisdictions. For example, if I want to invest in Turkey, we use [establish an SPV in] Luxemburg, which reduces dividend withholding tax from 15% to 10%...”
– Islamic Bank Manager

“[SPVs are used] To avoid double tax. If the bank establishes an SPV in India and invests in India, there is tax. If we establish an SPV in the Caymans [Cayman Island], then transfer funds to another SPV in Mauritius, that invests in an SPV located in India, it’s not taxable... the lawyers usually explain these taxation laws prior to a transaction” – Islamic Bank Manager

Furthermore, three out of the twenty-four interviewees further added that there are certain jurisdictions that either decrease or annihilates taxation on companies who are in debt. Therefore, Islamic banks sometimes establish two (or more) special purpose vehicles that lend to one another, known as inter-lending, as a technique to either decrease or eradicate tax. An example of a quote mentioning this is displayed below:

“SPVs owned by the same Islamic bank can lend each other interest-based loans - because they’re owned by the same entity – and the reason why we do this is to [either] remove or decrease tax” – Shari’a Manager

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43 The interviewee is referring to a Shari’a (Islamic law) concept, where one of the requirements for interest being considered as the prohibited riba is to have at least two separate parties (a lender can lend himself an interest-based loan). Therefore, SPVs that have one owner, can lend each other interest-based loans since it is not considered as the prohibited riba.

44 The interviewee is referring to jurisdictions that decrease or annihilate tax requirements to indebted entities.
6.2.2.4 Regulatory and Compliance Requirements

Through the use of special purpose vehicles, Islamic banks would have less reporting requirements. This encourages banks to use special purpose vehicles since more compliance/legal requirements are considered a hassle for investment managers. Ten out of thirty-five interviewees mentioned this reason.

One out of the ten interviewees elaborated on regulatory requirements. The interviewee explained that Islamic banks use special purpose vehicles as a tool to adhere to regulatory requirements, as displayed in the below quote:

“But for example, the Central Bank of Bahrain (CBB) requires a minimum of 12% Capital Adequacy Ratio (CAR). The Capital Adequacy Ratio is = Equity / Risk Weighted Assets (RWA). The percentage of this ratio should not be less than 12%. Therefore, some Islamic banks create special purpose vehicles, and transfer selected Risk-Weighted Assets to the special purpose vehicle (it is removed from the banks balance sheet and transferred to the special purpose vehicle balance sheet). This in turn reduces the banks Risk-Weighted Assets (RWA), which in turn would increase the Banks Capital Adequacy Ratio (CAR). Can you clarify what exactly is RWA? What constitutes RWA? ... Risk-Weighted Assets (RWA) are assets that are not easily liquidated. For example, cash holds a zero risk-weight, while the risk-weight on real estate is 200%. Therefore, if a bank owns real estate assets worth $5m, the risk-weight is $10m, used for calculation purposes”. – Risk Manager

The above quote may raise regulatory questions. With the same type of equity and assets, an Islamic bank may manipulate its capital-adequacy ratio by establishing special purpose vehicle(s) and transferring selected risk-weighted assets to a separate legal entity. A question that arises here is that if we were to assume that there are two Islamic banks with the identical financials that own identical assets, where one Islamic Bank established a special purpose vehicle and transferred a high risk-weighted asset(s) to the special purpose vehicle, and the other Islamic Bank did not establish a special purpose vehicle and continued to directly legally own all the high-risk weighted asset(s). This means that the two Islamic banks with initially the same financials and in reality identical assets now have different capital adequacy ratios
(CAR). Is this considered as a manipulation? Are regulators aware and/or do they accept this act? Is it legally acceptable and therefore the regulators or auditors are not able to object to this act? Or is it a perfectly acceptable strategy where other banks may choose to act similarly or not depending on their ability or strategy? This point may be debatable.

### 6.2.2.5 Legal Issues

Seventeen out thirty-five interviewees indicated that establishing special purpose vehicles means there will be less legal requirements for the Islamic banks. Also, it is much quicker to incorporate a special purpose vehicle in the known tax-haven jurisdictions (such as the Cayman Islands or Jersey), while on the other hand; incorporating a special purpose vehicle in the Kingdom of Bahrain requires a long and complicated process. The below quotes further elaborates on this advantage:

“In Bahrain, it might take me two weeks to establish an SPV. In Cayman, it takes one day”. – Compliance Officer

“SPV has easiness… no (Bahraini) municipality (requirements)… the board of directors formation is completed within twenty-four hours” – Islamic Bank Manager

“[SPVs are established because] This is how it’s done. Bahrain is a bureaucracy” – Islamic Bank Manager

Again, this further suggests that special purpose vehicles serve *maqāsid al-shari’a* (objectives of Islamic law) in terms of removing hardship, promoting easiness, and facilitating processes for individuals (Ash-Shubailī, 2015). In this regard and in August 2015, one interviewee indicated that the Kingdom of Bahrain was in the process of trying to enable the Kingdom of Bahrain to become a special purpose vehicle-hub. The interviewee mentioned:

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45 The interviewee is referring to the bureaucratic environment of the Kingdom of Bahrain that may slow the process of establishing an SPV in Bahrain.
“Bahrain was trying for a while to allow the establishment of SPVs in Bahrain to become easy (ease the process of SPV establishment in Bahrain) to replace Cayman and other secrecy jurisdictions…they (legislators, regulators, or the government) were trying to push the banks to open SPVs in Bahrain (rather than the Cayman islands and other preferred SPV jurisdictions)”

— Islamic Bank Manager

Later in April 2016, a local Bahraini newspaper publicised that the Kingdom of Bahrain was aiming to position itself as a regional special purpose vehicle hub (TradeArabia, 2016). This was evidenced based on a roundtable meeting held in cooperation with the Central Bank of Bahrain and the Economic Development Board (EDB) in the Kingdom of Bahrain (TradeArabia, 2016). This is probably due to the fact that the Economic Development Board rightfully wants to encourage a more positive investment climate in the Kingdom of Bahrain for economic purposes. This may obviously lead to necessary regulatory developments and enhancements. However, according to one elite interviewee, the Kingdom of Bahrain already started drafting a law specifically for special purpose vehicles in the Kingdom of Bahrain. This further indicates that the climate and nature of special purpose vehicles in terms of encouragement, and regulation, is heading towards a new path in the country. Although it may be encouraged from an economic point of view, it also raises questions about future prospects pertaining to special purpose vehicles, regulatory enhancements, and how to deal with challenges posed along with special purpose vehicles. One may conclude that if managed and regulated properly and as argued by Stewart (2005), a special purpose vehicle may be a perfectly acceptable designation. On the other hand, if challenges were still posed by special purpose vehicles, regulatory developments would continue to be critically required.

6.2.2.6 Shari’a Compliance

From an Islamic banking perspective, which includes a banking philosophy that is required to adhere to Shari’a (Islamic law) principles (Abdul-Raheem 2013, Kettel

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46 Islamic Bank Manager

47 The Bahrain Economic Development Board (EDB) is a public agency with an overall responsibility for attracting inward investment into the Kingdom of Bahrain and supporting initiatives that help enhance the investment climate in the country.
2011, Abdul-Rahman 2010, Abdulla and Chee 2010, Soumare 2008, and Ayub 2007), this may probably be the most significant element of the research, and may be one of the major challenges facing the Islamic banking industry. Since Islamic banks are prohibited from engaging in interest-based activities (Ayub, 2007, Khan 1986, Choudhury and Malik 1992), Islamic banks sometimes initiate the establishment of separate legal entities in order to indirectly engage in interest-based activities. The Islamic bank would execute a Shari’a compliant deal with a special purpose vehicle (for example, a tawarruq (monetization) financing), where the special purpose vehicle would then engage in a transaction that would have otherwise been prohibited for the Islamic bank to do so directly. Most commonly, this includes the legally separated special purpose vehicles to engage in interest-based activities. However, a common argument provided is that Islamic banks are neither responsible nor accounted for separate legal entities. Ten out of thirty-five interviewees mentioned this reason. This raised a number of questions such as: Is this authentic? Is the Islamic banking industry regulated properly? Are the Shari’a bodies conducting their duties efficiently? Or perhaps there might be explanations or justifications to such practices?

The two main views held by the interviewees regarding this practice, are that five interviewees believe this to be a manipulative and a misleading practice, while four interviewees believe this to be as a solution in times of necessity. The five interviewees who explained this as being a misleading practice, mentioned that the Islamic bank would either:

1. Execute these transactions without prior Shari’a approvals
2. Manipulatively structure investments in a way indicating that no Islamic financings are available for the investment, and that the bank would financially be in trouble if the investment were not entered into
3. Structure a transaction portraying the Islamic bank as not having a majority share (less than 33%) in the special purpose vehicle, where the bank realistically has full power and control over the special purpose vehicle.
4. Structuring a transaction that includes a special purpose vehicle, portraying the special purpose vehicle as an external investment partner. Therefore, the Shari’a Supervisory Board is not concerned nor asks about the activities of an external company. In reality, the Islamic bank fully controls this separate
special purpose vehicle and engages in prohibited activities freely without the supervision of the Shari’a Supervisory Board.

5. Amongst other techniques

The interviewees explained that by implementing the above, Islamic banks are able to: (1) convince the Islamic shareholders/investors that the investment was fully Shari’a compliant to obtain funds, (2) convince the Shari’a Supervisory Board that the investment structure should be deemed Shari’a compliant, (3) convince the regulator that the transaction was approved by the Shari’a Supervisory Board, (4) engage in non-Shari’a compliant investment or transactions freely and indirectly, amongst other actions.

“The mentality [of the investment department] is not to achieve Shari’a compliance in a manner that is acceptable to [the] investment [team], but rather how to trick the Shari’a department into believing it is Shari’a compliant and obtain an approval…” – Islamic Bank Investment Manager

“I work in the investment department and I see them (investment team). At the initiation stage of planning, they plan on how to initially structure it in a way to obtain a Shari’a approval, knowing that after the execution they will change the structure. After execution, they apply for another approval to change the initial structure and explain it’s out of necessity, (as if there were unseen future circumstances). The Shari’a body cannot cancel a whole executed transaction and waste millions [based on a structural issue], so they provide an exception (approval)…but it was all planned from the beginning. And this is just one example”. – Islamic Bank Investment Manager

The above example provided as an insight by an investment manager indicates that hiyal (legal stratagems) to engage in prohibited activities may exist in the Islamic banking industry. As explained in chapter three, engaging in hila (legal stratagems) in order to ultimately engage in a prohibited activity is prohibited according to Shari’a (Islamic law) (Al-Qaradhāwī, 1978 and Al-Enezi, 2015). The interviewees opinion indicate that a number of Islamic banks may have been engaging in prohibited activities without the knowledge of their Shari’a Supervisory Boards. A number of accomplished scholars such as Ibn Taymiyah (2005) regard this type of hila (legal
stratagems) as more prohibited and harmful than solely engaging in the prohibited activity. He argues that *hiyal* (legal stratagems) to engage in a prohibited activity are prohibited, in addition to having an element of deception (Ibn Taymiyah, 2005). However, it is apparent that the above two quotes are from investment managers who are willing to express their perspective regarding *Shari’a* compliance flaws within their investment team. It may be useful to note that biasness may exist within such interviews, or that the investment teammates the quotes refer to may have different opinions or rationales. However, the quotes may also be revealing a sense of a reality that exists within the Islamic banking industry, since the arguments put forth by these interviewees are in conformity with the claims made by the Central Bank of Bahrain and a senior *Shari’a* scholar (as included in chapter one), who claim that evidence exists where special purpose vehicle abuse exist within the Islamic banking industry (CBB 2013 and Umar 2013).

Due to the above analysis, it may be imperative to note that a methodology to tackle special purpose vehicle (or other) similar abuses may need to be created/initiated. This is because it may be non-comprehensible to have an Islamic banking industry, whose essence is largely based on the prohibition of interest (Ayub 2007, Khan 1986, Choudhury and Malik 1992), to freely engage in interest-based transactions through the use of special purpose vehicles. This argument may be further encouraged since evidence previously in this chapter suggests that special purpose vehicles are used by the majority of Islamic banks in approximately 90-100% of their investment transactions. Also, since the *Shari’a* Supervisory Boards are not made aware of similar violations except by the internal *Shari’a* reviewer, the importance and significance that is placed on the internal *Shari’a* reviewers needs to be emphasized.

“They use SPVs to obtain conventional financing, but this is prohibited – it’s misleading. They obtain investors, show them that it’s (the structure) is Islamic (without the investors knowing the underlying economic realities, who are shown the Islamic version of the transaction). The bank does not promote it, the bank does not entertain it” – *Shari’a Manager*

“Some deceptive banks use them (SPVs) as a means to obtain conventional finance” – *Shari’a Manager*
The above quotes indicate that a number of internal Shari’a reviewers may be aware of such violations. The question is, do they report it? Are the Shari’a Supervisory Boards being made aware of such violations? Is it mentioned in the publicised Shari’a Supervisory Board annual reports or are they mentioned in the confidential internal Shari’a review reports? Since chapter seven analyses secondary data, which Shari’a Supervisory Board annual reports are a part of, the question of whether similar violations are mentioned in such reports will be analysed.

However, it may be important to note that one Shari’a auditor hinted during a side talk after an official interview, that their (Shari’a auditors) jobs would be at stake if they consider reporting such findings. Although it was not a part of the interview questions, this statement initiated side talks with other interviewees conducted after this interview. As a result, during side talks with four other interviewees, two other Shari’a auditors and two investment managers either reiterated or confirmed this statement, all of which collectively represent five banks. This indicates that at least in five Islamic banks, the internal Shari’a reviewer may feel pressured to officially report special purpose vehicle violations in internal Shari’a audit reports. On a separate note, another investment manager stated that internal Shari’a reviewers might not report findings due to lack of awareness or lack of evidence, rather than solely management pressure. This may indicate that a considerable number of internal Shari’a reviewers may not officially report special purpose vehicle violations due to lack of awareness, lack of evidence, or management pressure. This also indicated to the researcher that the proper or deserved protection of internal Shari’a reviewers might not be applicable in all Islamic banks.

From a risk management perspective, the following quote displays a more technical methodology of engaging in interest-based conventional transactions through the use of special purpose vehicles:

“SPVs are also used to reduce a banks ownership in an asset from a high amount to 33% or less. You’re basically manipulating your ownership, in order to be able to: (1) buy non-Shari’a compliant investments, and (2) hide existing conventional loans from buyers, investors, regulator, Shari’a supervisory board and the Shari’a auditor…Actually, you either reduce the ownership to 33% or
less, or create a new structure that allocates the bank 33% or less to engage in non-Shari’a compliant activities. You mean obtaining conventional loans? Not necessarily, whatever [any non-Shari’a compliant transaction]. It’s 33% or less because our Shari’a board say it’s permissible if the ownership is less than a third” - Former Risk Manager, Islamic Investment Bank.

When tax avoidance was being discussed earlier in this chapter, a question that was raised was whether it was morally acceptable to legally avoid/decrease taxation through legal tools. This seems to be a similar case, however from a Shari’a (Islamic law) perspective rather than taxation. It is apparent from the above quotation that Islamic banks may orchestrate shareholding structures of newly established special purpose vehicles in a way that enables them to engage in prohibited activities, or manipulate a shareholding structure of an existing special purpose vehicle to engage in non-Shari’a compliant activities. Is it a type of special purpose vehicle abuse based on hiyal (legal stratagems) to engage in prohibited activities, or are they acceptable since legally they fit within the rules provided by the Shari’a Supervisory Board?

The Shari’a rulings pronounced by Shari’a Supervisory Boards regarding banking transactions seem to be based on Shari’a (Islamic law) rulings and the fiqh (Islamic jurisprudence) relating to sharikāt (companies). The challenge that arises is that special purpose vehicles are legal companies, however do not necessarily actually have physical operational office or employees, but are rather managed by trustees (Topno 2005, Gorton and Souleles 2007). According to Shari’a (Islamic law), should these types of companies be treated equally with normal companies, with normal offices and employees? Furthermore, as argued by many authors, a special purpose vehicle is usually established for a special, specific, or limited purpose (Amoruso and Duchac 2014, Abdulla and Chee 2010, Gorton and Souleles 2007, Topno 2005, Hartgraves and Benston 2002) and therefore, could it be logically claimed that the “special purpose” for an Islamic bank to establish a special purpose vehicle, was to engage in non-Shari’a compliant activities? The following two examples may clarify this argument further:
**Example 1:**
Originator: Islamic Bank One
Establishment: Special Purpose Vehicle One
Location: Bahamas
Reason for Establishment: To deposit investors’ cash and allocate shares according to amounts received from each investor to invest collectively.

**Example 2:**
Originator: Islamic Bank Two
Establishment: Special Purpose Vehicle Two
Location: Cayman Islands
Reason for Establishment: To allow a fiduciary relationship and obtain a conventional loan to purchase an asset for lease and investment purposes.

The first example may be understood, but is the second example apprehensible? How can the special or specific purpose of an Islamic bank, which is the initial originator of a special purpose vehicle, be to engage in non-Shari’a compliant activities? Is this conceivable? Or are there understandable explanations?

If Islamic banks are able to engage in non-Shari’a compliant transactions through the use of special purpose vehicles, does this mean special purpose vehicles may be used specifically to go against maqāsid al-shari’a (objectives of Islamic law)? If Shari’a (Islamic law) prohibits interest due to multiple negative impacts, does the Islamic banking practice of engaging in interest-based activities through special purpose vehicles serve maqāsid al-shari’a (objectives of Islamic law)? Does the insertion of a legally separated special purpose vehicle, inserted by the Islamic bank, make it sufficient enough to engage indirectly in interest-bearing activities?

On the other hand and the other end of the spectrum, four out of the ten interviewees explained this practice as being a solution when no Islamic financing exists for a specific investment. They explained that when Islamic financing exists, this structure is no longer approved or considered acceptable by the Shari’a body of the Islamic bank. The following two quotes are examples for this point of view:
“If no Islamic financings exist for a Western company, we can use an SPV to take a conventional finance. This is only out of necessity. It happened only once in the USA… if Islamic financing exists, this is not permissible. The excuse must be mentioned in the Shari’a resolution why an approval was granted for a conventional [loan included in an] SPV [structure]” – Shari’a Manager

“[SPVs are used] to make it Shari’a compliant. We bought two buildings in Australia with debt and equity, and there’s no Islamic financing in Australia (so the debt was conventional-based indirectly through an SPV)”. – Islamic Bank Investment Manager

It seems from the perception of these interviewees, that an Islamic special purpose vehicle structure with conventional activities is a solution only if no Islamic substitute exists. Does this indicate that if Islamic financing existed, this structure would not be deemed acceptable in the least, or are there more exceptions to this? Also, the internal Shari’a reviewer quoted above mentioned an interesting perception when he stated, “this is only out of necessity”. This is because it raises questions such as, what determines the conditions of a dharūra (necessity)? Is it the Shari’a Supervisory Board? What if Islamic financings were available, however the profit rate of the Islamic financing was higher than the interest rate on the conventional loan, can this be considered a dharūra (necessity) and approved as an exception? Or is it only when the fundamental necessities are involved such as food, clothing, shelter, peace, can the concept of dharūra (necessity) be applied and approved as an exception? It may be useful to officially clarify the concept of dharūra (necessity) through Shari’a standard setting bodies to enable practitioners and the public to understand the concept of dharūra (necessity).

The last interviewee explained that special purpose vehicles are used because it is easier to engage in Shari’a compliant activities. This is because the Articles of Association (AOAs) and establishing contracts of the special purpose vehicle (i.e. Cayman islands or elsewhere) requires Shari’a compliance for the activities the entity will engage in.
“They (SPVs) have standard Shari’a AOAs (Articles of Associations). All [of the] establishing contracts are in line with Shari’a. See… they also have ‘Shari’a committee’ (having a Shari’a committee for the SPV as a requirement in the Articles of Association of the SPV)”. – Islamic Bank Manager

Therefore, the interviewees who mentioned Shari’a compliance as a reason for Islamic banks establishing special purpose vehicles are divided into three categories: (1) those who view it is a misleading practice, (2) those who explained it is a temporary solution when no Islamic financing exists, and (3) that special purpose vehicles have Shari’a compliance requirements in its Articles of Association. This is illustrated below:

![Figure 27 Interviewee opinions of SPV Shari'a Compliance](image)

Interviewee perceptions regarding Islamic banking practices of engaging in conventional transactions through the use of special purpose vehicles is further elaborated in section 6.2.3. However, a general but main question that needs to be asked, is whether Shari’a Supervisory Boards are aware of the hiyal-based practices or not, and if so, what actions are being undertaken to stop similar loopholes from being abused?
6.2.2.7 Confidentiality Purposes

Since special purpose vehicles are separate legal entities, its legal owners are persons other than the initial originator or establishing bank. Therefore, an entity established in a jurisdiction (e.g. Cayman Islands) with an unfamiliar name legally owning it, would make it difficult for the public to track down the person who initially owns (or indirectly manages) the special purpose vehicle (although regulatory bodies may be able to do so). According to two interviewees, when Islamic banks want to be confidential in their dealings, special purpose vehicles help them achieve this objective.

“If you (a bank) wants confidentiality, you set up an SPV with a random name in the Caymans. This way you are able to hide… or make discrete… your ownership. Regulators will inevitably be able to track who owns what, but when the general public see an XYZ company in the Cayman, it is difficult for them to track the real owners of this company” – Risk Manager

“Some [banks] are not using SPVs in good faith. They are being established in secrecy jurisdictions because:

➢ No access to financials
➢ Purposely hiding information
➢ No disclosure requirements or share information with external parties

SPVs [are] not regulated… Banks are obviously regulated, but the SPVs they establish are not” - Compliance Officer

6.2.2.8 Easier Transfer of Funds

Two out of thirty-five interviewees mentioned that it is easier to transfer funds locally (for example, a special purpose vehicle in the United States of America to an Islamic bank’s investment also in the United States of America), rather than internationally transferring money (for example, from the Islamic bank in the Kingdom of Bahrain to its investment in the United States of America). Special purpose vehicles therefore ease the process of funds transfers between Islamic banks and its investments. In this regard, special purpose vehicles may be seen as serving maqāsid al-shari’a
(objectives of Islamic law) as it provides solutions, removes hardships and facilitates ease (Ash-Shubaili, 2015) with regards to these transactions and transfer of funds.

One interviewee mentioned that it is easier to transfer debts (rather than funds) to the special purpose vehicle to enhance the Islamic bank’s balance sheet and financial statements. This comment raises many issues that may need to be addressed. Chapter two explained that one of the main reasons that led a large corporation, the Enron Corporation, which had a market capitalisation of USD 60 billion in the beginning of 2001 to being bankrupt by the end of 2001, was off-balance sheet debts partially incurred through the use of special purpose vehicles (Amoruso and Duchac 2014, SEC 2005, and Dharan 2002). Does this mean Islamic banks are engaging in similar activities to those like Enron Corporation as well as other corporations that hide debt through special purpose vehicles? Or has the accounting rules changed to a level where consolidation requirements in the Kingdom of Bahrain disables Islamic banks to hide or transfer debt? According to one interviewee who is a lawyer and a previous regulator, explained that despite the rules being changed or enhanced by the regulator, his perception is that practitioners are always one step ahead of regulators, where they aim at benefitting from other legal loopholes. He mentioned:

“They’re [practitioners] always one step ahead [of regulators]” – Islamic Finance Lawyer

6.2.2.9 Sukūk (Commonly referred to as Islamic Bonds) and Syndication

Three out of thirty-five interviewees indicated that special purpose vehicles are used for sukūk (Islamic securitization) structures. The concept of sukūk (Islamic securitization) was explained in chapter four (Islamic financial products chapter). One interviewee mentioned that special purpose vehicles are required for syndication financings.

6.2.2.10 Strategic Reasons

One interviewee mentioned that investment companies (which may apply to Islamic banks) might prefer placing several investments under one brand. Therefore, a special
purpose vehicle with a specified brand is created in order to act as the mother brand, which houses a set of chosen investments.

6.2.2.11 Summary of Main Reasons

The below graph summarises the main reasons mentioned by the interviewees for why special purpose vehicles are used by Islamic banks, from highest to lowest, in chronological order:

![Reasons for Islamic Banks establishing Special Purpose Vehicles](image)

Figure 28 Reasons for using SPVs: Bar Graph

6.2.3 Special Purpose Vehicles and Conventional Financings

The practice and debate of Islamic banks indirectly engaging in conventional transactions through the use of special purpose vehicles was briefly discussed in the section 6.2.2.6, when a number of interviewees explained that Shari‘a compliance was one of the reasons of establishing special purpose vehicles.
However, pursuant to the fifth interview question displayed in the research methodology chapter, the researcher specifically asked the interviewees whether their respective Islamic banks engage in interest-based financings indirectly through special purpose vehicles. Therefore, this section discusses this practice in more detail. The question did not apply to four out of the thirty-five interviewees, while the remaining thirty-one interviewees replied with the following:

- **Islamic Banks obtaining conventional loans through special purpose vehicles (SPVs):** Twenty-four interviewees indicated that the Islamic banks they represent, or the Islamic banks they previously worked for, or the Islamic banks they regulate (or regulated) obtain conventional financings through special purpose vehicles. The explanation for this practice differed depending on the interviewees:
  
o Thirteen out of the twenty-four interviewees indicated that this practice exists because there are certain jurisdictions where Islamic financing is not available. Islamic banks use this structure (obtaining conventional financing through special purpose vehicles) only when no Islamic financings exist. This structure is used as a makhraj (Shari’a solution) when no alternative financings are in the market. The special purpose vehicle borrowing the conventional funds would legally be separated from the Islamic bank. However, if Islamic financing exists, the Islamic banks’ Shari’a Supervisory Board would not approve this structure. The following quotes elaborates on this issue:

  “You say you take conventional loans whenever you want (through SPVs). How do you reconcile this with Islamic finance, since Islamic finance’s main principal is the prohibition of interest? This is normal. This is a standard practice at least within the past ten years. Because when you invest in ships, plane, rigs, etc., no Islamic banks in the region is willing to finance them… I mean there are but they are very limited and take so much time. Bank [X]\(^{48}\) for example took them five months just to reply to us. The only sector the region (Islamic Banks in the Gulf or MENA region) offers is real estate. We used to use this conventional SPV structure for the real estate sector in the past, in the

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\(^{48}\) The real name of the Islamic bank the interviewee is referring to has been removed. The interviewee referred to an Islamic retail bank in the Kingdom of Bahrain.
U.K. for example. But when [Islamic Bank name] came, we started dealing with them and obtain Islamic financing.” – Chief Investment Officer

“How do you reconcile Islamic banks obtaining conventional financings freely, all they need is an SPV, with the fact that the main prohibition in Islamic banking is the prohibition of interest? It’s (the SPV) is a complete separate entity. See, if you get an alternative, fine. But if not, why should I complicate it? This is only acceptable because an alternative doesn’t exist. If an alternative exists, we’ll leave SPVs and conventional financings. Our bank invests in the energy and oil sectors, etc. there are no Islamic banks (to finance them). So if we don’t use [the] SPV [conventional] structure, the bank will shut down […] So [the acceptability of using SPVs] is a case-by-case basis per bank. But our bank must […] SPVs is a good makhraj (Shari’a solution) for now, but one may find an alternative. […] It’s not a standard practice (conventional SPV financing), but it’s the only tool available now. […] Let me be clear – if an Islamic financing substitute exists, this SPV conventional structure is not allowed, at all, no way” – Shari’a Manager

- Two interviewees indicated that although the Islamic banks they represent had obtained and lent conventional loans through special purpose vehicles, they had done so without the Shari’a Supervisory Board’s approval. They represented round 2% - 4% of the Islamic banks investments.
- Three interviewees representing the regulatory industry (either current or previous employees) explained that they had come across countless of transactions with this sort of structure. Abuse exists in the market where Islamic banks obtain conventional loans through special purpose vehicles without portraying the full true picture to the Shari’a Supervisory Board of the Islamic bank. The regulator explained that it had placed a new set of rules in the Central Bank of Bahrain’s rulebook because of this practice, but the Shari’a Supervisory Boards have a major role to play in the near future regarding this matter. Examples of quotations regarding this category includes the following:

49 The interviewee names an Islamic retail bank based in the United Kingdom
“Many Islamic banks obtained conventional loans deceptively, it happened with many banks. But the CBB (Central Bank of Bahrain) prohibited this in the PCD\textsuperscript{50} module. There are major changes in the rulebook for SPVs”
- Compliance Officer

“…No, we don’t take conventional financings. But I know of another Islamic bank who deceived their Shari’a board and maybe CBB (Central Bank of Bahrain), I’m not sure, but maybe CBB as well. But they were caught in the end. What did they do? They established two SPVs, one they own, which they show the Shari’a Supervisory Board for approval. The other one they indirectly own, but showed in the structure that they were only a partner to the first SPV. And that second SPV (not owned by the Islamic bank) obtained conventional financing, and they entered into a transaction. The Shari’a board found out that the Islamic bank was negotiating on behalf of the second SPV (not owned by the Islamic bank) for obtaining the conventional loan. […] Besides, the conventional bank would not give a conventional loan to an SPV owned by no one, they must feel satisfied or had a guarantee from the Islamic bank. The CBB found out as well and… (Interviewee paused) … something happened (there was a problem)” – Compliance Officer

“Yes… I’ve seen a lot. They do haram (engage in prohibited activities) and they say ‘we don’t know who’s the owner [of the SPV]’ (sarcastically). But they (Islamic banks) are the owners” – Islamic Finance Lawyer

- Three interviewees explained that their respective banks have obtained conventional loans through special purpose vehicles by engaging in misleading practices. However, it is unclear whether these employees were disgruntled or about to resign from the banks they represented, who may have provided a negative point of view, or were merely stating their opinions sincerely.
- One interviewee explained that the respective banks he represents obtained conventional loans through special purpose vehicles when the bank was a

\textsuperscript{50} The interviewee is referring to the Prudential Consolidation and Deduction Requirements (PCD) Module of the Central Bank of Bahrain (CBB) Rulebook for Islamic Financial Institutions, Volume II. Changes in the PCD module relating to SPVs was related transferred to the Reporting Requirements (BR) Module of the Central Bank of Bahrain Rulebook, Volume II. These changes will later be analyzed in the secondary data analysis section.
conventional investment (wholesale) bank, prior to its conversion to an Islamic retail bank.

- Two interviewees explained that this happens only in exceptional cases. The Islamic bank does not prefer to take business or legal risks that would end up being scrutinized by its *Shari’a* Supervisory Board or *Shari’a* auditor.

- **Islamic Banks that do not obtain conventional loans through special purpose vehicles (SPVs):** Seven out of thirty-one interviewees mentioned that the Islamic banks they represent do not obtain conventional loans through special purpose vehicles. However, four of the interviewees work in the same Islamic bank where previous interviewees mentioned that their respective Islamic banks did obtain conventional loans through special purpose vehicles, which indicates an inconsistency in the interviewee responses. The below bar graph summarises these opinions:

![Figure 29 Islamic banks obtaining conventional financing(s) through SPVs: Interviewee responses](image-url)
It may be useful to note that the thirty-one interviewees this question applied to, represent nine Islamic banks in the Kingdom of Bahrain\textsuperscript{51}. Furthermore, the interviewee responses reveal that eight out of the nine Islamic banks obtain conventional financing through special purpose vehicles\textsuperscript{52}. Out of these eight Islamic banks, evidence was submitted indicating that at least three of the Islamic banks that obtained conventional loans have done so through *hiyal* (legal stratagems) non-genuinely, while the remaining five Islamic banks might have done so out of genuine causes. An example for a *hiyal*-based practice is the investment department confirming to a *Shari’a* Supervisory Board that no legal powers were granted to the Islamic bank over the conventional special purpose vehicle. However, it was later revealed in an audit report that the investment team knowingly obtained legal powers to control the conventional special purpose vehicle, prior to providing the confirmation to the *Shari’a* Supervisory Board. Multiple similar scenarios exist, and therefore may indicate a sort of an abuse of special purpose vehicles in the industry.

Below summarises the interviewee perceptions regarding this matter:

\textbf{Islamic Banks obtaining Conventional Loans through Special Purpose Vehicles (Per Islamic Bank)}

![Figure 30 Islamic banks obtaining conventional financing(s) through SPVs: Per Bank](image)

\textsuperscript{51} This is because a tenth Islamic bank was solely a retail bank that did not engage in investment activities. Also, this excludes the regulator and Islamic infrastructure organisations.

\textsuperscript{52} The exception was an Islamic retail bank who invests locally using depositor funds, which is comparatively a rare or unique investment model.
Regarding the genuine practices, this means that no evidence for abuse existed in structuring and executing a special purpose vehicle transaction. This means that the Islamic bank had transparently conveyed to the Shari’a Supervisory Board their structures and information, and obtained an approval prior to executing the transaction. This indicated that no misleading practices were taking place and therefore was considered genuine. However, a considerably major finding revealed when analysing documents throughout the interview process, was that most, if not all, Shari’a Supervisory Boards stipulated necessary conditions for the special purpose vehicle transaction to be Shari’a compliant. These conditions partially included the Islamic bank not paying for the establishment costs, not having control (while other resolutions indicated not having ‘legal’ control), not manage, nor influence the conventional special purpose vehicle. The considerable major finding relates to the reality that most of these Islamic banks negate at least one of these conditions to sustain the transaction as Shari’a compliant. A number of interviewees provided documented evidence that openly displayed how Islamic banks, in reality and most commonly, do control these separately created special purpose entities. An example of the documented evidence was that the special purpose vehicles would not pursue an action without receiving a written request from the Islamic bank.

The researcher asked an interviewee who represented an Islamic infrastructure organisation for his thoughts on this issue, who mentioned:

“If it’s haram (prohibited) to take conventional loan financing, then if an SPV takes a conventional financing it doesn’t change the (Islamic) ruling. This is tahayul (engaging in legal stratagems). It’s haram (prohibited) to take conventional financing whether directly or through SPVs, because there is no dharūra (necessity). For example, the country will not fall if they don’t take conventional financing” – General Secretary, Islamic Infrastructure Organization

Lastly, when an elite interviewee, a senior Shari’a scholar, was asked if conventional financings existed within Islamic special purpose vehicle structures, his response was:
“Yes. There are conventional financings within a structure where Islamic banks are included as investors, but it happens with conditions. For Example:

- The Islamic bank can’t give the SPV a tawarruq, in order for the SPV to lend a conventional loan. But the opposite is okay, because sometimes, Islamic banks are in need (necessity) of liquidity. The only exception to this is with the big banks, such as H.S.B.C., who are not in need of us but we are in need of them, we can invest with them this way.
- Each Shari’a Supervisory Board (of the Islamic bank) checks, if this (submitted structure) is a genuine investment, or hila wadhiha (clear legal stratagems to engage in prohibited activities)?
- Also, the [Islamic] bank can’t pay for the SPV’s establishment, it doesn’t have Board seats, no management, no decision, nothing. They may only have an observing member in the Board with veto power to protect the banks rights.

... I saw an Islamic bank that gave a tawarruq to an SPV established by an external party. Then that SPV bought a conventional debt from a conventional bank that was owned by a different SPV - No that never happened - but I saw it? - Not in any of the banks I’ve seen…” – Shari’a Scholar

The second condition mentioned above indicates that Shari’a Supervisory Boards may be aware that hila (legal stratagem) practices may exist. It also suggests that a number of Shari’a Supervisory Boards may consider the possibility of hiyal (legal stratagems) prior to issuing a fatwa (Shari’a legal opinion).

6.2.4 Accounting of Special Purpose Vehicles

Nine out of thirty-five interviewees responded to the question regarding the accounting treatment of special purpose vehicles by Islamic banks. Two interviewees mentioned that special purpose vehicle have an “off-balance sheet treatment”, similar to statements made by Amoruso and Duchac (2014) and Gorton and Souleles (2007). Another two interviewees indicated that special purpose vehicle assets were fully consolidated with the Islamic banks financials. A fifth interviewee indicated that special purpose vehicles have their own independent financials, accountants, and auditors.
The remaining four interviewees provided a more detailed response explaining that the accounting treatment of special purpose vehicles is dependent on several factors, thereafter concluding whether the special purpose vehicle financials should be consolidated with the Banks financials or not. These factors include the Islamic banks: (1) percentage of ownership in the special purpose vehicle (2) Banks representatives as members of the board of directors in the special purpose vehicle (3) Banks influence (or veto power) over the special purpose vehicle, and (4) Ability or control over the special purpose vehicles management. Depending on these factors, the special purpose vehicle will either be consolidated with the Islamic bank or not. The higher the ownership, board seats, influence, or power the bank has over a special purpose vehicle, the more likely it will be consolidated, and vice versa.

6.2.5 Difference between Islamic and Conventional Banks Practice towards Special Purpose Vehicle

When asked what the difference was between Islamic banking practices with special purpose vehicles and conventional banking practices, fifteen out of thirty-five interviewees did not answer the question because they either did not know the answer, abstained from answering, or the question was not applicable to them.

Out of the remaining twenty interviewees, twelve responded explaining that the concept of special purpose vehicles with Islamic banks, including its advantages and disadvantages, does not differ from conventional banks, except for the Shari’a aspect of the transaction. Conventional banks use special purpose vehicles to benefit from the entire benefits special purpose vehicles offer, with the exception of Shari’a compliance. Two out of these twelve interviewees reiterated that the difference is in the Articles of Association (AOA) of the special purpose vehicle, where adhering to Shari’a rules and principles is a requirement in the establishing documents of the Islamic banks established special purpose vehicle.

Four out of twenty interviewees explained that Islamic banking practices does not differ from conventional banking practices, where they both largely engage in interest-based activities. The only difference is that an Islamic bank establishes a special purpose vehicle to engage in the conventional aspect of the transaction. Two
of the four interviewees mentioned this as obviously being misleading, a *hila* (legal stratagem) to engage in a prohibited activity, while one explained that this is done because no Islamic financing is available in certain jurisdictions. The following quotes are examples:

“**Islamic banks and conventional banks is exactly the same. However, Islamic banks always add more steps to a transaction. For example, if the conventional bank goes from A to B, the Islamic bank will go from A to Z to C to B**” – *Islamic Bank Investment Manager*

“It’s only different when Islamic banks want to play around” – *Shari’a Manager*

It may be beneficial to note that both of the above are quotations from full-time practitioners. When senior *Shari’a* scholars who serve on *Shari’a* Supervisory Boards were asked the same question, they had an opposite view as displayed below:

“They is not at all the same. Islamic banks follow *Shari’a* (Islamic law) principles by mandate and order in the annual general meeting (AGM).” - *Shari’a Scholar*

“It is not the same. Islamic banks do not want to have any sort of relationship with the interest-bearing loans in the transactions.” - *Shari’a Scholar*

There seems to be a difference of opinion between practitioners and *Shari’a* Supervisory Board members regarding this issue. The above quotes suggest that *Shari’a* scholars are convinced that there is a major difference between Islamic special purpose vehicle transactions and conventional special purpose vehicle structures. Their main point of argument is that even though both structures may include interest-bearing transactions, the Islamic structure completely legally segregates the Islamic bank from the prohibited activities. The practitioners on the other hand, find so much similarities and resemblance that they believe investment teams may only alter the structure slightly to make it seem *Shari’a* compliant. Is there a misunderstanding on behalf of the practitioners or *Shari’a* scholars? Or is it the same practice with different views or opinions?
Another considerably significant point to be addressed is the separation between Islamic banks and the conventional special purpose vehicles in a single structure that Shari’a scholars usually refer to. It seems that this separation may solely refer to a legal separation, which raises the following question: according to Shari’a (Islamic law), is an Islamic bank allowed to initiate the establishment of a special purpose vehicle that engages in prohibited transactions or activities, if it was solely a beneficiary and did not legally own the special purpose vehicle? Is it solely the legal aspect the Shari’a Supervisory Boards are concerned with? Or are there other rules or concerns?

Later in this chapter, section 6.4 analyses responses obtained from Shari’a Supervisory Board interviewees who were asked these types of questions. Therefore, details of the conditions for approving Islamic special purpose vehicle structures with prohibited activities are displayed in more detail in section 6.4.

6.2.6 Difference between Special Purpose Vehicle practices in the Islamic Banking Industry of the Kingdom of Bahrain relative to the International Islamic Banking Industry

When asked about the differences between special purpose vehicle practices in the Kingdom of Bahrain’s Islamic banking industry relative to the international Islamic finance industry, twenty out of thirty-five interviewees either: (1) Did not know the answer, (2) could not judge, (3) or the question was not applicable to them.

Fourteen of the remaining fifteen interviewees mentioned that the special purpose vehicle practices were either the same, or almost the same. Three of them indicated that the differences that exist are due to local laws, while one added that Islamic banks out of the Kingdom of Bahrain will try to engage in hiyal (legal stratagems or ruse) differently due to the local law of the Islamic bank. One of the thirteen interviewees also mentioned that the only difference he has witnessed is the choice of jurisdiction, “for example, an Islamic bank in Malaysia may prefer to establish a special purpose vehicle in Langkawi53 rather than the Cayman islands”. The below figure illustrates this matter:

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53 Langkawi is an archipelago made up of 99 islands on the west coast of Malaysia (Langkawi-Info, 2016).
As witnessed above, the majority of Islamic banking practitioners in the Kingdom of Bahrain are either not aware or not in a position to judge whether the international Islamic banking special purpose vehicle practice is similar or different than that of the Islamic banking industry of the Kingdom of Bahrain. This may indicate a limitation on conducting interviews as a data collection method when using a single case study design as a methodology.

6.2.7 Summary of Industry Feedback: Special Purpose Vehicle Practices

The industry feedback obtained from interviewees indicates that the majority of Islamic banks that engage in investment transactions use special purpose vehicles in their investment transactions. On the other hand, Islamic banking retail activities do not require special purpose vehicles. Out of the 31 interviewees who represented Islamic banks that use special purpose vehicles in their investment transactions, 90.3%54 indicated that special purpose vehicles are used in around 90% - 100% of their investment transactions. These figures indicate that the practice of using special purpose vehicles in Islamic investment transactions may be widely spread.

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54 \( \frac{28}{31} = 0.903 \times 100 = 90.3\% \)
Different reasons were obtained from interviewees relating to the reason(s) for why special purpose vehicles are used in Islamic investment transactions. These include creating a desired shareholding structure, risk management, limiting the liability of a bank, creating what is known as a bankruptcy-remote structure, taxation benefits, Shari’a compliance reasons, meeting regulatory requirements, amongst others. The reasons mentioned by interviewees were similar to those mentioned in the review of literature, except that the empirical work was linked to the case study jurisdiction (Kingdom of Bahrain), and Shari’a compliance as a reason was not mentioned the literature probably due to the fact that most of the literature relating to special purpose vehicles are from a conventional viewpoint. Minimal literature relating to special purpose vehicles in Islamic banking and the reasons for them being established were located.

The diversity of the interviewees proved beneficial since similarities in answers indicated a common understanding amongst different positions and sectors within the Islamic banking industry, while differences indicated that specific positions had similar understandings that were contrary to other positions (e.g. Investment managers’ understanding differed from Shari’a scholars). It appears that the nature and type of a position of an individual may impact his/her understanding and formulated his/her perceptions. Limitations may have existed since biasness may have existed and, by using a single case study design as a methodology, the majority of interviewees have similar backgrounds or experiences where responses may have lacked diversifications in some aspects.

Twenty-four interviewees that represented eight banks indicated that the Islamic banks they represent obtain conventional financings through special purpose vehicles. The answers relating to the reasons for why this practice exists varied. The interview analysis summarises that out of these eight Islamic banks, the interviewee responses tend to reveal that five of the Islamic banks engage in this sort of practice out of genuine causes, while the other three Islamic banks engage in hiyal (legal stratagems) to engage in prohibited activities and obtain conventional financings through the use of special purpose vehicles. These hiyal-based practices include investment teams not being fully transparent with the banks Shari’a body, in order to try and obtain a Shari’a approval for a special purpose vehicle structure that does not reflect the
reality underlying the transaction. Another hiyal-based practice witnessed includes the investment team obtaining an approval for a special purpose vehicle structure, thereafter changing the structure after the transaction has been executed and seeking a second Shari’a approval from the Shari’a Supervisory Board explaining that this alteration was out of necessity – while the whole process of these two approvals was pre-planned prior to the first approval. This was revealed by an Islamic investment manager who works as part of the investment team of an Islamic investment bank. Also, another considerable finding revealed in this chapter is that in reality, most Islamic banks, including those considered to have genuinely engaged in special purpose vehicle transactions, may have been commonly negating at least one major condition stipulated by their Shari’a Supervisory Board to sustain the transaction as Shari’a compliant.

It is unclear whether the Shari’a Supervisory Boards are unaware of the misleading practices, or are aware but report them internally. What may be suggested is that generally, Shari’a Supervisory Boards are not aware of these violations unless informed by the full-time in house internal Shari’a reviewers. This indicates a heavy and significant responsibility on the role and positions of internal Shari’a reviewers, especially in relation to the overall Shari’a compliance of Islamic banks. Yet, evidence suggested that a considerable number of internal Shari’a reviewers do not report such findings due to lack of awareness, lack of evidence, or management pressure. This may partially explain why Shari’a Supervisory Boards may not be officially and formally aware of hiyal (legal stratagems) practices taking place. Therefore, it may be important to further investigate if this crucial control function is properly protected? Who protects internal Shari’a reviewers? Is it the regulator or the backing of the Shari’a Supervisory Board? Can management influence internal Shari’a reviewers? Who decides whom to hire or whom to release from internal Shari’a review functions?

The secondary data analysis in chapter seven addresses a number of the above questions by analysing regulatory consultations regarding conventional special purpose vehicle practices by Islamic banks and management control functions, including the internal Shari’a review function.
6.2.8 *Shari’a Approval Structure*

The question of when the Islamic bank would submit a special purpose vehicle transaction to the *Shari’a* Supervisory Board for approval did not apply to fifteen out of thirty-five interviewees. The remaining twenty interviewees, without exception, all replied with almost identical answers. They explained that there are generally two phases of when the *Shari’a* Supervisory Board is exposed to a transaction: the initial stage, and the final stage.

The initial stage is when the concept (i.e. through a concept paper), an idea, initial proposal, or initial memo is submitted to the in-house *Shari’a* auditor for review. After reviewing the documentation, the internal *Shari’a* reviewer submits the initial documentation either to the *Shari’a* Supervisory Board (or executive members of the *Shari’a* Supervisory Board) for initial approval. Thereafter, after formalising the documentation (transaction structure, private placement memorandums, contracts, etc.), they are submitted to the *Shari’a* Supervisory Board for final approval.

Two of the twenty interviewees explained that although the *Shari’a* Supervisory Board approving a transaction in the initial and final stage is the policy of the bank, the reality is (1) Interviewee one: it is in the middle stages rather than the initial stages (2) Interviewee two: the investment department persists on not adhering to the process and are supported by the chief executive officer which “worsens” the actual process.

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55 This is because: Three interviewees represented Islamic retail banks not engaging in special purpose vehicle transactions. Two interviewees represented Islamic infrastructure organizations. Three interviewees represented external law firms. One interview represented a sovereign investment company (not an Islamic bank). One interviewee represented a conventional wholesale bank. One interviewee was a Board member and therefore this question is applicable to on-the-job practitioners. Two interviewees represented the regulator. Two *Shari’a* scholars are aware of when the transaction is revealed to them, but are not necessarily aware when the initial investment concept was initiated in the Islamic bank.
When is the *Shari’a* Supervisory Board (or SSB) exposed to a (SPV) structure or a transaction, and when do they approve/disapprove it?

![Diagram](image)

**Figure 32 Shari’a approval structure**

One interviewee, who was a former chief executive officer of an Islamic investment bank, stated:

“I wanted to see the *Shari’a* comments from the beginning…I did not even ask for commercial comments. I was keen to get a solution from the start. If it was doable, we went ahead. If not, we killed it right there and then [in the initial stage]”.  – Former Chief Executive Officer

The adoption of this sort of model where the chief executive officer is keen on obtaining a solution from the start annihilates the possibility of future complications or disputes (i.e. between the investment and *Shari’a* departments). This may also be indicatively evident since another interviewee revealed that a chief executive of an Islamic bank who did not adopt a similar method (who secretly supported the investment team to exhort pressure on the internal *Shari’a* reviewer to obtain approvals on non-*Shari’a* compliant structures) led to a situation where the chief executive officer was almost removed from his job due to mismanagement. This is
because this mismanagement led the bank to falling into a dilemma. The interviewee who discussed this matter explained that:

“Imagine, the sole reason for these unneeded events where the CEO stressed himself was only because he was persistent on supporting investment [the investment team] to deceive the Shari’a board and ‘bully’ the Shari’a auditor”.

– Islamic Bank Manager

Chief executive officers may need to take internal Shari’a matters seriously, who otherwise may find themselves in loopholes needing to utilise their time in rectifying approval processes and other operational work that may have been accomplished by subordinate employees. This as a result may also lead to ineffective management that may negatively affect the management capabilities of these chief executive officers. Regulators may also need to take these matters seriously, by implementing programs to educate chief executive officers of Islamic banks regarding these crucial Shari’a and corporate governance requirements that may not necessary exist in conventional banks. This is mainly due to the fact that the chief executive officer is the ultimate decision maker in an Islamic bank, who has the ultimate internal responsibility. The lack of a proficient chief executive officer may place the Islamic bank in unwanted situations. Also, if numerous Islamic banks were mismanaged, this would affect the industry in terms of practice and reputation, which may place the authenticity and Islamic banking industry at risk.

6.2.9 Non-Existence of a Shari’a-Approved Islamic Special Purpose Vehicle “Mother-Structure”

The question of whether an “Islamic SPV mother-structure” exists did not apply to fifteen interviewees, either because the question is related to an approval process and they were not full-time employees, or because they represent retail banks with no investment transactions.

Out of the remaining twenty interviewees who responded to this question, eighteen replied that a special purpose vehicle mother structure does not exist, and that the Shari’a approval for special purpose vehicle transactions was on a case-by-case basis.
Two of the eighteen interviewees added that they believe a special purpose vehicle mother structure should exist.

“For an SPV, new or existing, the approvals are on a case-by-case basis. The SSB (Shari’a supervisory board) must approve. Because there was major SPV abuses… For example, the Bank fully owned an SPV that gave a conventional loan to a (country) company. It is very difficult to follow SPVs because [they are] large in quantity. But then after [these] SPV abuses the SSB (Shari’a Supervisory Board) required all SPV (and wakala) transactions to be on a case-by-case basis in a written resolution” – Shari’a Manager

“It’s [the approvals for SPVs] a case-by-case basis, but I believe there should be a mother structure. Anyway…” – Islamic Bank Manager

“It’s on a case-by-case basis. The mother structures only exist for murābaha transactions, not SPVs.” – Shari’a Scholar

On the other hand, the two interviewees who mentioned that a mother structure did exist, explained that the in house Shari’a auditor would have to verify the structure prior to the transaction, and the Shari’a Supervisory Board would be notified after the transaction takes place. The below diagram illustrates these responses:

![Figure 33 Interviewee responses on whether a Shari’a-approved mother structure exists](image_url)

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6.2.10 Perceptions of Regulatory Circular regarding Shari’a Compliance and Special Purpose Vehicle

This research started with a quote from a Central Bank circular stating: “Following a round table discussion with the Waqf Fund involving several notable Shari’a scholars, it was observed that some SPVs associated with locally incorporated Islamic banks were not subject to Shari’a compliance review which has resulted in some SPVs to undertake activities that were not Shari’a compliant, or at least their activities had not been reviewed as Shari’a compliant.” (CBB Circular, 2013). This circular was issued in order to circulate a consultation paper to review possible amendments to the regulatory rules relating to special purpose vehicles. It is analysed in more detail as secondary data analysis in chapter seven.

Interviewees were asked what they thought of the circular extract. Eleven interviewees agreed with the statement and mentioned that the regulatory behaviour, indicating that this is part of the duties and responsibilities of the regulator, which is protecting stakeholders. The quotation below is an example:

“[The] CBB[‘s action] is perfect. The problem is with managements. The Shari’a supervisory boards gave them a solution (to use SPVs when necessary), but managements started to abuse them (SPVs). So this (Shari’a Supervisory Boards solution) opened the door for managements to [be able to] abuse them (SPVs). The CBB is excellent for having done this” – Shari’a Manager

Two interviewees however mentioned that this action comes quite late, shown below:

“They’re (Central Bank of Bahrain) late, but being late is better than doing nothing” - Compliance Officer

One of the interviewees elaborated, stating that the regulator changing a regulatory rules relating to wrongful Shari’a practices may not be sufficient. Rather, the regulator qualifying these types of amendments by allowing the Central Shari’a Board to comment on Shari’a matters would give it more credibility, as witnessed below:
“The CBB (Central Bank of Bahrain) is a regulator, if they see wrong implementations, they act. But changing the rulebook is not enough. The change must come as a direction from the Central Shari’a Board… But initiatives are being taken to establish a Central Shari’a Board and the rulebook change is clear - Yes, but you must qualify it with the Central Shari’a Board” – Shari’a Scholar

6.3 Opinions of Chief Executive Officers

The opinions of chief executive officers reflect the responses obtained from the third segment of interviews.

“First, we took [the] investment structure from the lawyers, they [the lawyers] said the IDB [Islamic Development Bank] used this, it was approved by their [Shari’a] board, including [Name of Shari’a Supervisory Board member of the Islamic Development Bank] and the rest… it all turned out to be wrong [the structure was not Shari’a compliant]. – Chief Executive Officer

During the analysis stages of the research, it was analysed that a common reason for Islamic banks falling into erroneous or non-Shari’a compliant transactions is due to them listening to lawyers, who confirm that the same structure was approved by another Islamic bank of banks. The following issues arise:

1. The lawyers are not aware of the specific details or conditions set out by the Shari’a Supervisory Board for approving a structure and transaction. An approved structure by one Islamic bank may be completely non-Shari’a compliant with another Islamic bank due to the details involved. The lawyers are not aware of this yet continue to provide Islamic banks with structures approved by other Islamic banks. For example and as displayed previously, an Islamic special purpose vehicle structure may include special purpose vehicles not legally owned by the Islamic bank that continuously engages in prohibited transactions or activities. This structure may be approved by one Shari’a Supervisory Board, because as a result of the conditions set out by the Shari’a Supervisory Board for this structure, the Shari’a Supervisory Board were provided evidential assurances that not only was the Islamic bank legally separated from the conventional
special purpose vehicles, but rather the Islamic bank had no indirect control, legal control, proxies, or any type influence on the conventional special purpose vehicles that engage in prohibited activities.

The law firm involved in this transaction would then be appointed by another Islamic bank. As a result, the law firm would provide the new client (Islamic bank) with the same structure, explaining that the Shari’a Supervisory Board of another Islamic bank approved it. This new Islamic bank would adopt this structure; replicate it, which would violate all the conditions set out by the Shari’a Supervisory Board of the previous bank. Therefore, two identical structures had the opposite Shari’a (Islamic law) rulings. Minimally, this new Islamic bank would have legal control and influence on the conventional special purpose vehicles that engage in prohibited transactions, which violates Shari’a (Islamic law). The next point discusses that part of the problem, was Islamic banks depending on other Shari’a Supervisory Boards rather than their own.

2. There were Islamic banks that executed a transaction based on the Shari’a approval of a Shari’a Supervisory Board of another Islamic bank. The Islamic investment managers revealed these structures to their Shari’a Supervisory Board after executing the transaction. According to an interviewee, and the annual reports of the Islamic bank the interviewee was referring to, at least one Islamic bank remained in a dilemma for five years trying to exit the investment due to it not being Shari’a compliant and simultaneously non-profitable.

A concept that seems to be difficult to understand may actually be very simplistic in nature. In order for Islamic investment managers to execute a transaction, they need the opinion and approval of their Shari’a Supervisory Board. As discussed in section 6.2.9, special purpose vehicle structures/transactions need to be approved by Shari’a Supervisory Boards on a case-by-case basis. For some reason and according to a chief executive officer, many Islamic investment managers fail to realise this. Another possibility is that it may be intentional. This leads to clashes between the Shari’a Supervisory Board and managements.
“Who told you? When I first became CEO of this bank, there were 4 or 5 aircrafts with conventional financings. When I first asked the investment team to start obtaining Islamic financings, they explained to me that the jurisdiction does not offer Islamic financings, and it was difficult to take Islamic financings. When I asked them [external financing party], it happened [external financing part started offering Islamic financing], keeping in mind that the party providing the finance is a Canadian company who may not have previously provided Islamic financings. Go to [employee name] and he’ll show you all the papers” - Chief Executive Officer

Whether an Islamic bank indirectly obtains conventional financings through special purpose vehicles, rather than obtain available Islamic financings may be dependent on the chief executive officer (CEO). As the ultimate decision maker within an organisation, the chief executive officer may instruct the investment team to find viable Islamic financing solutions. The researcher has witnessed an Islamic financial institution where the chief executive officer needed to retain the investment team (for certain purposes), and therefore may have been weak in terms of being the ultimate power or decision maker within the Islamic bank. When it came to the investment team not wanting to convert conventional financings to Islamic ones, the chief executive officer exhorted effort not to obtain Islamic financings and obtain conventional financings through special purposes vehicles. The amount of debates and arguments exhorted by the chief executive officer with the Shari’a Supervisory Board (that consisted of well-versed professors and scholars), trying to convince them that a certain special purpose vehicle (discreetly controlled by the Islamic bank) transaction with conventional financings should be deemed Shari’a compliant, raises questions about the roles or influence that chief executive officers may have on Shari’a Supervisory Boards and their fatwas (Shari’a legal opinions). In this regard, Shakir Ullah (2012) conducted a study regarding a hidden struggle between Islamic banking managers (which includes chief executive officers) and Shari’a managers (which includes Shari’a Supervisory Boards), suggesting that both may influence each other at times using certain methods. Shakir Ullah (2012) explains that Shari’a scholars want to issue rulings to attain the highest level of Shari’a compliance, while management want to influence the fatwas (Shari’a legal opinions) of the Shari’a Supervisory Boards to suit the business interests of the Islamic bank. But why do
managements influence Shari’a Supervisory Board decisions? Shari’a Supervisory Boards should have authoritative powers to exercise their rights and issuing opinions based on Shari’a (Islamic law) without the influence of management. More importantly, how do managements influence Shari’a Supervisory Boards? Does their compensation play a role in this regard? Shakir Ullah (2012) mentions that:

“…there are minor chances that Shari’a scholars would actually compromise on Shari’a compliance purely for their personal gains because of their strong sensitivity to eternal pressure. The majority of the Shari’a scholars are committed to the development of the industry and presenting it as an alternative to the conventional banking system so some of them work for Islamic banks even without compensation” (Shakir Ullah, 2012, p.69-70).

6.4 Opinions of Shari’a Supervisory Board Members

The opinions of Shari’a Supervisory Board members reflect the responses obtained from the third segment of interviews.

As discussed in section 6.2.5, a main question to be asked is whether an Islamic bank obtaining or providing conventional loans through separate legal entities, such as special purpose vehicles, was Shari’a compliant or not. Although the opinions of Shari’a scholars were almost unanimous and similar in nature, below are three detailed opinions of three Shari’a scholars pertaining to this matter (in order to understand the nature of their opinions):

**Shari’a Scholar One:** If, within an Islamic investment structure, a special purpose vehicle exists and engages in interest-based activities, then it may be acceptable if:

a) The Islamic bank is legally separated from the special purpose vehicle  
b) The Islamic bank may not legally control the special purpose vehicle  
c) The Islamic bank does not pay for the establishment costs of the special purpose vehicle  
d) The Islamic bank does not contribute to the capital of the special purpose vehicle
e) The Islamic bank does not have any sort of control over the special purpose vehicle

f) The Islamic bank may not manage the special purpose vehicle in any way

In other words, if the special purpose vehicle was actually owned by an external party, rather than legally structured in such a manner for *hiyal* (legal stratagems) purposes, then the Islamic bank literally has nothing to do with the special purpose vehicle.

**Shari’a Scholar Two:** If, within an Islamic investment structure, a special purpose vehicle exists and engages in interest-based activities, then it may be acceptable if:

a) The Islamic bank actually does not own the special purpose vehicle

b) The Islamic bank actually did not pay for the establishment of the special purpose vehicle

c) There are no legal documents indicating that special purpose vehicle is linked to the Islamic bank by forms of power, control, ownership, and name.

**Shari’a Scholar Three:** If, within an Islamic investment structure, a special purpose vehicle exists and engages in interest-based activities, then it may be acceptable if:

a) The special purpose vehicle has an actual physical presence

b) The Islamic bank may not request the establishment of a special purpose vehicle (or any entity) to engage in *riba*-based transactions, even if the Islamic bank does not own the special purpose vehicle or control it.

c) The Islamic bank may not manage the special purpose vehicle in any form.

d) The Islamic bank may not pay or be involved in the establishment of the special purpose vehicle.

All responses obtained from *Shari’a* scholars were similar to the above opinions. This indicates that this opinion may be common amongst *Shari’a* scholars. Furthermore, although not conducted through official interviews or included within the study, the

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56 For the term “control” the *Shari’a* scholar used an Arabic term, called “*saytara*”, which the researcher translated as control.
above opinions were further verified by at least twelve other Shari’a scholars serving on numerous Shari’a Supervisory Boards of Islamic banks, central banks, and international Islamic infrastructure organisations. It appears that there may be an ijma’ (consensus) relating to the essence of the above opinions by Shari’a scholars pertaining to special purpose vehicles. It would be useful to pose this question to the Shari’a scholars at Majma’ Al-Fiqh (International Islamic Fiqh Academy) to obtain a Shari’a ruling on this issue on an institutional level, which may also determine whether an ijma’ (consensus) exists relating to the essence of the above opinions, and if not, to find out what the other opinions are.

As witnessed in the above Shari’a scholar opinions, common traits exist between all Shari’a scholar conditions for a special purpose vehicle transaction to be Shari’a compliant. Firstly and as mentioned earlier, it appears that there may be an ijma’ (consensus) amongst Shari’a scholars that Islamic banks engaging in conventional loans indirectly through special purpose vehicles are prohibited in Shari’a (Islamic law). Minimally however, evidence tends to suggest the vast majority of Shari’a scholars believe that Islamic banks indirectly engaging in interest-based activities through special purpose vehicles are not Shari’a compliant. Second, all Shari’a scholar opinions indicate that if the special purpose vehicle was “actually” an external party, and not legally structured by the Islamic bank for hiyal (legal stratagem) purposes, then the activities of the special purpose vehicle does not affect the Shari’a compliance of the Islamic bank. However, if the special purpose vehicle was partly established, influenced, managed, or controlled by the Islamic bank, then it is not Shari’a compliant. Interestingly and probably more strictly, the third Shari’a scholar opinion above, a highly qualified Shari’a scholar, who serves on countless of Shari’a boards and acts as the Shari’a Board chairman of major Islamic infrastructure organisations, mentioned that it is prohibited for Islamic banks to even “request” external parties to establish entities or special purpose vehicles to engage in interest-based activities. To emphasize, the condition was repeated three times by this scholar. This indicates that according to one of the most respected senior Shari’a scholars, it is strictly prohibited for an Islamic bank to solely “request” an external party to establish special purpose vehicles that engage in prohibited transactions such as interest-based activities. According to the same scholar, he mentions “Allah [God] curses the one who engages in riba?” - indicating, is it not obvious?
It was previously in section 6.3, that one of the misconceptions managements tend to have is that there is an approved “Islamic SPV structure with a conventional loan” as a mother structure, where such transactions do not need to be approved on a case-by-case basis. This may be due to the excessive amount of executed special purpose vehicle transaction with conventional loans, where investment managers believed that this was an approved mother-structure. Although this may understandably be difficult for investment managers to understand, evidence tends to suggest that there is not an approved mother-structure that includes special purpose vehicles and conventional financings.

However, according to one interviewee, this confusion seems to have spread out to a minority of Shari’a Supervisory Board members themselves. Due to the countless replications of the same structure, these members may have started to believe that if a special purpose vehicle were solely legally separated from the Islamic bank, it may engage in prohibited activities without affecting the permissibility of the transaction. Therefore, information relating to the Islamic bank requesting the establishment of these prohibited special purpose vehicles (and at times paying the establishment costs), amount of control, influence, or management, the Islamic bank has on the conventional special purpose vehicles may not have been asked for. The assumption of obtaining a structure that includes a “legally” separate entity may have inaccurately indicated there were no control-based relationships between the Islamic bank and conventional special purpose vehicles.

Although, when details relating to establishment costs, managerial influences, or other Islamic banks indirect relationships with these conventional special purpose vehicles were revealed to these Shari’a scholars, none of them approved the slightest relationship between an Islamic bank and the conventional special purpose vehicle. The most lenient opinion given in this relationship regard was that the Islamic bank may have a representative on the board of directors of the conventional special purpose vehicle as an observer, without any control, say, or power. This was in order for the Islamic bank to be aware of the activities of the special purpose vehicles.
6.5 Conclusion

A total of forty-four interviewees were interviewed for this research. All interviews were face-to-face interviews. The interviewees included internal Shari’a reviewers, investment managers, compliance managers, Shari’a Supervisory Board members, chief executive officers, members of boards of directors, lawyers, the regulator, amongst others.

According to the study conducted in this chapter, evidence tends to suggest that special purpose vehicles are used in almost 90% - 100% of Islamic investment transactions. Special purpose vehicles are used for a number of reasons, including designing the shareholder structure, creating bankruptcy-remote structures, limiting the liabilities of Islamic banks, taxation purposes, Shari’a compliance purposes, engaging in hiyal (legal stratagems) to ultimately engage in prohibited activities, or using special purpose vehicles as a makhraj (Shari’a solution to a current problem).

A main challenge that exists within the Islamic banking industry may be the engagement of hiyal (legal stratagems) by investment managers, through special purpose vehicles, to ultimately engage in prohibited activities. Evidence tends to suggest that to a certain extent, some investment managers at Islamic banks engage in hiyal (legal stratagems) practices with Shari’a Supervisory Board members by structuring transactions in a manner portraying it as Shari’a compliant, by not revealing the reality underlying the structure and transaction process. The underlying reality of the structures and transactions reveals that some Islamic banks engage in interest-based transactions through special purpose vehicles by violating Shari’a conditions stipulated by Shari’a Supervisory Boards. The continuity of such actions, and the ability of its continuation, indicates that there may be a weakness within internal Shari’a reviewers in the Islamic banking industry.

In support of this argument, many Shari’a Supervisory Board fatwas (legal opinion) and resolutions shown to the researcher during the course of the interview process revealed that Shari’a Supervisory Boards have approved structures and transactions that have not been executed in the same manner explained to the Shari’a Supervisory Board when their approval was sought. This may serve as a further indication that a
weakness exists within internal Shari’a reviewers in the Islamic banking industry, which needs to be strengthened. For example, many Islamic banks, whether having engaged in conventional financings through genuine or *hiyal* (legal stratagems) practices, have either:

1. Some sort of control, whether legal or otherwise, over the conventional special purpose vehicle.
2. Partly or fully paid for its establishment cost.
3. Hidden proxies obtained by the Islamic bank from the special purpose vehicle providing them full control.
4. Fully or partly manage the special purpose vehicle.
5. Influence the special purpose vehicle, for example, through board representatives.
6. Negotiate conventional deals on behalf of the separately legal special purpose vehicle.
7. Requested an external part to establish the special purpose vehicle (this was not acceptable to only one Shari’a scholar, however many of the Islamic banks he represents have requested external parties to establish special purpose vehicles to engage in interest-based activities).
8. Some or all of the above

Although Shari’a Supervisory Boards issued *fatwas* (Shari’a legal opinions) approving many special purpose vehicle structures that include conventional financings, evidence tends to suggest that the information they based their opinions on may not be totally accurate. Also, many Islamic banks commonly violate at least one necessary condition placed by these Shari’a boards to sustain the transaction as Shari’a compliant. Based on this information, it appears that many Shari’a Supervisory Board *fatwas* (Shari’a legal opinions) relating to special purpose vehicle transactions may need to be revised, in order to address loopholes that may have enabled investment managers to exploit or take advantage of. Minimally, Shari’a Supervisory Boards and the regulator may want to consider new methodologies to strengthen and protect internal Shari’a reviewers, since they are the main component responsible to conducting internal Shari’a audits and informing Shari’a Supervisory Boards of the realistic practices taking place.
7. Chapter Seven: Practice and Behaviour of the Islamic Banking Industry towards Special Purpose Vehicles

The below figure highlights the position of chapter seven in light of the research outline:

Figure 34 Chapter Seven Position
7.1 Introduction

Since this thesis aims to investigate the practice of special purpose vehicles within the Islamic banking industry, it was explained in the research methodology chapter that this would be done through the analysis of primary data, which was done in chapter six, and the analysis of secondary data, which is included in this chapter. The main selected secondary data used for analysis in this chapter are:

1. Annual reports, which includes financial and Shari’a Supervisory Board annual reports.
2. Publicised regulatory consultations with the Islamic banking industry, especially those relating to special purpose vehicle practices and Shari’a compliance.
3. A contemporary executed special purpose vehicle transaction structure executed by an Islamic bank, a structure that is widely used by Islamic banks.

7.2 Special Purpose Vehicle usage by the Islamic Banking Industry

One of the key secondary data related to Islamic banks are the annual and financial reports. A review of secondary data for a sample of nine Islamic banks (displayed in Appendix V) revealed that all of these Islamic banks use special purpose vehicles, which indicated that the majority of Islamic banks use special purpose vehicles. In chapter six, the analysis of interviews also revealed that the majority of Islamic banks use special purpose vehicles in their investment transactions. Therefore, the results of both the primary and secondary data analysis are in conformity with each other. This may also support the notion that special purpose vehicles are widely spread in the Islamic banking industry, and are merely tools used in investment transactions.

7.3 Behaviour of Shari’a Supervisory Boards towards Special Purpose Vehicle Abuse

According to the Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI), Shari’a Supervisory Boards are required to issue an annual Shari’a Supervisory Board report (AAOIFI, 2015g). Shari’a Supervisory Board annual reports usually have a standard format, adhering to the Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI) requirements (AAOIFI, 2015g). General statements are made in the report relating to their review and where necessary, specific statements are made by the Shari’a Supervisory Boards.
if they feel the need to inform the shareholders regarding specific issues or transactions within an Islamic bank. Furthermore, most of the Shari’a audits conducted by the internal Shari’a review function result in the issuance of Shari’a audit reports that are circulated to the management and Shari’a Supervisory Board of the respective Islamic bank. These reports remain confidential due to the sensitivity of the information, such as internal audit or any other internal report. Therefore, it may be imperative to note that detailed internal Shari’a audits would not generally be publicised.

A review of Shari’a Supervisory Board annual reports of nine Islamic banks evidences that Shari’a Supervisory Boards referring to specific special purpose vehicle transactions in their annual reports was minimal. However, since Shari’a Supervisory Boards may refer to specific transactions in its annual reports if they feel the need to do so, the Shari’a Supervisory Board of one Islamic bank in the Kingdom of Bahrain chose to reveal in its annual report that it did not deem a special purpose vehicle transaction(s) executed by the Islamic bank they represent to be Shari’a compliant. The Shari’a Supervisory Board annual report mentioned two points that the internal Shari’a audit of the bank revealed, one of them being the following:

“…2. The Bank reviewed a ‘draft’ agreement between SPV’s and the conventional lenders without taking prior approval from Shari’a Board to review such agreements. The Shari’a Supervisory Board considered this to be a violation of its pronouncements in this regard and therefore requested that any profits on the financing be waived to regularize the matter which was agreed by the Bank’s Management.” (2013 Annual Report, Islamic Bank)

In analysing the rhetoric in the above statement, since the Shari’a Supervisory Board considered the Islamic bank reviewing conventional agreements between special purpose vehicles and conventional lenders as a violation to its pronouncement, indicates that the Shari’a Supervisory Board had a pronouncement that included the prohibition of the Islamic bank reviewing these conventional agreements. Furthermore, the fact that the Shari’a Supervisory Board chose to reveal this in their

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57 The parties internal Shari’a audits are circulated to may differ depending on the policy and procedure of an Islamic bank. Regardless, internal Shari’a audit reports are confidential reports that are generally not publicised.
annual report rather than solely being mentioned in the internal Shari’a audit report reveals a sense of importance to the violation. According to the financial reports of this Islamic bank, the abovementioned violation refers to its aviation portfolio.

The Shari’a Supervisory Board annual report further mentioned that this finding was revealed by the internal Shari’a audit function. Therefore and as suggested in chapter six, since the Shari’a Supervisory Board became aware of such violations from the internal Shari’a audit report(s), this reveals the significance of the internal Shari’a audit practice. The lack of efficient internal Shari’a auditing or control would not have revealed this point to the Shari’a Supervisory Board, where transparency may not have been practiced towards the Shari’a Supervisory Board. In turn, the Shari’a Supervisory Board may not have revealed the violation in its annual report that was publicised to shareholders. This may strengthen the argument that the internal Shari’a control function is key to adequate transparency for an Islamic bank. The lack of a strong internal Shari’a control function may weaken the bank in terms of Shari’a compliance, even if the bank has a superb Shari’a Supervisory Board. This is simply because the Shari’a body involved in the day-to-day transactions of an Islamic bank is the internal Shari’a control function under the guidance of the Shari’a Supervisory Board, rather than the Shari’a Supervisory Board itself.

To reiterate, this analysis supports the suggestions claimed in chapter six, where the internal Shari’a audit control function may be a crucial and integral part of the Shari’a governance framework of an Islamic bank. An efficient internal Shari’a control framework is crucial in order for Shari’a Supervisory Boards to be aware of the banks activities and to issue efficient pronouncements reflect the underlying banking realities.

Another evidence that may indicate the significance of the internal Shari’a control function is that the same Shari’a Supervisory Board reiterated in its annual report of the following two years (2014 and 2015), that the same non-Shari’a compliant activity had continued and therefore asked management to disclose it in the annual general meeting (AGM) to shareholders. This may suggest that the Shari’a Supervisory Board was aware of what transactions to specifically consider for review.
due to the internal Shari’a audit report of the previous year. The statement mentioned by the Shari’a Supervisory Board in its 2014 and 2015 annual report is as follows:

“An audit of the Bank’s activities brought attention to the continuation of the 2013 Shari’a audit observation that the Bank renewed a conventional financing facility associated with leased aircrafts.” (2014 and 2015 Annual Report, Islamic Bank)

The 2014 annual report of the Islamic bank also revealed that as a result of the aviation portfolio of the Islamic bank (in which the special purpose violations existed, according to the financial reports), the Islamic bank reported a loss of $52.3 million in the following year. This is evidenced in the statement of the chief executive officer when he stated “[Bank name] has reported a loss of $52.3 million (consolidated loss of $58.9 million) for the year ended 31st December 2014” (2014 Annual Report of the Islamic Bank), as well as the consolidated financial statements for the year ended 31 December 2014. This evidences that despite the bank entering into non-Shari’a compliant special purpose vehicle violations as determined by the Shari’a Supervisory Board in its annual report, the bank nevertheless ended up encountering a massive loss. This implies that the conventional financings obtained were not necessarily needed, where the investment did not positively commercialize. Also, the investment did not protect the māl (wealth) of the shareholders, which means the transaction was against maqāsid al-shari’a (objectives of Islamic law) (Al-Ghazālī 2008 and Al-Būtī 2009).

Since evidence suggests that the abovementioned Islamic bank violated Shari’a (Islamic law), does this mean that this bank should not be considered Islamic? The researcher argues that the above evidences only prove the opposite. This is because, since Islamic banks are managed by humans (who by nature are creatures of error), the Shari’a governance framework installed enables the internal Shari’a reviewer to report similar observations, where the Shari’a Supervisory Boards are made aware and act/decide accordingly. In other words, if an Islamic bank were perfect, would it need an internal Shari’a reviewer or a Shari’a Supervisory Board?
The challenge may be those Islamic banks that have engaged in similar violations, but have not reported in internal *Shari’a* audit reports or *Shari’a* Supervisory Board annual reports. This is simply because these Islamic banks are able to repeatedly engage in similar violations without being spotted. Many reasons may exist pertaining to why similar violations are/were not reported. For example and as suggested in chapter six, the internal *Shari’a* reviewer may not be aware such violations, or may be subject to management pressure that makes it very difficult to report these types of observations.

### 7.3.1 Comparing Industry Feedback and *Shari’a* Supervisory Board Annual Reports

The evidence from the primary data analysis in chapter six indicates that out of eight Islamic banks that engage in conventional financings, five of them do so through genuine causes, while three Islamic banks use *hiyal* (legal stratagems and ruses) against the *Shari’a* body of the Islamic bank. However, the review of *Shari’a* Supervisory Board annual reports in this chapter reveals that only one *Shari’a* Supervisory Board mentioned special purpose vehicle violations in its annual report. The following summarises a number of possibilities for this finding:

1. *Shari’a* Supervisory Boards are not aware of certain special purpose vehicle violations; or
2. The violations were solely internally mentioned in internal *Shari’a* audit reports where the *Shari’a* Supervisory Board decided not to disclose such violations; or
3. The violations were not spotted or not mentioned by the internal *Shari’a* function

Regarding the third point above, it may be important to reiterate that evidence in chapter six suggested that a considerable amount of internal *Shari’a* reviewers may not officially report special purpose vehicle violations in internal *Shari’a* audit reports due to lack of awareness, lack of evidence, or management pressure. To elaborate on management pressure, if internal *Shari’a* reviewers do not feel protected, the freedom to conduct their jobs truthfully may be difficult since their jobs may be jeopardized.
The exception to this may be internal Shari’a reviewers who are willing to place the sincerity of conducting their jobs over their job interests. As the evidence in this chapter (along with chapter six) indicates the significance of internal Shari’a control functions, and that Shari’a Supervisory Boards are not aware of the Islamic banking practices except through these internal Shari’a control functions, the lack of protection for internal Shari’a reviewers may lead to weaknesses in the Islamic banking industry. The Central Bank and the Shari’a Supervisory Board may need to ensure that proper protections are in place to protect internal Shari’a reviewers.

Imagine an internal Shari’a reviewer with a mortgage, being cornered into a situation where revealing a Shari’a audit finding may jeopardize his job. However, concealing the finding would protect his job. Does this not suggest that managements may influence internal Shari’a audit observations if internal Shari’a reviewers feared the risk of losing their jobs? How many would actually risk their jobs to sustain Shari’a compliance?

Since the evidence in chapter six suggests that a considerable number of internal Shari’a reviewers may not officially report special purpose vehicle violations in internal Shari’a audit reports, this may serve as a partial explanation as to why the mentioning of special purpose vehicle violations in Shari’a Supervisory Board annual reports may be minimal.

7.4 Regulator Behaviour towards Special Purpose Vehicle Abuse

Numerical data relating to the amount of special purpose vehicles established by Islamic banks in the Kingdom of Bahrain published by the regulatory body in the Kingdom of Bahrain was not available during the course of the research. Secondary data relating to the regulatory behaviour towards special purpose vehicles may be witnessed through a circular proposing change to the Central Bank of Bahrain (CBB) Rulebook sections relating to special purpose vehicles. The below extract is from a circular circulated proposing the changes:

“Following a round table discussion with the Waqf Fund involving several notable Shari’a scholars, it was observed that some SPVs associated with
locally incorporated Islamic banks were not subject to Shari’a compliance review which has resulted in some SPVs [special purpose vehicles] to undertake activities that were not Shari’a compliant, or at least their activities had not been reviewed as Shari’a compliant.\footnote{This paragraph extract was used in the introduction chapter and as part of the interview questions}

The suggestion was made that such SPVs [special purpose vehicles] should be monitored by the Shari’a Supervisory Board(s) of the concerned bank(s). This would provide reassurance to stakeholders in the concerned SPVs [special purpose vehicles] and banks that the principle of Shari’a compliance was being upheld by Bahraini banks in all of their activities and associated entities.

As a result of the feedback presented at the meeting and in subsequent discussion and correspondence, the Central Bank of Bahrain is proposing changes to module PCD (Prudential Consolidation and Deduction Requirements)\footnote{Although the circular mentions the PCD (Prudential Consolidation and Deduction Requirements), the finalized changes was later transferred (as of January 2016) to the BR (CBB Reporting Requirements) Module, (CBB, 2016)} for Volume 2\footnote{Volume 2 of the Central Bank of Bahrain (CBB) Rulebook is the volume related to Islamic banks.} of the CBB Rulebook\footnote{The CBB Rulebook is the set of regulatory rules banks (and financial institutions) in the Kingdom of Bahrain are obliged to abide by.}. Shari’a compliance is at the heart of Islamic banking and these proposals represent specific comments and thoughts on best practice relating to Shari’a. These changes should apply not only to new activities and SPVs [special purpose vehicles] but also to existing and legacy SPVs [special purpose vehicles] and their associated assets, liabilities, and transactions.

[…] recipients should also address how to deal with transitional arrangements for existing SPVs [special purpose vehicles] which may not be fully compliant or which have not been reviewed for Shari’a compliance.” (CBB Circular, 2013, p.1)

Along with the interviewee responses analysed in chapter six, the first paragraph in the above circular further suggests that some special purpose vehicles associated with Islamic banks were undertaking activities that were not Shari’a compliant. Furthermore, after providing a suggestion, a statement read, “This would provide reassurance to stakeholders in the concerned SPVs [special purpose vehicles] and
banks that the principle of Shari’a compliance was being upheld by Bahraini banks in all of their activities and associated entities”. This implies that the behaviour of the Central Bank of Bahrain involves exhorting effort to reassure stakeholders of the Shari’a compliance authenticity of the special purpose vehicles, and that regulatory procedures are taking place. This may also indicate that the regulatory behaviour is that of a reacting one, where it approaches challenges by responding with action.

The statement “Shari’a compliance is at the heart of Islamic banking…” suggests that the Bahraini regulator believes that Shari’a compliance should be upheld by banks claiming to be Islamic, or in other words, licensed Islamic banks. The fact that the circular was circulated, and effort was exhorted in proposing regulatory changes to special purpose vehicle practices by Islamic banks may confirm this point. However, many interviewees in the second segment of interviews in chapter six believed that although this action was a positive response by the regulator, it nevertheless comes at an excessively late timing.

7.5 Islamic Banking Industry Reaction to Regulatory Changes

The Islamic industry feedback regarding special purpose vehicle Rulebook changes were obtained from the regulator and are analysed in this section. The analysis includes industry feedback obtained from five Islamic banks.

According to the regulatory proposed changes (displayed in Appendix VI), it is evident that the regulatory behaviour is that which is concerned regarding the discrete nature of special purpose vehicles, by making it mandatory for Islamic banks to provide additional information, before the Central Bank could issue an approval to establish a special purpose vehicle. This additional information includes:

“PCD-4.1.3 The CBB requires any locally incorporated bank associated with an SPV to confirm the following points in any request for approval under Paragraph PCD 4.1.2:

(a) The purpose of the SPV; (b) The nature of the relationship between the bank and the SPV (e.g. originator, sponsor, manager, investor, controller etc.); (c) The bank management’s proposed consolidation/accounting treatment of the SPV in relation to the concerned bank both for PIR and audited financial
statements’ purposes and the bank should agree the treatment of the SPV with its external auditor and confirm the same to the CBB; (d) The availability of financial and other information relevant to the SPV and access to its business premises and records; and (e) Whether the bank is providing any guarantees, warranties or financial/liquidity support of any kind to the SPV. (f) That the Shari’a Supervisory Board of the Bank has approved the whole investment structure involving the use of the concerned SPV(s) and a written copy of such SSB approval must be submitted with the notification.” (CBB, 2014, p.1-3)

The above also evidences the regulator proposing a requirement for Shari’a Supervisory Boards to issue an approval prior to issuing the regulatory approval. However, the researcher argues that with the a possible lack of a strong internal Shari’a control function, the Shari’a Supervisory Board approvals are easy to obtain through the use of hiyal (legal stratagems).

As part of the feedback obtained regarding the abovementioned proposed change, an Islamic wholesale bank mentioned that:

“It is not practical to acquire the SSB [Shari’a Supervisory Board] approval on the Structure & the use of the SPV and overlook the later practices or changes in the SPV, as some changes might have Sharia implications. The recommended rectification will condition acquiring the SSB approval on any changes that request CBB approval” (CBB, 2014, p.2-3).

The impracticality of acquiring the Shari’a Supervisory Board approvals for future changes in executed special purpose vehicle transactions must be addressed, rather than relaxing the rule. During the interview analysis in chapter six (section 6.2.2.6), evidence tended to suggest that a minority of investment managers seek an approval by the Shari’a Supervisory Board for specific special purpose vehicle structures, with a hidden intention to alter the structure later on, which was revealed by an investment manager interviewee within the investment team. The reason why their actions were in such a way may probably be due to their prior knowledge that if their preferred structure were applied to the Shari’a Supervisory Board from the start, it would not have been approved due to obvious non-Shari’a compliant factors. However, the alteration of an already executed structure may be Shari’a-approved due to exceptions
or necessities to save the transaction from having major negative financial implications. This method may serve as one example of how *hila* (legal stratagem) may be practiced by Islamic banks.

The second proposed change by the regulator was as follows:

“PCD-4.1.3A In addition to the points noted in PCD-4.1.3 above, banks which are involved with SPVs in any of the relationships described in PCD-4.1.2 must not allow such SPVs to obtain any conventional financing to fund themselves or any transactions that they enter into. Shari’a compliance must be written into the memorandum and articles of association of such SPVs so that entry into structures or transactions that are not Shari’a compliant is ultra vires.” (CBB, 2014, p.3-4)

Another indication that the Bahraini regulator is keen to ensure Shari’a compliance may be since it directly stated that Islamic banks “must not allow such SPVs [special purpose vehicles] to obtain any conventional financing to fund themselves or any transactions that they enter into. Shari’a compliance must be written into the memorandum and articles of association of such SPVs so that entry into structures or transactions that are not Shari’a compliant is ultra vires” (CBB, 2014, p.3). One investment manager mentioned during an interview: “who are the CBB [Central Bank of Bahrain] to issue such a statement? We have a Shari’a board to tell us what is Shari’a compliant or not. They are interfering with the work [meaning duties] of the Shari’a board”. Although this statement may have been harshly expressed, it nevertheless may rightfully imply that the proposed changes (or any Shari’a related changes for that matter) for special purpose vehicles and Shari’a compliance must be qualified by the Central Shari’a Board, which did not exist during the consultation period, but was appointed in 2016.

The regulator further proposed that the Shari’a Supervisory Board of the Islamic bank must monitor the ongoing Shari’a compliance of special purpose vehicles on a continuing basis, as displayed below:
“PCD-4.1.3C The Shari’a Supervisory Board of the Bank must monitor on an ongoing basis the Shari’a compliance of the SPVs and must oversee the conduct of the annual Shari’a compliance review of transactions, assets, liabilities and other commitments and relationships entered into by all SPVs with which the concerned bank is involved (by way of the relationships described in PCD 4.1.2 above). The Shari’a compliance function of the bank would be required to perform such reviews.” (CBB, 2014, p.4)

However, some Islamic banks believe that such directives puts heavy responsibility and trust on Shari’a Supervisory Boards (CBB, 2014). Regarding the above proposed change, a bank noted that “the clause is putting heavy responsibility & Trust on the SSB, Such responsibility on the SSB and the Sharia function must be parallel to a sufficient power of & proper reporting system” (CBB, 2014, p.4).

Although the publicised industry comments for the Islamic wholesale banking industry were specific comments relating to each draft directive, the regulator publicised both general and specific comments on the proposed CBB Rulebook changes for the Islamic retail banking industry (CBB, 2014a). An example of a general Islamic banking industry feedback is as follows:

“A bank noted that they humbly submit that additional regulations imposed will put Islamic Banks operating in the Kingdom at a further disadvantage compared to their conventional peers. They are concerned that having to seek Shari’a Supervisory Board (“SSB”) approval on new SPVs prior to seeking CBB written approval will result in longer turnaround times leading to Islamic banks being less competitive in the market place. Therefore, they urge the CBB to consider providing conditional approval for establishing new SPVs parallel to obtaining SSB approval” (CBB, 2014a, p.1).

The above statement indicates that the secondary data related to industry feedback and the interview analysis in chapter six is in conformity with each other. Both sets of feedback suggest that the Islamic banking industry expresses concern relating to additional Shari’a compliant regulations, where they believe places them in a disadvantageous situation relative to their conventional peers. Another Islamic bank held the view that existing regulatory rules sufficed, as displayed below:
“A bank noted that CBB is assured that it has adequate procedures in place to ensure Shari’a compliance in all its activities including establishing SPVs to hold Bank’s investments. While they recognize the need to uphold Shari’a compliance at all levels in the conduct of Islamic Banks, non-compliance may be the exception and not the rule. Therefore, they believe that currently there are sufficient regulations to govern Islamic banks and further regulation will only make the industry less competitive” (CBB, 2014a, p.2)

An interesting point raised by this Islamic bank is that “non-compliance may be the exception and not the rule” (CBB, 2014a, p.2). This point is imperative to understand because; it implies that non-compliance, as a rule is obviously problematic. This research is concerned with these types of non-compliance, where it is as if non-Shari’a compliance is a policy or procedure. Exceptions may exist in all arenas or industries. It may be suggested that the only way Islamic banks may continue to practice non-Shari’a compliance on a repetitive continuous basis is if its internal Shari’a control function does not report violations in its findings within internal Shari’a audit reports, or if their Shari’a Supervisory Boards are weak, or lastly, if managements simply do not listen or adhere to Shari’a requirements. Regarding the last possibility, management continuously ignoring Shari’a requests may only arise if the chief executive officer has either set a system in place that allows the practice to continue, or did not rectify an existing flaw that enables ignoring Shari’a requirements. This may indicate that the chief executive officer plays a significant role, and is partially responsible for maintaining Shari’a compliance, since the chief executive officer has the ultimate authority and power internally in an Islamic bank.

As suggested in chapter six and earlier in this chapter, internal Shari’a reviewers may play a crucial role in attaining Shari’a compliance. This is because the Shari’a Supervisory Boards are not aware of violations except through the internal Shari’a reviewers. Also, since chapter six (section 6.3) and the analysis in this section highlights the crucial role of chief executive officers in maintaining Shari’a compliance as the ultimate authority or decision makers, it may be suggested that attaining and maintaining Shari’a compliance is a responsibility upon both the Shari’a body and senior managements. This suggestion may lead to the importance of understanding the relationship between Shari’a managers (Shari’a Supervisory
Boards and internal Shari’a reviewers) and managements. As suggested by Shakir Ullah (2012), a hidden struggle to maintaining Shari’a compliance already exists within Islamic banks between these two bodies, where the Shari’a body continuously tries to issue rulings to adhere with Shari’a (Islamic law), while managers exhort efforts to influence these Shari’a (Islamic law) rulings to meet their business objectives. But can management influence Shari’a Supervisory Board rulings? This re-raises a similar question posed in section 6.3, which was, how could managements influence Shari’a Supervisory Board rulings?

7.6 Regulator Action to Protect Control Functions at Islamic Banks

The analysis of secondary data in previous sections emphasized on the significance of internal Shari’a control functions of Islamic banks. Therefore, the protection of persons in this (and other) control functions is thus vital. Regarding this topic, in 2014, the Central Bank of Bahrain circulated a consultation paper for the banking industry proposing to require Islamic (and conventional) banks to obtain prior approval if they were to dismiss persons in control functions, such as internal audit, risk management, compliance, anti-money laundering, and Shari’a compliance (CBB, 2014b). The following was the proposed rule:

“Where a person occupies a position in an internal audit, risk management, AML, compliance function or internal Shari’a review, of the bank [financing company], and the bank [financing company] wishes to dismiss or suspend the subject person, the bank [financing company] must seek the CBB’s prior written approval before the proposed dismissal or suspension takes place and communicated to the person involved” (CBB, 2014b, p.1)

A total of twenty-four sets of feedback were obtained from the Islamic banking industry. Due to many feedbacks received from the banking industry that may be considered reasonable, the Central Bank of Bahrain decided that a notification after the dismissal will apply, and did not implement the requirement of prior approval before dismissal. An example of reasonable feedback is that employees who exercise fraudulent activities must be terminated immediately, since retaining such employees until obtaining the approval of the regulator may cause further damage or risk to the bank.
Although the action of the regulator to modify the proposal removing the requirement for banks to obtain prior approvals before dismissing personnel in control functions may be reasonable, the researcher believes that the internal Shari’a review function should be distinguished from the remaining control functions. This is due to the significance of protecting internal Shari’a review functions, as suggested in this research. The data collected in this research, in addition to the analysis, indicates that managements may influence internal Shari’a reviewers to suit their interests. This in turn may affect the authenticity of the Shari’a compliance of the industry. Also, Shari’a Supervisory Boards may not be aware of Shari’a findings except through internal Shari’a reviewers. It may be beneficial to require a prior approval from the regulator if an Islamic bank chooses to dismiss an internal Shari’a reviewer. The corporate governance protection and prior approvals for dismissing persons in internal Shari’a review functions may need to be reconsidered in order to protect the authenticity of the Shari’a compliance of the Islamic banking industry. A possible suggestion would be to introduce new laws, rather than rules, to protect internal Shari’a reviewers.

The feedbacks further included Islamic banks alerting the regulator that employees in control functions may sometimes be cornered into forced resignations, which is technically not a dismissal, by stating “on the down side, the ‘unwanted’ employee could be cornered into a resignation situation, which is technically not a dismissal (CBB, 2014b, p.1). These types of comments may need to be taken into account if the requirement for Islamic banks to obtain prior regulatory approval for dismissing personnel in internal Shari’a review functions was considered, since hiyal (legal stratagems) may be practices in this regard as well.

7.7 Case Study: XYZ Islamic Bank

In order to understand a realistic investment structure adopted by Islamic banks, it may be imperative to illustrate a real life special purpose vehicle investment structures that was executed by an Islamic bank in the past. The interview process revealed many structures to the researcher, in which a common special purpose vehicle transaction structure existed. Therefore, the researcher obtained a structure commonly used, from an interviewee who agreed to display the investment structure
in this thesis. For confidentiality purposes however, the name of the Islamic bank has been altered to XYZ Islamic Bank. The structure will be explained and analysed in this section.

**Case No. 1 – Aircraft Leasing Structure of XYZ Islamic Bank**

The above structure is a contemporary structure that has been executed by an Islamic bank in the Kingdom of Bahrain. According to the lawyers appointed for this transaction, the above structure was designed to split between the Aircraft’s legal and economic benefits to satisfy commercial, legal, tax, and Shari’a requisites. Although the above may be a complex structure, from a Shari’a (Islamic law) perspective, the main issue would be to look at the conventional debt. As explained in chapter three, this is because in the Qur’an, Allah (God) has not only condemned *riba*, which interest is a part of\(^62\), but waged war against those who engage in such a malignant

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\(^{62}\) The concept of *riba* and interest was explained in chapter three. Although, it may be important to note that there are two types of *riba*: *riba al-fadhl* and *riba al-nasee’a*. The *riba* that exists in interest-based loans is *riba al-nasee’a* (Ishaq, 2016)
act. There is no question about the impermissibility of a conventional interest-based loan in the Qur’an and sunna (Prophetic traditions and sayings). In addition and as detailed in chapter three, there is an *ijma’* (consensus) on the prohibition of interest-based loans.

As illustrated in the above structure, the conventional debt that exists is from two banks (as senior lenders), offering a conventional loan to a special purpose vehicle (SPV) in the Bahamas, named “Novus XYZ FIN 5 Ltd”. This special purpose vehicle is owned by another special purpose vehicle, called “The Novus Foundation (Bahamas)”. Since both special purpose vehicles (SPVs), are owned by external parties and not XYZ Islamic bank, XYZ Islamic bank is legally separated from these special purpose vehicles. The conventional section of this structure is therefore displayed below:
The above structure displays that the conventional loan was obtained by a different legal entity, “Novus XYZ FIN 5 Ltd (Bahamas), and not the Islamic bank. This special purpose vehicle used the funds obtained from the conventional loan to purchase an Aircraft, where the title deed was transferred to “Novus XYZ FIN 5 Ltd (Bahamas)”.

After concluding this part of the transaction, where Novus XYZ FIN 5 Ltd (Bahamas) now owns the aircraft, “XYZ Leasing 5 Ltd (Bahamas)” - the special purpose vehicle that is partially owned by the XYZ Islamic Investment Bank and its Islamic investors, leases the Aircraft from its owners “Novus XYZ FIN 5 Ltd (Bahamas)”. As far as the Islamic bank is concerned, it is leasing an Aircraft from its original owners. XYZ Islamic Investment Bank is legally separated from the conventional loan. Thereafter, once the Aircraft is in the possession of “XYZ Leasing 5 Ltd (Bahamas)”, this special purpose vehicle partially owned by XYZ Islamic bank then leases (or sub-leases) the Aircraft to an airline company (e.g. Emirates, Gulf Air, British Airways, etc.). Therefore, the Islamic bank solely leased an Aircraft, thereafter legally sub-leased it to an airline company. So far, this is Shari’a compliant, because the Islamic bank is entering into Shari’a compliant ijāra (lease) agreements and investing in a Shari’a compliant (airline) industry. This is one of the key reasons why the Shari’a Supervisory Board of XYZ Islamic Investment Bank approved this structure. The Islamic / Shari’a compliant section of this structure is displayed below:
To summarise and as seen in figures 36 and 37, the transaction structure of XYZ Islamic Bank includes two sections: (1) A conventional and non-Shari’a compliant section with conventional loans, transacted by external parties and not the Islamic bank, and (2) an Islamic and Shari’a compliant section that includes ijāra (leasing) an aircraft to an airline industry, transacted by a special purpose vehicle partially owned by the Islamic bank and its Islamic investors. The below figure re-displays the full transaction structure, and clearly differentiates between the Islamic / Shari’a compliant section of the transaction and the conventional / non-Shari’a compliant section of the structure:
Displaying the Conventional / Non-Shari’a Compliant Section and the Islamic / Shari’a Compliant Section of the Transaction Structure

Up until this point and based on the diagrams plus the explanations provided in this section, it is now clear that XYZ Islamic bank has nothing to do with the conventional loan, and solely engages in Shari’a compliant transactions and activities. This is why the Shari’a Supervisory Board approved the transaction structure. The Shari’a Supervisory Board set a number of conditions for this transaction. Some of these conditions are summarised below:

1. The three legal entities associated with the Islamic Bank, namely XYZ Islamic Bank, XYZ Leasing Company (Cayman), and XYZ Leasing 5 Ltd (Bahamas), should not bear the establishment cost of “Novus XYZ FIN 5 Ltd (Bahamas)”, the external legal entity borrowing an interest-based loan.
2. The three legal entities associated with the Islamic Bank, namely XYZ Islamic Bank, XYZ Leasing Company (Cayman), and XYZ Leasing 5 Ltd (Bahamas), should not have control over “Novus XYZ FIN 5 Ltd (Bahamas”).

3. The three legal entities associated with the Islamic Bank, namely XYZ Islamic Bank, XYZ Leasing Company (Cayman), and XYZ Leasing 5 Ltd (Bahamas), should not have legal control or influence on “Novus XYZ FIN 5 Ltd (Bahamas”).

4. The three legal entities associated with the Islamic Bank, namely XYZ Islamic Bank, XYZ Leasing Company (Cayman), and XYZ Leasing 5 Ltd (Bahamas), may not bargain or negotiate the interest-bearing loan deals on behalf of “Novus XYZ FIN 5 Ltd (Bahamas)”.

5. The three legal entities associated with the Islamic Bank, namely XYZ Islamic Bank, XYZ Leasing Company (Cayman), and XYZ Leasing 5 Ltd (Bahamas), may not manage “Novus XYZ FIN 5 Ltd (Bahamas)” in any form, way, or method.

It is apparent from the above-summarised conditions, that the Shari’a Supervisory Board approved the structure, if “Novus XYZ FIN 5 Ltd (Bahamas)” was actually an external party, with no influence by the Islamic bank. This is where the challenge or the following questions arise: Who actually manages the conventional special purpose vehicles? Who actually paid for its establishment cost? Does the Islamic bank not have board representatives? Who ordered or initiated the establishment of the conventional special purpose vehicles? Would the conventional special purpose vehicle have been established if the Islamic bank did not ask for it? Who negotiated the rates for the conventional interest-based loans? And lastly, who controls this conventional special purpose vehicle? The same investment manager explained to the researcher:

“Yes, we’re [Islamic bank] not supposed to control them [Novus XYZ FIN 5 Ltd (Bahamas)]. But who do you think controls them? Who? Of course we’re controlling them” – Investment Manager, Islamic Bank

63 More leniently, in a condition stipulated by a Shari’a Supervisory Board of another Islamic bank for a similar structure, the Shari’a Supervisory Board mentioned that the respective Islamic bank they represent could not “legally” bargain the interest-bearing loan transactions. In other words, if the Islamic bank did so, it may be out of the hands of the Shari’a Supervisory Board. However, the Shari’a Supervisory Board tried to ensure that the Islamic bank did not have the legal authority to do so.
The investment manager explained the following realities:

1. The conventional special purpose vehicle (SPV) “Novus XYZ FIN 5 Ltd (Bahamas)” as a result of a request by the XYZ Islamic bank, through discussions with lawyers.

2. The conventional special purpose vehicle (SPV) “Novus XYZ FIN 5 Ltd (Bahamas)” is controlled by XYZ Islamic bank.

3. XYZ Islamic bank approaches conventional lenders, on behalf of “Novus XYZ FIN 5 Ltd (Bahamas)”, handpicks attractive interest rates, and negotiates the conventional deals.

4. “Novus XYZ FIN 5 Ltd (Bahamas)” does not execute a transaction, such as obtaining the conventional loan from a conventional lender, except with a “written” request by the Islamic bank.

5. According to the investment manager, the conventional special purpose vehicle, Novus XYZ FIN 5 Ltd (Bahamas), “does nothing without our [Islamic bank’s] request”.

Based on the above information, it appears that XYZ Islamic bank may have violated some, if not the majority of conditions set out by the Shari’a Supervisory Board to make the transaction Shari’a compliant. Although the structure may theoretically be considered Shari’a compliant due to the legal separation of the conventional special purpose vehicle and the Islamic bank, the practice conflicts with the conditions set by the Shari’a Supervisory Board to sustain the transaction as Shari’a compliant. This case study (unit of analysis) may act as an example and further support the argument put forth in section 6.2.3⁶⁴, which stated that the challenge is that many Islamic banks with similar structures violate similar conditions.

Evidence in this chapter along with chapter six unfortunately suggests that many Islamic banks, whether practicing genuinely, unknowingly, or misleadingly, control the conventional special purpose vehicles (SPVs) actions. According to an investment officer of a different Islamic bank, not only did the Islamic banks he was employed

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⁶⁴ Please refer to page 146
with have control over the conventional special purpose vehicles, he mentioned “we [Islamic bank] even negotiate the [financial] compensation for the board of directors of the [conventional] SPV [special purpose vehicle]”. This statement indicates that although the conventional special purpose vehicle is legally owned and controlled by an external party and not the Islamic bank, it is almost as if the Islamic bank fully owns and controls the conventional separated special purpose vehicles.

It was also observed when witnessing multiple contemporary executed transaction structures during the interview phase that were similar in nature, that Islamic banks might not have paid for the establishment costs, however provided financing to the mother company of the conventional special purpose vehicle in order to establish the conventional special purpose vehicles. Other Islamic banks directly established the conventional special purpose vehicles discretely through the lawyers. In many cases witnessed, at least one major condition to sustain the transaction structure to remain Shari’a compliant was being violated. This indicated to the researcher that this might be a reality that needs to be addressed.

The line between the Shari’a compliance and non-Shari’a compliance in the abovementioned case study structure may be considered thin. It may be Shari’a compliant since the Islamic bank has solely leased an aircraft and sub-leased it. However, it may be considered not Shari’a compliant not because of the structure, but rather because of the practice, where the “Aircraft Owner” is an external special purpose vehicle obtaining a conventional loan that is – in reality - managed and controlled by the Islamic bank. If the conventional special purpose vehicle was actually an external party, owned and managed by the external party, then the transaction structure may be considered Shari’a compliant.

When an entity buys a Shari’a compliant product, the method of how the seller originally purchased the product (whether through an advanced payment or a conventional loan) may not concern the buyer. As far as the buyer is concerned, he is buying a Shari’a compliant product from its legal owner. This is the basis for why most Shari’a Supervisory Boards approve similar structures.

65 The interviewee referred to here was the Head of Investment of at least three major Islamic investment banks in the Kingdom of Bahrain.
To conclude this section, the researcher came across similar transaction structures where the conventional special purpose vehicles were actually owned and controlled by an external party. An example of this is a computer company, who established a special purpose vehicle, transacted conventionally with external parties, thereafter executed transactions with other special purpose vehicles owned by an Islamic bank. The Islamic bank did not establish, control, nor influence the conventional special purpose vehicle. This means that the same structure that meets the Shari’a conditions may have no impact on Shari’a compliance. Therefore, it is often nearly impossible to tell whether a transaction is Shari’a compliant solely by looking at the structure. Rather, the transaction should be Shari’a audited to observe whether necessary Shari’a conditions have been met.

7.7.1 Applying the Developed Qualitative Criterion on the Case Study

The previous section illustrated, displayed, and holistically analysed a contemporary case study of a special purpose vehicle transaction executed by an Islamic bank in the Kingdom of Bahrain. In the research methodology chapter, a qualitative criterion was created in order to determine whether a special purpose vehicle transaction structure is Shari’a compliant or not. This section applies the created qualitative criterion to determine whether the transaction structure of XYZ Islamic bank is Shari’a compliant or not.

A. Application of Qualitative Criterion on XYZ Islamic Bank Transaction Structure

I. Test Question One: Is the business the Islamic bank is investing in Shari’a compliant?

Yes. XYZ Islamic Bank is investing in the airline industry offering international transportation services to the public. There is nothing in Shari’a (Islamic law) that prohibits individuals or entities to invest in the airline or transportation industry offering international transportation services. In fact, this may be encouraged due to its masālih (benefits) on the economy and society.
II. Test Question Two: Is there a Special Purpose Vehicle in the structure that will engage in non-Shari’a compliant activities or transactions?

**Yes.** There is a special purpose vehicle named “Novus XYZ FIN 5 Ltd (Bahamas)”, that engaged in a conventional based transaction, by obtaining a conventional interest-based loan.

III. Test Question Three: Does the Islamic Bank legally own the Special Purpose Vehicle that will engage in a conventional/non-Shari’a compliant transaction(s)?

**No.** The special purpose vehicle that obtained a conventional interest-based loan is “Novus XYZ FIN 5 Ltd (Bahamas)”, which is owned by “The Novus Foundation (Bahamas)” and legally separated from XYZ Islamic Bank.

IV. Test Question Four: Does the Islamic bank have any sort of control, whether direct or indirect, through proxies for example, on the non-Shari’a compliant separately owned Special Purpose Vehicle?

Legally, the answer is **No.** In the specific case of XYZ Islamic bank and during the approval-seeking stage from the Shari’a Supervisory Board, XYZ Islamic bank did not have legal control over the non-Shari’a compliant separately owned special purpose vehicle, namely “Novus XYZ FIN 5 Ltd (Bahamas)”. However, the investment manager later revealed to the researcher that in reality, XYZ Islamic bank does have control over the conventional separately owned special purpose vehicle, by receiving a proxy for example, in addition to other legal methods to gain control. This was pre-agreed between XYZ Islamic bank, the lawyers, and “The Novus Foundation (Bahamas)”. Therefore, although the Shari’a compliance analysis first mentioned No as the answer; this information indicates that the real answer is **Yes.** This raises the following question: Is the investment considered a *dharūra* (necessity)? The answer may be “no” as the transaction does not appear to have elements of *dharūra* (necessity), such as affecting food, clothing, housing, or other necessities.
V. Test Question Five: Is there evidence for hiyal (legal stratagems) taken place by an Islamic bank after executing the special purpose vehicle structure or transaction?

If one were to look at the documents outwardly, without revelations from the investment manager, the answer would be No. The investment manager also believes that it is up to the internal Shari’a reviewer to audit the investment transactions, observe non-Shari’a compliant findings (including XYZ Islamic Bank having control, indirectly establishing, continuously request in writing, and other non-Shari’a compliant actions with the conventional separately owned special purpose vehicle). The investment manager elaborated that these findings are supposed to be noted down in the internal Shari’a audit reports where corrective actions by the management should be taken. Hiyal (legal stratagems) may be considered practiced if the investment team hides necessary information requested by the Shari’a body.\footnote{It may be argued that since the investment team is aware of the violations, it may need to be considered as hiyal (legal stratagems) even if the internal Shari’a reviewer did not note down the violations. This issue may be subject to different interpretations.}

As a result of the answers to the above qualitative criterion, the following may be possible Shari’a (Islamic law) rulings to the transaction:

1. If XYZ Islamic bank has no legal control over the conventional SPV, then the transaction may be considered Shari’a compliant.
2. If XYZ Islamic bank obtained legal control over conventional SPV, then the transaction is not Shari’a compliant.
3. If XYZ Islamic bank does not have legal control over the conventional SPV, but in reality does control the SPV through other methods, then may depend on the interpretation of the Shari’a Supervisory Board. However, the researcher argues that if it was considered Shari’a compliant, the reality of the transaction must be displayed to the Shari’a Supervisory Board, regulators, and “others with the right to know” (Stewart, 2005, p.23). Engaging in a similar transaction through non-transparent practices negates the Shari’a compliance of the transaction.
In theory, the researcher concludes that the structure may be Shari’a compliant due to the legal separation between the Islamic bank and conventional special purpose vehicles, provided that Shari’a conditions are met. However, in practice, this structure may be considered misleading, which Shari’a Supervisory Boards may unknowingly continue to approve. This is because the reality pertaining to the practice of the transaction was revealed by investment managers, such as: (1) the Islamic bank ordering the establishment of the conventional special purpose vehicle, (2) Islamic bank paying for its establishment costs indirectly, (3) Islamic bank negotiating the conventional loans on behalf of the conventional special purpose vehicle, (4) Islamic bank managing the conventional special purpose vehicle, and (5) Islamic bank controlling the special purpose vehicle, amongst others.

Therefore, although in theory this structure may be Shari’a compliant, Shari’a Supervisory Boards may need to reconsider their approvals for similar structures due to the common reality of the practices that underlie these structures. Evidence tends to suggest that the practice commonly largely conflicts with conditions set out by Shari’a Supervisory Boards.

7.8 Conclusion

A review of annual reports for a sample of nine Islamic banks revealed that all of them use special purpose vehicles. This indicates that the majority of Islamic banks may use special purpose vehicles. This review also revealed that only one Shari’a Supervisory Board mentioned in their annual report that conventional financings with special purpose vehicle violations existed. Since chapter six suggested that more than one Islamic bank may have misused special purpose vehicles, this finding may suggest that the Shari’a Supervisory Boards of other Islamic banks are either not aware of special purpose vehicle violations or chose not to report them.

The findings also suggest that the regulator has exhorted effort to combat special purpose vehicle abuse by the minority of Islamic banks. However, it seems that the Central Bank of Bahrain rulebook changes may not be sufficient enough, where the newly appointed Central Shari’a Board may need to issue new rulings as the ultimate Shari’a authority in the Islamic banking industry. The findings emphasize on the importance of protecting internal Shari’a functions, since it is the only channel that
provides Shari’a review information to the Shari’a Supervisory Boards. Therefore, the regulator may need to protect the internal Shari’a control functions by introducing new legislation (rather than rules) that protects internal Shari’a reviewers. This may be true since Islamic banks may not specifically adhere to all rules, but would they risk not adhering to the law?

Lastly, an analysis of a real-life executed special purpose vehicle transaction suggests that the special purpose vehicle structure approved by the Shari’a Supervisory Board may be in theory, Shari’a compliant. This is because special purpose vehicles that engage in prohibited interest-based loans were legally separated from the Islamic bank. In practice however, the analysis revealed that the execution of the transaction structure by the Islamic bank might not be Shari’a compliant due to violating necessary Shari’a conditions. For example, the Islamic bank manages, influences, and controls the conventional special purpose vehicle, which negates the Shari’a compliance of the transaction structure.
8. Chapter Eight: Conclusion

The below figure highlights the position of chapter eight in light of the research outline:

Figure 39 Chapter Eight Position
8.1. Introduction
This chapter first explains the contribution to knowledge this research may have provided. Thereafter, it provides a summary of the research, followed by its main findings. The possible different types of Islamic banks relating to special purpose vehicle practices are explained. The chapter then discusses potential future work, followed by possible limitations that may have existed on this research. Finally, the concluding remarks include final testimonies made by the researcher.

8.2. Contribution to knowledge
This research may have acted as one of the first doctoral researches focusing on special purpose vehicles in Islamic banking, without solely focusing on one Islamic product such as sukūk (commonly referred to as Islamic bonds). Also, it focuses on special purpose vehicle Shari‘a compliance factors, which appears that it may not largely exist in literature. Furthermore, since the researcher was unable to locate a doctoral research pertaining to special purpose vehicles in Islamic banking, and therefore has further not located a similar doctoral research that uses the Kingdom of Bahrain as a case study, this indicates that its existence may be minimal in the research arena. Therefore, the jurisdiction used as a case study relating to the research topic may be considered as another contribution to knowledge.

8.3. Summary of the Research
After the 2008 global financial crisis, special purpose vehicles received extra scrutiny and negative publicity from the regulators and the public, respectively (Amoruso and Duchac, 2014). Institutions are able to hide debt from shareholders through the use of special purpose vehicles (Amoruso and Duchac, 2014). The establishment of special purpose vehicles “...very easily develops in to a sustained policy of deceiving or depriving those with a right to know…which have to compound their deceit in order to remain intact and to sustain the lie” (Stewart, 2005, p.23). However, the term “special purpose vehicle” does not intrinsically indicate that it is negative, such as being illegal or a scam (Stewart, 2005). Special purpose vehicles, as a legal tool, may
remain a perfectly designated tool that may be used for legitimate business advantages.

Islamic finance is a system of finance that follows the rules and principles of Shari’á (Islamic law). One of the main prohibitions of Islamic finance is engaging in interest-based activities. An exception may exist if the transaction(s) was considered a dharūra (necessity). An example of a dharūra (necessity) would be the need to buy shelter, food, or clothes. If the only way to attain shelter or food was through obtaining an interest-based loan, this is acceptable in Shari’á (Islamic law) and considered as a dharūra (necessity). However, most of the Islamic banking transactions in the Islamic banking industry appear that they do not include an element of dharūra (necessity). Yet, the Islamic banking investment industry seems, in certain circumstances, to be based on interest-based activities. By interviewing forty-four stakeholders and analysing a real special purpose vehicle transaction structure, this research confirms a point iterated by Al-Enezi (2015), which is that some Islamic banks engage in hila (legal stratagems) to engage in prohibited (i.e. interest-based activities). Based on this study, a sizeable minority of the Islamic banking industry engages in hila (legal stratagems) through the use of special purpose vehicles to engage in interest-based activities.

It may be important to understand the history underlying the initiation of using Islamic banking special purpose vehicle structures that included interest-based activities. The establishments of Islamic investment structures were mainly initiated around mid to late 1990s (McMillen, 2013). This started when a group of Middle Eastern investors and their Shari’á Supervisory Boards were trying to invest in the United States of America in a Shari’á compliant manner, but where the existing laws of the United States of America made it difficult to do so (McMillen, 2013). The Shari’á Supervisory Boards and United States lawyers exhorted respectable efforts to come up with Shari’á compliant solutions to what were then modern challenges. These efforts led to the establishment of special purpose vehicle structures where the Islamic banks or investors were able to distance themselves from conventional financings or any non-Shari’á compliant activities through the use of special purpose vehicles. Islamic banks had literally no relationship with the conventional special purpose vehicles.
However, the Islamic banking industry is now faced with a challenge due to the use of *hiyal* (legal stratagems) and special purpose vehicles. Islamic banks are able to engage indirectly in interest-based activities by not revealing the realistic transaction information to the *Shari’a* Supervisory Board. This challenge becomes greater if the internal *Shari’a* review function was weak or not protected. The continuity of non-*Shari’a* compliant special purpose vehicle practices and/or violations indicates that there may be a flaw in the system that needs to be rectified. Evidence tends to suggest that a considerable number of internal *Shari’a* reviewers do not report these violations due to unawareness, lack of evidence, or to avoid disrupting their relationships with their management. *Shari’a* Supervisory Boards and the regulator are encouraged to take possible steps to protect, enhance, and strengthen this function.

Another challenge revealed in this research is that whether through *hiyal* (legal stratagems) or genuinely, evidence suggests that a significant amount of Islamic banking special purpose vehicle transactions violate at least one major condition by either having: (1) control over a conventional purpose vehicle, (2) partly or fully paid for its establishment cost (3) hidden proxies obtained by the Islamic bank from the conventional special purpose vehicle providing them full control, (4) fully or partly manage the special purpose vehicle, (5) negotiating conventional deals on behalf of the conventional special purpose vehicle, amongst others.

Due to this information, the research may pose the following questions: Will these practices continue despite the violation(s) being clarified through suggested evidence? Are not Islamic banks largely about realistically abstaining from interest-based activities? Or is it sufficient for Islamic banks to legally find ways to distance itself from interest-based activities, but in reality partly establish, manage, pay, and control separately legal entities that engage in prohibited activities? Are *Shari’a* Supervisory Boards not aware of these actions? Or are *Shari’a* Supervisory Boards aware of these actions but are unable to stop it? Is the Central Bank allowing this to happen by witnessing *Shari’a* approvals? Is there a flaw within the system? Is it a matter of different opinions? Or are managements able to sideline *Shari’a* Supervisory Boards or regulators by approaching an elite class, such as individuals with high political power, to influence approvals? What is the issue?
At the start of this research, evidence indicated that one Shari’a Supervisory Board member officially and publicly denounced these Islamic banking practices. Are the others not aware or do they disagree?

Furthermore, this research suggests that one of the key factors to sustain Shari’a compliance in the Islamic banking industry is to have a strong internal Shari’a control function. This is simply because Shari’a Supervisory Boards may not be aware of the reality of transactions or violations except through the internal Shari’a reviewers. As mentioned earlier, the regulator may consider finding ways to provide adequate protection for internal Shari’a reviewers, such as introducing new laws (rather than rules) that protect internal Shari’a reviewers. This is because Islamic banks may not tend to adhere to all Shari’a rules or requirements, but would they risk not obeying the law? Introducing a law to protect internal Shari’a reviewers may be a key aspect to protect the Islamic banking industry.

The secondary data analysis revealed that the regulator was aware of similar violations taking place in the Islamic banking industry. The analysis revealed that the regulator, through a reactionary measure, was taking measures to ensure Shari’a compliance in special purpose vehicle transactions. This is particularly true through the proposal of new changes to the Central Bank of Bahrain (CBB) rulebook pertaining to special purpose vehicles and Shari’a compliance. The implication of these changes may require further research. This action is well noted. One must ask however, is this action enough?

8.4. Main Findings

The empirical analysis indicates that the majority of Islamic banks use special purpose vehicles in their investment transactions. Furthermore, it also indicates that these Islamic banks use special purpose vehicles in the majority of their investment transactions.

Evidence tends to suggest that there may be a discrepancy between Islamic banking theory and practice. The theory mentions that one of the main prohibitions in Islamic
banking is the engagement in interest-based transactions. Furthermore, all the Shari’a Supervisory Board interviewees mentioned that Islamic banks engaging in conventional loans indirectly through special purpose vehicles are prohibited in Shari’a (Islamic law). Evidence in this research suggests that there may be an *ijma* (consensus) between Shari’a Supervisory Board scholars, that it is prohibited for an Islamic bank to establish, manage, control, or influence a special purpose vehicle that engages in prohibited or interest-based activities. Minimally, evidence suggests that the majority of Shari’a scholars hold this view. Yet, the practice suggests that the Islamic banking investment industry may commonly be based on interest-based transactions through the use of special purpose vehicles. Also, evidence suggests that in many cases (whether practicing genuinely or through *hiyal* (legal stratagems)), Islamic banks engaging in these structures are establishing, managing, controlling, and/or influencing these conventional special purpose vehicles. Therefore, this may indicate that there is discrepancy between Islamic banking theory and practice. It also indicates that there may be a discrepancy between the opinion of the majority of Shari’a Supervisory Board scholars and Islamic banking practices.

If **Islamic Bank A** is prohibited from engaging in interest-based transactions, can **Islamic Bank A** engage in interest-based transactions under the realm of a separate legal entity? To simplify this example, if “John” finds it unlawful to trade in alcohol, could he lend money to “Mark” for Mark to engage in alcohol? Even more so, can John now act on behalf of Mark to trade in alcohol? So that when Mark obtains his profit, he returns it to John as a debt repayment? Even more so, John returns it to himself on behalf of Mark. What was Mark’s role? John, through Mark, engaged in a prohibited transaction under the name of a separate individual.

Now assuming Mark was a legal entity rather than a human being. An Islamic bank is operating through a separate legal entity that they do not legally own, and are free to engage in any transaction they wish, under a different name. Has Islamic banking become solely about legal arguments? For example, has Islamic banking become solely about legally separating itself from an entity, which then are able to act freely through that entity? Or has Islamic banking become about using legal tools, *hiyal* (legal stratagems), to engage in the very same manner conventional banks do? Is a legal separation sufficient? What about the special purpose vehicle establishment,
control, management, decision-making, and influence? How is it possible for the findings in this research to suggest that although it is impermissible, a significant amount of conventional separately legal entities are partly established, managed, controlled, and/or influenced by Islamic banks, while on the other hand, evidence suggests that there may be an *ijma’* (consensus) between *Shari’a* Supervisory Board scholars that this practice is not lawful according to *Shari’a* (Islamic law)? How then did this practice spread? Are internal *Shari’a* reviewers not conducting their jobs? Is there a flaw or weakness in the system? Are regulators not providing feedback regarding these violations to *Shari’a* Supervisory Boards through inspection reports? Or does the regulator solely depend on *Shari’a* Supervisory Board approvals without realising that Islamic banks are violating a major condition(s) that negates the *Shari’a* compliance of the transaction? Are there certain stakeholders who are trying to turn a blind eye on this practice? If so, who are they?

It was previously mentioned that the findings suggests that a considerable number of internal *Shari’a* auditors/reviewers do not report this in internal *Shari’a* audit reports either because they are not aware of the violation taking place, lack of evidence, or they fear this would disrupt their relationship with management that would end up in risking their jobs. As a result, many *Shari’a* Supervisory Boards may not be officially aware of these violations. Therefore, most Islamic banks would not have these major violations included in *Shari’a* Supervisory Board annual reports. Out of nine Islamic banks in the Kingdom of Bahrain in which *Shari’a* Supervisory Board annual reports were analysed, only one *Shari’a* Supervisory Board clearly mentioned that conventional transactions/special purpose vehicles violations existed. But is it really possible that all the remaining *Shari’a* Supervisory Boards are not aware of these violations? Is this conceivable, or do they firmly believe that Islamic banks do not engage in *hiyal* (legal stratagems) nor establish, manage, control, and/or influence legally separated conventional special purpose vehicles?

What about *sad al-tharâ‘i* (prohibition of evasive legal devices)? It may be argued that due to frequent special purpose vehicle violations being witnessed, whether unintentionally or through abuse, a new *fatwa* (*Shari’a* legal opinion) may need to be issued stating that a legal separation on its own may not suffice to make a transaction structure *Shari’a* compliant. This is because special purpose vehicles include many
legal forms that by definition, means an individual legally owns the special purpose vehicle for a different party to benefit from. Can companies own special purpose vehicles that deals in conventional activities, initially established for and managed by Islamic banks? As mentioned in chapter seven and according to one investment manager interviewee, the Islamic bank even negotiates the compensation for the board members in the separately legal special purpose vehicle. Due to this knowledge and updates, should the fatwas (Shari’a legal opinions) regarding special purpose vehicles, in the least, need to be revised? It may also be altered in a manner that disables loopholes or abuse by the minority of Islamic banks.

A lot of literature relating to Islamic finance criticisms refer to Islamic banking mistakes, and then claim that Islamic banks are not truly Islamic. The researcher disavows this view, because by nature, humans are creatures of error. Islamic banks, which are run by humans, may be bound to make mistakes. If Islamic banks were infallible, they may not require Shari’a Supervisory Boards and/or internal Shari’a reviewers. However, the researcher believes that what makes an Islamic bank “Islamic”, may be a governance system that enables Shari’a (Islamic law) mistakes/violations to be spotted, noted, or rectified. The researcher argues that a lack of a proper/strong Shari’a governance system may allow Islamic banks not to adhere to Shari’a (Islamic law) requirements. The continuity of this non-Shari’a adherence may then lead Islamic banks to not being truly “Islamic”. Therefore, a strong and adequate Shari’a governance framework may be needed in order to sustain an Islamic bank as being truly Islamic, especially in light of the findings that indicate non-Shari’a compliant practices may spread throughout the industry.

8.5. Types of Islamic Banks relating to Special Purpose Vehicle Practices

It may be suggested that there are generally three types of Islamic banks that deal with special purpose vehicles and conventional financings:

**Islamic Bank Type One:** These are Islamic banks that entered into special purpose vehicle transactions for genuine causes or investments and are transparent with their Shari’a Supervisory Board and the regulator. For example, this includes Islamic banks that want to invest in a jurisdiction where Islamic financings do not exist, or
where its laws do not allow banks to buy and sell (which is the essence of Islamic banking products). If Islamic banks want to invest in these jurisdictions, the only option available is through special purpose vehicle structures that may include interest-based financings.

**Islamic Bank Type Two:** These are Islamic banks that intentionally engage in *hiyal* (legal stratagems) to obtain a *Shari’a* Supervisory Board approval on a non-*Shari’a* compliant transaction by not revealing all the relevant information to its *Shari’a* Supervisory Board. For example, this includes Islamic banks confirming they have no control over a special purpose vehicle engaging in conventional activities, however it later gets revealed that the Islamic bank managers concealed proxies that grant them full legal control, amongst other violations.

**Islamic Bank Type Three:** These are Islamic banks that may engage in non-*Shari’a* compliant special purpose vehicle transactions, by obtaining previously *Shari’a* approved special purpose vehicle structures of another Islamic bank from the lawyers. The transaction lawyers may not be aware of the *Shari’a* conditions to sustain the transaction as *Shari’a* compliant, and therefore, the Islamic banks may violate the majority of the conditions stipulated by the respective *Shari’a* Supervisory Board to sustain the transaction as being *Shari’a* compliant (such as establishing the conventional special purpose vehicle, controlling and directing it, managing it, amongst others).

Since Islamic banks are generally supervised by *Shari’a* Supervisory Boards, it may useful to note down the possible types of *Shari’a* Supervisory Boards, which may be divided into the following three categories:

**Type One – Strong and Efficient *Shari’a* Supervisory Boards:** This category includes *Shari’a* Supervisory Boards that consist of members who are highly qualified, deeply knowledgeable in *Shari’a* (Islamic law) and *fiqh* (Islamic jurisprudence). In addition, at least one or two members are simultaneously knowledgeable in legal studies and legal requirements of different jurisdictions, commercial law, accounting standards and internationally accepted accounting standards, taxation, and more. They are mainly multidisciplinary individuals who are
highly educated in a number of fields. Furthermore, these Shari’a Supervisory Boards include at least one member who is fluently bilingual in Arabic and English, who is able to understand all Shari’a (in Arabic) and banking (in English) requirements and translates what is needed from the Shari’a Supervisory Board to investment managers in an efficient manner. Members in these Shari’a Supervisory Boards include many highly prestigious Shari’a scholars.

Type Two – Weak Shari’a Supervisory Boards: This category includes Shari’a Supervisory Boards who may be well versed in Shari’a (Islamic law) and fiqh (Islamic jurisprudence), but who may lack a member who either is also well-versed in modern commercial law and transaction knowledge, or lacks at least one member who is fluently bilingual. These boards are either not able to comprehend a structure fully, where investment managers may easily engage in hiyal (legal stratagems) and obtain Shari’a approvals on transactions that are not Shari’a compliant. No accounting experts exist within the board to annually review the financial statements of Islamic bank or detect Shari’a compliant violations. These Shari’a Supervisory Boards may also include one member who has previously experienced being released by an Islamic bank, who may not want to be released again.

Type Three – Shari’a Supervisory Boards that Focus on Transactions Outwardly: These Shari’a Supervisory Board members have one common trait. They all issue a fatwa (Shari’a legal opinion) on what was presented to them in terms of structure, details, and transactions. Although they are aware that many discrepancies or violations may exist, they go with a narrated hadith (Prophetic saying) that mentions: “nahnu nahkumu bil dhaher, w’Allahu yatawalla al-sara’ir”67, which may be translated as “we judge based on what was provided to us (outwardly), and Allah [God] will take care of the secrets/intentions”.

Chapter six, seven, and this chapter, collectively suggest that Islamic banks engaging in conventional transactions through special purpose vehicles may generally fall into the following four categories:

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67 This saying is also reported in a dha’if (weakly narrated) hadith.
1. Islamic banks who have a strong internal *Shari’a* control function and whose management engage in genuine special purpose vehicle practices.

2. Islamic banks who have a strong internal *Shari’a* control function but whose management engage in special purpose vehicle practices through *hiyal* (legal stratagems).

3. Islamic banks who have a weak internal *Shari’a* control function whose management engage in genuine special purpose vehicle practices.

4. Islamic banks who have a weak internal *Shari’a* control function and whose management engage in special purpose vehicle practices through *hiyal* (legal stratagems).

These above four categories are illustrated in the following diagram:

**Categories of Islamic Banks Engaging in non-*Shari’a* Compliant Activities through SPVs**

<table>
<thead>
<tr>
<th>Strong internal Shari’a Review Function</th>
<th>Weak internal Shari’a Review Function</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Genuine Practices</strong></td>
<td><strong>Hiyal (Legal Stratagems)</strong></td>
</tr>
<tr>
<td>Category One: Islamic banks who have a strong internal Shari’a control function and whose management engage in genuine SPV practices</td>
<td>Category Four: Islamic banks who have a weak internal Shari’a control function and whose management engage in SPV practices through <em>hiyal</em> (legal stratagems)</td>
</tr>
<tr>
<td>Category Two: Islamic banks who have a strong internal Shari’a control function but whose management engage in SPV practices through <em>hiyal</em> (legal stratagems)</td>
<td>Category Three: Islamic banks who have a weak internal Shari’a control function and whose management engage in genuine SPV practices</td>
</tr>
</tbody>
</table>

*Figure 40 Categories of Islamic banks engaging in non-Shari’a compliant activities (Author’s Theory)*
8.6. Potential Studies

Future research may include studying the Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI) Shari’a standard relating to special purpose vehicles. Future research may also include the Central Bank of Bahrain law pertaining to special purpose vehicles. Both of these documents were not readily available during the course of this research. An analysis of these documents, and their impact on the Islamic financial industry may prove to be useful. Furthermore, these two documents may also be used as secondary data in similar research areas once they become available. The availability of these documents may have an impact on future Islamic banking special purpose vehicle practices and/or findings.

With regards to Shari’a Supervisory Board fatwas (Shari’a legal opinions), Shakir Ullah (2012) suggests that that these fatwas may be repositioned from high levels of Shari’a compliance, to the lowest levels of Shari’a compliance, categorized into the following five categories: (1) deep Shari’a compliance, (2) reasonable Shari’a compliance, (3) minimum Shari’a compliance, (4) superficial Shari’a compliance, and (5) no Shari’a compliance. Therefore, a new potential future study may lead to distinguishing fatwas (legal opinions) relating to special purpose vehicles in the abovementioned categorical levels of Shari’a compliance.

Also, similar research may be conducted using different jurisdictions as case studies. For example, a similar study that uses the United Arab Emirates or Malaysia as a case study may reveal further or different findings, and may also be used in cross-comparison with this study. Furthermore, a similar study that uses the Kingdom of Bahrain as a case study may also be researched, however, by using different research methodologies and/or methods conducted by researchers with different philosophical epistemologies or paradigms. For example, different paradigms and methodologies may include positivists who solely use quantitative methodologies to derive results.

Lastly, the concept of a special purpose vehicle as a company, where the legal owners are not the beneficiaries, may also be studied from a Shari’a (Islamic law) perspective. Cattan (1955) did explain that the concept of trust, which special purpose vehicles were derived from, is similar and probably derived from the Islamic
institution of “
waqf
”. However, special purpose vehicles may have different characteristics and traits that distinguishes it from a trust and, Shari’a related studies under the realm of fiqh al-sharikāt (Islamic jurisprudence of companies) may theoretically be examined to position the theoretical concept of special purpose vehicles under Shari’a (Islamic law) rulings.

8.7. Limitations

1. At the time of the research, there was not much literature relating to Shari’a compliance and special purpose vehicles. This provided a limitation on the research with regards to the accessibility of literature-related information relating to the topic of the research.

2. Confidentiality was another limitation on the research. For example, similar to internal audit reports, internal Shari’a audit reports are confidential and not publicised. Therefore, it was not possible to obtain this possibly informative type of data to be analysed. Also, countless documentation was obtained revealing the methods of how Islamic banks were able to mislead the Shari’a Supervisory Boards to obtain approvals. These could not be included or formally analysed due to the request of interviewees to keep them confidential due to the sensitivity of the information.

3. The case study methodology uses a “single/holistic” design. It may be argued that this provides a limitation on this research, since a “single/embedded” case study design may be more informative due to having more units of analysis as case studies. Even if this were considered true, most special purpose vehicle structures obtained were from practitioners who requested the information to be confidential.
8.8. Concluding Remarks

The research concludes that the challenge posed by special purpose vehicles may not be the existence or the “use” of special purpose vehicles in the Islamic banking industry. The research further concludes that the challenge may not be the inclusiveness of conventional loans in an Islamic special purpose vehicle structure, where the conventional loan(s) is not obtained nor controlled by the Islamic bank. This means that the conventional loans are actually obtained by external parties having nothing to do with the Islamic bank, where the Islamic banks are truthful and transparent with Shari’ a Supervisory Boards. In fact, the researcher argues that this may be beneficial, as it enables and broadens the scope of Islamic finance instead of limiting it.

However, the research concludes that the challenge pertaining to special purpose vehicles may be the “abuse” of special purpose vehicles by a sizeable minority of Islamic banks. These actions may negatively impact and discredit the Islamic banking industry if no corrective action is taken. The negative affects of riba (commonly referred to as usury or interest) may still impact the Islamic banking industry, even if these riba-based transactions were executed indirectly through special purpose vehicles. Also, public awareness may increase where it realizes that a sizeable minority of Islamic banks may be engaging in interest-based transactions through special purpose vehicles, contrary to Islamic banking theories and claims publicised to them. Another example of a special purpose vehicle abuse may relate to one of the traits of special purpose vehicles, which is a lack of transparency. Islamic banks are able to engage in non-transparent transactions where regulators or Shari’ a Supervisory Boards are unaware of the realistic practices taking place.

The chief executive officer is the ultimate internal decision making power. If he/she supports investment managers to mislead the Shari’ a body, investment managers may continue to do so. On the other hand, if the chief executive officer instructs them to genuinely try to adhere to Shari’ a Supervisory Board requirements, they would have no choice but to do so. Therefore, regulators should ensure that chief executive officers are genuine who do not support special purpose vehicle non-transparent practices. If it was proven that a chief executive officer supported hiyal-based special
purpose vehicle practices on a continual basis, then the regulator may want to note
down the possible affects these actions may have on the industry and take corrective
actions. This is because the regulator may not afford for unworthy reasons for the
Islamic banking industry to be discredited.

The research suggests that although Shari’a Supervisory Boards may have issued
valid Shari’a (Islamic law) rulings based on the theory and fiqhi (jurisprudential)
rulings, it may be useful to revisit their Shari’a rulings based on the new updates and
practices arising in the industry. For example, if a sizeable minority of Islamic banks
use Shari’a Supervisory Board previous fatwas (legal opinions) as the means to be
able to abuse the Islamic banking special purpose vehicle market and engage in
interest-based activities indirectly, this indicates that the fatwas (legal opinions),
along with certain legislations, may have been providing Islamic banks with
loopholes to engage in non-Shari’a compliant practices. Otherwise, the abuse of
special purpose vehicle may continue and be as Ibn Al-Qayyim (1991) described:

“…Rather, the mafsada [harm] which because of it, riba was prohibited, itself
[still] exists, in addition to hiyal [legal stratagems], or more [worse] than that, and
it [riba] increased by engaging in hiyal [legal stratagems] and did not fade away
nor decrease; it is impossible for the Shari’a [Islamic law] of the Wisest of Rulers
[God] to prohibit what has a mafsada [harm, referring to riba] and curses who
engages in it [riba] and declare a war alongside His Messenger against him and
promises him the harshest promise, but then [He, God] makes [it] permissible to
engage in hiyal [legal stratagems] to engage in it [riba] clearly, just because this
mafsada [harm, referring to riba] was done through additional fatigue [extra
effort or work] of engaging in hiyal [legal stratagems] to sin and deceive Allah
and His Messenger. No law proposes this; riba on the ground [a normal riba-
based loan] is easier and has less mafsada [harm] than a riba [executed] through a
longer process [engaging in riba through hila (legal stratagems)]…”
(Ibn Al-Qayyim, 1991, p.91-92)

Ibn Al-Qayyim (1991) continued to question:

“…Astonishingly, which mafsada [harm] of the mafāsid [harms] of riba was
eradicated by engaging in this ihtiyal [engaging in hila, legal stratagems] and
khida’ [deception]? So did this great sin [riba] to Allah [God] which is from the greatest of sins, become a righteous deed and worship by khida’ [deception] and ihtiyal [engaging in hila, legal stratagems]? … How did khida’ [deception] and ihtiyal [legal stratagems] convert what is actually malignant to pure? And from a mafsada [harm] to a maslaha [interest/benefit]? And made it [riba] loved by the Lord AlMighty after it was discontented by Him [Allah/God]? …”

(Ibn Al-Qayyim, 1991, p.91-92)
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Appendices

Appendix I: Pilot Study Extract

This pilot study is a qualitative analysis of responses received from five interviewees conducted during the empirical and data collection phase for this research. Semi-structured interviews were conducted with various stakeholders of Islamic banks in the Kingdom of Bahrain. The first five interviewees have been selected for this pilot study in order to initially understand the industry’s response and reaction to the study. The five interviewees represent five Islamic investment banks, three of whom are current employees at three Islamic investment banks, and two ex-employees of another two Islamic investment banks (although one of these banks recently changed license to become an investment company). The roles of the interviewees include two Shari’a officers, two investment managers, and one risk manager.

A. Special Purpose Vehicles Market Share

All five interviewees indicated that their respective banks use special purpose vehicles in their investment transactions. As a result, this study reveals that the sample selected of Islamic investment banks in the Kingdom of Bahrain all use special purpose vehicles in their transactions. Also, three interviewees explained that special purpose vehicles were used in all of their investment structures without exception. The other two interviewees, both of whom were the Shari’a officers, replied that special purpose vehicles were used in (1) Funds and Real Estate (2) Most of investments and financings. However, the Islamic investment banks these interviewees represent majorly (and perhaps solely) deal in Funds and Real Estate / investments and financings. This implies that it may be safely said that special purpose vehicles are used in the vast majority of investments used by the five Islamic investment banks the interviewees represent.

B. Reasons for using Special Purpose Vehicles

The reasons mentioned by the interviewees for their respective banks using the special purpose vehicles are the following:
• **Shareholding Structure:** The Islamic investment banks may be required to allocate voting and other decision-making powers to certain investors, such as placing them as members of the Board of Directors. The Islamic investment bank may not take the risk to place investors for one investment on the board of directors of the bank with board power, and therefore creates a separate legal entity structured in a pre-agreed manner in terms of Board representation, distribution of control of power and decision making (veto) for that specific investment. This reason was mentioned by two of the five interviewees.

• **Risk Management:** Interviewees indicated that their respective Islamic investment banks legally structure their investments in a manner where the bank will not be held liable for any default or damages. Rather, the special purpose vehicle is the sole entity that would be responsible for liabilities. This enables banks to manage their risk of loss effectively that are able to enter into investments without putting the Islamic bank at risk. Two out of the five interviewees mentioned this reason.

• **Taxation:** special purpose vehicles are usually established in “tax havens”. Therefore, Islamic banks prefer using special purpose vehicles in certain jurisdictions to benefit from their taxation laws and in turn are used as a strategy to enhance their investment performance. Three out of the five interviewees mentioned this reason.

• **Compliance:** Through the use of special purpose vehicles, the Islamic banks would have less reporting requirements. This encourages banks to use special purpose vehicles since more compliance/legal requirements are considered a hassle for investment managers. Two out of the five interviewees mentioned this as a reason.

• **Legal:** Establishing special purpose vehicles means there will be less legal requirements for the Islamic investment banks. Also, it is much quicker to
incorporate a special purpose vehicle in the known tax-haven jurisdictions (e.g. Cayman Islands, Jersey), while incorporating a special purpose vehicle in the Kingdom of Bahrain requires a long and complicated process. One out of five interviewees mentioned this as a reason.

- **Shari’a:** Since Islamic banks are prohibited from engaging in interest-based activities, the Islamic banks sometimes use special purpose vehicles in order to indirectly engage in interest-based activities. The Islamic bank would execute a Shari’a compliant deal with the special purpose vehicle, where the special purpose vehicle would then engage in a transaction that would have otherwise been prohibited for the Islamic bank to do so directly. This practice may give rise to many debatable issues and will be discussed in seven. In light of the context of this chapter, three out of the five interviewees mentioned this reason: two of which explained it as being a manipulative and practice, while one explained it as being a solution in times of necessity.

One of the three interviewees further mentioned that sometimes their respective banks are allowed to invest in companies with conventional or non-Shari’a compliant dealings, if the Islamic bank’s ownership as an investor will not exceed 33% (a third). Therefore the Islamic bank would create a special purpose vehicle to: (1) buy non-Shari’a compliant investments – through reducing its ownership from a percentage exceeding 33% to a percentage lower than 33% (the amount of ownership percentage reduced is transferred to a separately created special purpose vehicle), and (2) hide existing conventional loans from buyers, investors, regulators, Shari’a supervisory boards and the Shari’a auditor. This also obviously raises Shari’a compliant questions with regards to special purpose vehicle practices in the Islamic banking industry that will further be discussed in chapter seven. However, these interviewee responses may act as a clarification to the Central Bank of Bahrain circular mentioned in chapter one (CBB Circular, 2013).
A fourth interviewee mentioned Shari’a compliance as being a reason for using special purpose vehicles, who explained that special purpose vehicles are used because it is easier to engage in Shari’a compliant activities. This is due to the Articles of Association (AOAs) and establishing contracts of the special purpose vehicle requiring Shari’a compliance for the entity’s activities.

- **Confidentiality**: Since special purpose vehicles are separate legal entities, its legal owners are persons other than the initial originator or establishing bank. Therefore, an entity established in a jurisdiction (e.g. Cayman Islands) with an unfamiliar name legally owning it, it is difficult for the public to track down who initially owns (or indirectly manages) the special purpose vehicle (although regulatory bodies are able to do so). According to one interviewee, when Islamic banks want to be confidential in their dealings, special purpose vehicles help them achieve this objective.

- **Regulatory Requirements**: Islamic banks use special purpose vehicles as a tool to adhere to regulatory requirements. For example, the Central Bank of Bahrain requires a minimum of 12% Capital-Adequacy Ratio (CAR). The Capital Adequacy Ratio is \( \frac{\text{Equity}}{\text{Risk-Weighted Assets (RWA)}} \). The percentage of this ratio should not be less than 12%.

Therefore, some Islamic banks create special purpose vehicles, and transfer selected Risk-Weighted Assets to the special purpose vehicle (it is removed from the banks balance sheet and transferred to the special purpose vehicle balance sheet). This in turn reduces the banks Risk-Weighted Assets (RWA), which in turn would increase the Banks Capital Adequacy Ratio (CAR).

To further clarify the above example, Risk-Weighted Assets (RWA) are assets that are not easily liquidated. For example, cash holds a zero risk-weight, while the risk-weight on real estate is 200%. Therefore, if a bank
owns real estate assets worth $5m, the risk-weight is $10m, used for calculation purposes.

One out of five interviewees mentioned this reason. Islamic banks use special purpose vehicles to adhere to regulatory requirements with other similar practices as well.

C. Significance of Special Purpose Vehicles

When asked whether the interviewees believed that special purpose vehicles were essential to use as a bank, all five interviewees indicated that special purpose vehicles are essential. One interviewee emphasized that it is “currently” essential, while a second interviewee mentioned that it depends on the project, however the current practice reveals that it is essential. The reasons for special purpose vehicles being essential are the same as section (number above).

D. Special Purpose Vehicles and Conventional Financings

All five interviewees responded differently when asked which of their (Islamic) banks’ investments included conventional financings:

Interviewee One (Shari’a Manager): One investment structure included the Islamic bank obtaining conventional financing through a special purpose vehicle, however this was done without the approval of the Shari’a Supervisory Board. This investment represents around 2–4% of the banks investments.

Interviewee Two (Investment Manager): This Islamic bank never took conventional financing. The business model this bank adopts is raising money through equity rather than financing. Therefore, when special purpose vehicles are established, it is to raise equity and distribute shares to the equity holders. In rare cases when the business model is altered to obtain financing, the Islamic bank will obtain Islamic financing. The interviewee further clarified that even when the Islamic bank approaches a conventional bank for financing, it still obtains Islamic financing through the conventional banks Islamic branch/window. Obtaining conventional financing
through a special purpose vehicle was out of the question and, the interviewee did not even understand how the question was possible.

Interviewee Three (Risk Manager): The interviewee was not aware of any conventional financings through special purpose vehicles (however, it was later revealed through interviews with other employees in the same bank and not included in this pilot study, that conventional loans through special purpose vehicles existed, with the reasons and analysis explained in chapter seven.

Interviewee Four (Investment Manager): This interviewee responded mentioning that Islamic banks’ obtaining conventional loans through special purpose vehicles is a normal and standard practice, for at least the past 10 years. This is because most companies Islamic banks purchase or invest in investments such as the aircraft or shipping industry, which do not have Islamic banks within those regions to finance them (or, the Islamic financing options are very limited and take a long time to approve e.g. one Islamic bank took 5 months to approve a financing transaction). According to this interviewee, the only industry Islamic financiers readily finance is the real estate sector. Also, the interview indicated that the profit rate of Islamic banks are usually higher than conventional ones, which makes the conventional financiers more attractive. The interviewee lastly indicated as an example that Islamic banks used to purchase property in the United Kingdom through special purpose vehicles and conventional financing. However, when an Islamic bank in the United Kingdom became available, the switched to Islamic financing. Therefore, this indicates that it depends on the availability in the market.

Interviewee Five (Shari’a Manager): This interviewee indicated that the Islamic bank does obtain conventional financings of various forms through special purpose vehicles. This is for two main reasons: (1) special purpose vehicles are separate legal entities, therefore the Islamic bank legally does not have any relationship with conventional financing (2) this is only acceptable because an alternative has not been found in the industry. Once an acceptable alternative is available, Islamic banks should discard this practice. This interviewee also mentioned (similar to Interviewee Four) that most industries the Islamic banks invest in lack Islamic financiers, and therefore the Islamic bank is left with no option other than to obtaining conventional
financing (through special purpose vehicles). However, if an Islamic financing option that is similar to the conventional options is available, this practice would immediately be disapproved by the banks Shari’a body.

E. Accounting of Special Purpose Vehicles

One interviewee mentioned that special purpose vehicles have their own independent financials, accountants, and auditors. A second interview explained that the assets that the special purpose vehicles “house” are included in the Islamic bank’s balance sheet.

The remaining three interviewees explained that the accounting treatment of special purpose vehicles is dependent on several factors, thereafter concluding whether the special purpose vehicle financials should be consolidated with the Islamic bank’s financials or not. These factors include the Islamic bank’s: (1) percentage of ownership in the special purpose vehicle, (2) representation on the board of directors in the special purpose vehicle, (3) influence (or veto power) over the special purpose vehicle, and (4) ability or control over the special purpose vehicle’s management. Depending on these factors, the special purpose vehicle will either be consolidated with the Islamic bank or not. The higher the ownership, board seats, influence, or power the bank has over a special purpose vehicle, the more likely it will be consolidated, and vice versa.

F. Difference between Islamic and Conventional Banks Practice towards Special Purpose Vehicle

All five interviewees indicated that the concept of special purpose vehicles, including its advantages and disadvantages, does not differ from conventional banks, except for the Shari’a aspect of the transaction. Conventional banks use special purpose vehicles to benefit from the entire benefits special purpose vehicles offer, with the exception of Shari’a. None of the five interviewees further elaborated on this concept, except for one interviewee who indicated that the only difference is adding a Shari’a clause in the Articles of Association of the established special purpose vehicle.