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AIRCRAFT FINANCING: CAN ISLAMIC FINANCE PROVIDE A GOOD ALTERNATIVE?

by

Delphine Defosez*

ABSTRACT

The 2008 Financial Crisis has demonstrated that unlike conventional banks, Islamic banks, which endorse *Shari'ah* (Islamic law) principles, were not affected. Moreover, the aviation sector has witnessed, in the recent years, the fast growth of Middle East airline companies, such as Emirates, Qatar Airways and flydubai. This fulgurant growth raises the question of whether the flexibilities and particularities of Islamic finance offers can provide a good alternative and enable airlines to grow s. Indeed, Islamic finance requires banking institutions not only to look after their own interest but also the best interests of their clients. Islamic banks might be more willing to help financing aircraft knowing that if the airline's positive growth increases, the value of the *sukuk* (Islamic bonds) might increase which will be profitable for the bank. The interest in Islamic finance as an alternative to conventional aviation financing is gaining traction and could prove to be an alternative catalyst for aviation growth.

KEYWORDS

Islamic finance; aviation financing; *sukuk*; risk-sharing; air law

I. INTRODUCTION

The global financial crisis has resulted in the drying up of conventional aircraft financing sources and resulted in more difficulties in obtaining conventional interest-based loan financing.¹ On the other hand,

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¹ Borislav Bjelicic, "Financing airlines in the wake of the financial markets crisis" (2012)

Islamic finance is booming with the number of lessors using Islamic finance “growing at astronomical rates”.² Davide Barzilai, a banking and finance lawyer, came to a similar conclusion when he noted that:

we are seeing strong indications that Islamic financing is becoming more popular in aircraft finance because of difficulties in the conventional interest-based loan financing ... fewer banks are lending, so Islamic finance can be used to wide choice and tap into the liquidity of the Middle East”.³

Indeed, in 2018 the Middle East was even forecasted to be “one of the fastest growing aviation regions over the next 20 years”,⁴ with much of this growth led by Middle East airlines, such as Emirates, Qatar Airways and flydubai.⁵ While some European airline companies, such as Alitalia,⁶ struggle to stay afloat, the sky is bright blue for Middle East airlines. These recent difficulties compared to the fulgurant growth of some Middle East airlines raise the question whether flexibilities and particularities that Islamic finance offers can provide a good alternative and enable airlines to grow.

Admittedly, the growth of Middle East-based carriers can not only be attributed to the use of Islamic financing, as these airlines enjoy other commercial advantages, such as more lenient labour laws, little competition, access to inexpensive fuel, on top of some allegations of being recipients of government subsidies.⁷ However, these factors alone cannot explain the astonishing growth in the fleet of some airlines. For instance, Qatar Airways’ “fleet rose from 4

²¹ Journal of Air Transport Management 10.

² Labuan IBFC Inc, “Malaysia: Commercial Aircraft: The New Buzz Within The Islamic Finance Community”, *Mondaq* (9 November 2017), online: *Mondaq* <www.mondaq.com/x/644790/islamic+finance/Commercial+Aircraft+The+New+Buzz+Within+The+Islamic+Finance+Community>.

³ Will Roberts, “Sharia Deals Boost Aviation” (2008) 313 *Airfinance* J 30.

⁴ Global Ethical Banking, “ADGM’s Aviation Finance Structure Utilised in Sukuk Issuance” (30 August 2018), online: *Global Ethical Banking* <www.globalethicalbanking.com/adgms-aviation-finance-structure-utilised-sukuk-issuance/>.

⁵ Charles F Yeterian, “Islamic Financing Takes to the Air in the Aviation Industry”, *Islamic Finance News* (13 March 2015), online: *Islamic Finance News* <islamicfinancenews.com/2015_supplement/guide/IFNGuide.pdf>.

⁶ Paolo Beria, Hans-Martin Niemeier and Karsten Frohlich, “How Liberalisation Can Go Wrong: The Case of Alitalia”. in Peter Forsyth et al. (eds) *Liberalisation in Aviation: Competition, Cooperation and Public Policy* (Ashgate, 2013); Liz Alderman, “Alitalia Files for Bankruptcy, but Italy Balks at a Third Bailout”, *The New York Times* (2 May 2017), online: *New York Times* < www.nytimes.com/2017/05/02/business/italy-alitalia-airline-bankruptcy.html?mcubz=0 >; Brian Sumers, “Delta Air Lines and 3 Other Groups Will Work To Rescue Alitalia”, *Skift* (16 July 2019), online: skift.com/2019/07/16/delta-air-lines-and-three-other-groups-will-work-to-rescue-alitalia/>; David Slotnick, “Italy will renationalize the struggling Alitalia airline after the coronavirus pandemic brought the carrier to its knees”, *Business Insider* (17 May 2020) online: *Business Insider* <www.businessinsider.com/coronavirus-italy-to-renationalize-alitalia-airline-under-rescue-plan-2020-3>

⁷ Kristian Coates Ulrichsen, *The Gulf States in International Political Economy*. (Palgrave, 2016), p. 162

aircraft in 1997 to 28 in 2003”,⁸ to 146 planes by the end of 2014, and finally reached the milestone of 250 aircraft in March 2019.⁹ This impressive growth was achieved despite the fact that Doha remains “a relatively low-volume tourist destination” compared to, for instance, neighbouring Dubai.¹⁰ Even if Qatar Airways received some government subsidies, the fact that it could buy 246 aircraft in 23 years is impressive compared, for instance, with Lufthansa which bought 41 aircraft in 10 years.¹¹ As Middle East expert Kristian Ulrichsen pointed out:

an investigation conducted by Reuters in February 2015 found that local cash-rich banks increasingly were playing a greater role in aircraft financing for the Gulf airlines, in addition to the traditional reliance on the controversial use of export credit agencies and cash injections to fund acquisitions. Whereas only 17 per cent of aircraft deals in the Middle East (as a whole) were funded by local banks in 2013, the figure rose substantially to 47 per cent in 2014.¹²

Islamic financing can help diversify sources of funding and provide a viable alternative to traditional aviation financing.¹³ The most used type of Islamic finance to pre-fund aircraft financing is *sukuk*, which is a type of bond¹⁴ with yields that are currently “relatively more competitive than conventional loans”.¹⁵ For that reason, various *sukuk* programmes have been launched in Europe, with the very first dating back to 2004 in Germany.¹⁶

Emirates was a pioneer in the Islamic capital market, which it uses since 2005. Since then, many other airlines have followed its lead. In 2014, a US\$ 5 billion *Shari’ah*-compliant leasing fund was launched jointly by the International Air Finance Corporation (IAFC), Airbus and the Islamic Development Bank, which demonstrated “an

⁸ Ibid, p. 157; “Qatar Airways Fleet Details and History”, *Planespotter* (16 June 2019), online: *Planespotter* <www.planespotters.net/airline/Qatar-Airways>.

⁹ Ibid; Joanna Bailey, “Qatar Airways Now Has An Incredible 250 Aircraft In Its Fleet”, *Simpleflying* (21 March 2019), online: *Simpleflying* <simpleflying.com/qatar-airways-250th-aircraft/>

¹⁰ Kristian Coates Ulrichsen, *The Gulf States in International Political Economy* (Houndmills, Basingstoke: Palgrave, 2016) at 157

¹¹ Lufthansa had 234 aircrafts in 2005 and 275 in 2015. See: Regina Kenney, “Maintenance, Repair and Overhaul, Then & Now: Lufthansa Fleet 2005 vs 2015”, online: *inside MRO* <www.mro-network.com/maintenance-repair-overhaul/then-now-lufthansa-fleet-2005-vs-2015>.

¹² Ulrichsen, *The Gulf States in International Political Economy*, *supra* note 7 at 162.

¹³ Roberts, *supra* note 3.

¹⁴ Mahmoud Mohieldin, “Realizing the Potential of Islamic Finance”, (2012) 77 *World Bank- Economic Premise* 1, at 7

¹⁵ Mushtak Parker, “Sukuk: A ‘new’ option of aircraft financing”, *Saudi Gazette* (2 April 2013), online: *Saudi Gazette* <saudigazette.com.sa/article/38683>

¹⁶ MIF, “Europe: A Rising Opportunity for Islamic Finance” (11 March 2015), online: *Islamic Finance Foundation* <www.islamicfinance.com/wp-content/uploads/2015/03/MIFC-Islamic-Finance-in-Europe.pdf>.

acknowledgment that *sukuk* are no longer a rare alternative -specific to a certain region- but rather a new trend in the global aircraft market".¹⁷ The first ever approved *sukuk* for pre-funding aircraft financing was by Emirates worth US\$ 913 million in 2015.¹⁸

At a time when conventional banks are more and more reluctant to grant loans, Middle East airlines have secured historical deals. Aircraft financing is well-suited to Islamic finance as it typically revolves around an asset. Indeed, the purchase of an aircraft is a highly capital-intensive venture, namely because Islamic finance allows to alleviate such burden. In fact, some European airlines, such as Lufthansa, have already financed some assets through the use of hybrid loan.¹⁹ Islamic finance thus offers a business-friendly alternative. This is especially true given that major conventional banks have in recent years opened an Islamic window and proposed Islamic products in Europe.²⁰

This article highlights how Islamic finance might represent a good alternative for aircraft financing by first analysing Islamic aviation financing and the different types of Islamic finance products. Then it looks at the prospect of Islamic aviation financing and finally at the possible conflict with international conventions.

II. TYPES OF ISLAMIC FINANCING SUITABLE FOR AVIATION FINANCING

The 2008 Financial Crisis has demonstrated that unlike conventional banks, Islamic banks which endorse *Shari'ah* (Islamic law) principles were not affected.²¹ *Shari'ah* law²² differs greatly from

¹⁷ "Sharia-compliant aircraft leasing - will it change the market?", *AviaAM Leasing* (28 November 2014), online: *AviaAM Leasing* <www.aviaam.com/sharia-compliant-aircraft-leasing-will-it-change-the-market/>.

¹⁸ Jennifer Urban, "Islamic Financing: A Successful Takeoff or A Crash Landing? Whether or Not Islamic Financing Should be Used to Finance and Lease Aircraft" (2015) 9 *J Bus Entrepreneurship & L* 329 at 329.

¹⁹ Lufthansa, "Bonds", online: *Lufthansa Group* <investor-relations.lufthansagroup.com/en/share-bonds/debt-capital-rating/bonds.html>.

²⁰ Mohamed Bechir Chenguel, Abdelkader Derbali & Meriem Jouiro, "Installing Islamic banking windows in conventional bank: Effects on performance" (2019) 6 *International Journal of Financial Engineering*; K. Kubiszewska & Rafal Komorowski, "The UK's banking system as financial hub for Islamic banking" (2014) 4 *International Journal of Behavioural Accounting and Finance* 245; Bank of England, "Topical article; Islamic banks and central banking" (2017), online: *Bank of England* <www.bankofengland.co.uk/-/media/boe/files/quarterly-bulletin/2017/islamic-banks-and-central-banking.pdf?la=en&hash=15D94BD65C2EFA6962989D10E21543B7B7013C1C>.

²¹ Rasem Kayed & Kabir Hassan, "The Global Financial Crisis and Islamic Finance" (2011) 53 *Thunderbird International Business Review* 55.

²² *Shari'ah* law is based on the Quran and the Sunnah (daily practice of Prophet Muhammad). However, the Quran and Sunnah just provide foundation solutions which need interpretation to cover all of the questions confronting the contemporary Muslim community. Thus, secondary sources, such as Islamic jurisprudence (*fiqh*) according to

the two conventional forms systems of civil law and common law, as it is based on religious traditions which have not been fully codified.²³

While Islamic banks have the same purpose as their conventional counterparts, the emphasis on moral and ethical values, such as fairness, is a key component of Islamic banking. One of the underlying principles of Islamic banking is profit-sharing,²⁴ and lending on interest is prohibited as it is against Islamic law. This unique risk-sharing aspect of Islamic finance not only allowed it to weather the global crisis but also encourages its expansion while other financial institutions were deteriorating.²⁵

Due to the ban of levying interest (*riba*),²⁶ Islamic finance has developed some ingenious and intricate ways of financing. As a result, there are some major transactional structure differences between aircraft financing under conventional finance and Islamic finance. The final result is, nonetheless, the same, namely that the lessee acquires the right to quiet enjoyment of the aircraft over an agreed period.²⁷

One of the main instruments used in Islamic finance for aviation is *sukuk*, especially after the 2008 Financial Crisis. *Sukuk* are defined by the Accounting and Auditing Organisation for Islamic Financial Institutions (AAOIFI)²⁸ as:

the interpretations (*ijtihad*) of Islamic legal experts in specific problem based on the deductive reasoning (*qiyas*) and expert consent of various Islamic schools of thought (*ijma*), are also important. See generally Janin Hunt & Andre Kahlmeyer, *Islamic Law: The Sharia From Muhammad's Time to the Present* (Jefferson, NC: McFarland & Company, 2007).

²³ *Ibid*

²⁴ MO Farooq, "Partnerships, Equity-Financing and Islamic Finance: Whither Profit-Loss Sharing?" (2007) 11 Review of Islamic Economics Special Issue 67.

²⁵ Hussein Alasrag, "Global Financial Crisis and Islamic Finance", (2010) MPRA Paper 22167; Nafis Alam, Sara Sophia Binti Zainuddin & Syed Aun R Rizvi, "Ramifications of varying banking regulations on performance of Islamic Banks", (2019) 19 Borsa Istanbul Review 49

²⁶ Latifa Algaoud & Mervyn Lewis, "Islamic critique of conventional financing", 38 in MK Hassan & M Lewis (eds), *The Handbook of Islamic Banking*, (Cheltenham: Edward Elgar Publishing, 2007); Filippo di Mauro, et al, "Islamic Finance in Europe", Occasional Paper Series No.146 (June 2013), online: *European Central Bank* <www.ecb.europa.eu/pub/pdf/scpops/ecbocp146.pdf>; A Saeed & O Salah, "Development of sukuk: pragmatic and idealistic approaches to sukuk structures" (2014) JIBLR 41.

²⁷ Mara Abols et al, "Structuring Aircraft Financing Transactions" (2019) online: *Holland & Knight* <www.hklaw.com/-/media/files/insights/publications/2019/02/structuring-aircraft-financing-transactions-w0016292.pdf?la=en> traditional finance at 1-2; Islamic finance at 8-9; Emma Giddings, "Islamic finance - Aviation and innovation" (December 2016) online: *Norton Rose* <www.nortonrosefulbright.com/en/knowledge/publications/66940dd2/islamic-finance--aviation-and-innovation>; CMS, "Aircraft Finance and Leasing in England" (March 2020), online: *CMS* <cms.law/en/int/expert-guides/cms-expert-guide-to-aircraft-finance-and-leasing/england>

²⁸ The author decided to base her analysis on standards published by this organization

certificates of equal value representing undivided shares in ownership of tangible assets, usufruct and serves, or (in the ownership of) the assets of particular projects or special investment activity [...].²⁹

Sukuk is therefore a form of bond, which is issued to the investor as evidence of ownership for an asset, wholly or in part, or the usufruct of such ownership.³⁰ *Sukuk* differs from conventional bonds on various aspects such as the investment criteria, the effects and cost, the investment rewards and risks and the asset ownership. Unlike its conventional counterpart, *sukuk* cannot be issued without having an underlying tangible asset either in ownership or in master lease agreement, *sukuk al-ijara*.³¹ *Sukuk* therefore represents a share in the underlying asset or pool of assets and not in the debt, as is the case with conventional bonds.³² The relationship between the *sukuk* holder with the issuer is, therefore, that between an investor and not of a creditor. Indeed, the claims embodied in *sukuk* are not simply a claim to cash flow but also an ownership claim. This feature also partially explains why the “[s]ukuk market has been quite resilient during recent instability in global financial markets”.³³ This attractive feature has resulted in the launch of various *sukuk* programmes in Europe since 2014, the major ones being in the United Kingdom and Luxembourg.³⁴

Sukuk can be either tradable or non-tradable, and there are various types of *sukuk*, such as *ijarah* (lease),³⁵ *murabaha* (cost-plus

as it is widely followed. The AAOIFI Shari’ah Standards can be regarded as soft law. For more information about the role this institution had on *sukuk* please refer to Omar Salah, “Islamic Finance: The Impact of the AAOIFI Resolution on Equity-Based Sukuk Structures”, (2011) TISCO Working Paper Series on Banking, Finance and Services No. 02/2011.

²⁹ “Shariah Standard No. 17: Investment Sukuk”, *Shari’ah Standards: Full Text of Shari’ah Standards for Islamic Institutes as at Safar 1439 A.H. – November 2017 A.D.*, (Manama: Accounting and Auditing Organisation for Islamic Financial Institutions, 2015) at 468, para 2.

³⁰ “Shariah Standard No. 17: Investment Sukuk”, *ibid*.

³¹ Mohamed Ariff & Meysam Safari, “Are *sukuk* securities the same as conventional bonds?” (2012) 1 Afro Eurasian Studies 101; C Godlewski, R Turk-Ariss & L Weill, “*Sukuk* vs. conventional bonds: A stock market perspective” (2013) 41 Journal of Comparative Economics 745.

³² Mervyn K Lewis & Latifa M Algaoud, *Islamic Banking* (Edward Elgar, 2007) at 3; IA Alvi et al, *Sukuk Report: A Comprehensive Study of the International Sukuk Market*, 3rd ed (Bahrain: International Islamic Financial Market, 2013), online: *International Islamic Financial Market* <www.iifm.net/system/files/private/en/IIFM%20Sukuk%20Report%20%283rd%20Edition%29%20A%20Comprehensive%20study%20of%20the%20Global%20Sukuk%20Market_1.pdf>.

³³ Labuan, *supra* note 2.

³⁴ MIF, “Europe: A Rising Opportunity for Islamic Finance” (11 March 2015) online: *Islamic Finance* <www.islamicfinance.com/wp-content/uploads/2015/03/MIFC-Islamic-Finance-in-Europe.pdf>

³⁵ *Ijarah* is defined by jurist as “Possessing of a usufruct for a consideration”. See Kashf

financing), *mudarabah* (sweat capital), *musharaka* (joint partnership), *wakala*³⁶, *al-manafa'a* and *al salam* (sale contract).³⁷ For instance, the 2005 Emirates *sukuk* used to construct its engineering centre and head office was a *musharaka* (joint partnership).³⁸ Sayd Farook also gives the example of Emirates Medjool *sukuk* which:

used a *wakala* structure where the investors' funds were used to purchase the rights to travel, measured using Available Tonne Kilometres (ATKM); an industry measure. The ATKM were sold by Emirates to the SPV and Emirates was appointed to serve as the agent for investors and sales of the ATKM were used to fund the periodic payments. At maturity, Emirates purchased the unsold ATKM to redeem the *sukuk*.³⁹

In 2014, flydubai followed Emirates' lead by issuing the same type of *sukuk* to purchase rights based on ATKM.⁴⁰ The following will describe the various types of Islamic financing vehicles that are available, and how they have been utilised in the aircraft finance market. These various types of Islamic financing vehicles and *sukuk* aircraft finance deals are also summarised in Table 1, at the end of the article.

A. SUKUK AL-IJARAH (LEASE)

The most preferred instrument used in aircraft financing is *sukuk al-ijarah* because of its similarities with the conventional financial lease while protecting the Islamic financier from some of the inherent risks linked to a lease.⁴¹ This transaction requires the purchase of the

Al Haqaig 2/151, 1322H edition; Mabsut 15/74, first edition; Al-umm 3/250, first 1 edition, 1321; H, Al Mughni with Al-Sharh Al-Kabeer, and Al-Sharh Al-Sagheer, Al-Manar 1347H. According to the Federal Law Number 5 of 1985 of the United Arab Emirates (Civil Code) the *ijarah* is "a hire (that shall be conferred) by the lessor on the lessee of the right to use (that is) intended for the thing hired for a (given) period in consideration of an ascertained rent".

³⁶ Investor entrusts an agent to act on his behalf. See: di Mauro, et al, "Islamic Finance in Europe", *supra* note 26.

³⁷ Latham and Watkins LLP, "The Sukuk Handbook: Guide to Structuring Sukuk", online: [www.lw.com/thoughtLeadership/guide-to-structurings-sukuk#:~:text=Sukuk%20al%20Dijara%20involves%20the,ownership%20interests%20in%20such%20assets](http://www.lw.com/thoughtLeadership/guide-to-structurings-sukuk#:~:text=Sukuk%20al%20Dijara%20involves%20the,ownership%20interests%20in%20such%20assets;); MI Usmani, "Fixed Income Securities Shari'a Perspective" (2007) 3 SBP Research Bulletin 63.

³⁸ Laura Wood, "Research and Markets: Emirates Airlines - Musharaka Sukuk Issue for Corporate Financing", *Business Wire* (1 September 2005), online: www.businesswire.com/news/home/20050901005322/en/Research-Markets-Emirates-Airlines--Musharaka-Sukuk; Sayd Farook, "Islamic Finance Takes Flight", *EME Outlook* online: www.emeoutlookmag.com/industry-insights/article/262-islamic-finance-takes-flight

³⁹ Sayd Farook, "Islamic Finance Takes Flight" online: www.emeoutlookmag.com/industry-insights/article/262-islamic-finance-takes-flight

⁴⁰ *Ibid.*

⁴¹ O Salah, "Dubai Debt Crisis: A Legal Analysis of the Nakheel Sukuk" (2010) 4 Berkeley Journal of International Law 19; Ariff & Safari, *supra* note 31

asset, which is then leased through a special purpose vehicle (SPV).⁴² This SPV is the one issuing the *sukuk* certificate, which allows the *sukuk* holder an ownership and right to receive a proportion of the rental payment.⁴³ In fact, various European financial institutions have already begun to offer *Shari'ah*-compliant products through the system of Islamic Windows.⁴⁴ For instance, in 2017, Natixis, which is part of the French banking group Groupe BPCE, and Etihad Airways completed a “sale-and-leaseback” arrangement for two Airbus A380 aircraft. Under this arrangement, the aircraft are owned by special purpose companies based in Abu Dhabi Global Market (ADGM) and are leased to Etihad for a period of 12 years.⁴⁵

Ijarah is a form of lease where the owner of the aircraft transfers the legal right to use the aircraft, or derive profit from it, to another person – under the circumstances the airline company (the lessee) –, for an agreed period of time and at an agreed rent, as the renting of property is not *riba*.⁴⁶ For instance, AirAsia issued a 500 million ringgit (US\$ 158.5 million) *sukuk* to partially finance its capital expenditure.⁴⁷

Although similar, *ijarah* differs from the conventional lease. Indeed, the liabilities and ownership rights remain with the lessor, the owner of the aircraft, rather than with the lessee, which is the airline company. The lessor, rather than the lessee, remains responsible for the major maintenance and structural repair as well as for the hull insurance and the ownership taxes, if any.⁴⁸ The lessor and the lessee could agree to appoint the lessee as an agent, and that the lessor repay

⁴² This requirement was only codified in Indonesia in the Law 19 of 2008 on the Sovereign Sharia Securities (SUKUK Negara). In other countries it is the norm as well but based on customs. See: AAOIFI Shari'ah Standard no. 17, *supra* note 29, “Investment Sukuk”; Wilson Rodney, “Overview of the Sukuk Market,” in NJ Adam & A Thomas, eds., *Islamic Bonds: Your Guide to Issuing, Structuring and Investing in sukuk*, (Euromoney Books, 2004); ZA Abd Rahman, “Sukuk, SPV and Borrowing with Collateral?” (12 January 2011), online (blog): *Islamic Law of Finance* <islamiclawoffinance.blogspot.nl/2011/01/sukuk-spv-and-borrowing-with-collateral.htm >; and Omar Salah, “Understanding sukuk: Sharia scholars’ perspective meets lawyers’ perspective” (2017) 32 JIBLR 73

⁴³ Emre Balibek, “Establishing a Legal Framework for Sovereign Sukuk Issuance: A Public Debt Management Perspective” MFM Discussion Paper No. 18 (2017).

⁴⁴ Cristiano Osnaghi, “Islamic Finance: A New Chance for European Markets”, *Cattolica Global Markets Magazine* (23 May 2019), online: *Cattolica Global Markets Magazine* <cattolicaglobalmarketsmagazine.com/2019/05/23/islamic-finance-new-chance-european-markets/>.

⁴⁵ Natixis, “Etihad Airways and Natixis close the first Aircraft Leasing Transactions in Abu Dhabi Global Market (ADGM)” (23 January 2017), online: *Natixis* <pressroom-en.natixis.com/assets/etihad-airways-and-natixis-close-the-first-aircraft-leasing-transactions-in-abu-dhabi-global-market-adgm-f93d-8e037.html?lang=en>.

⁴⁶ For general information on the *sukuk al-ijarah*, please refer to Usmani, *supra* note 37; Alvi et al, *supra* note 32; Jia Hui Yip, “Islamic Aircraft Financing” (February 2013) online: *Bird & Bird* < www.twobirds.com/en/news/articles/2012/islamic-aircraft-financing0213>

⁴⁷ AirAsia, “Proposed Issuance of Bank Guaranteed Sukuk Ijarah Of Up To Rm500.0 Million In Nominal Value Under A Sukuk Programme” (28 April 2008) online: <ir.airasia.com/news.rev/id/651704>

⁴⁸ AAOIFI Shari'ah Standard no. 17, *supra* note 29.

the costs of maintenance and hull insurance to the lessee. If the aircraft suffers a total loss, the lessee would be freed from any further rent, namely because the *ijarah* must abide by the principles of certainty and fairness.

According to the AAOIFI, the payment of the rent may correlate as investors are expected to share the risks with the *sukuk* issuer. Since the investors are expected to share the risks with the *sukuk* issuer, namely the lessee, they are also dependent on the lessee's profits and losses in relation to the assets for which the *sukuk* certificate was issued.⁴⁹ When the certificate approaches its expiry date, the issuer may buy the aircraft based on its market price. Islamic law prohibits the selling of the aircraft at a pre-agreed fixed price, as the pre-agreed price might not be fair. This means that the investors may face extra risks, as the residual value of the aircraft might be lower or higher than the one expected at the beginning of the lease.⁵⁰ An *ijarah* can be combined with sale and purchase undertakings between a lessor and lessee to create a product akin to a finance lease (an *ijara wa iqtina*).⁵¹

In theory, all this seems fairly simple, but in practice it is much more complicated. Indeed, when an airline company wishes to purchase an aircraft through the issuance of *sukuk*, the seller or supplier of the aircraft must be identified, and then a deal must be reached between the seller or supplier and the airline.⁵² When an agreement is reached, a SPV is created by the airline as a separate company or any structure that the airline deems fit, but which is entirely owned by the airline. The SPV will then issue a *sukuk* certificate and purchase the aircraft.⁵³

Through this purchase, the SPV becomes the trustee for the investors and will lease it to the airline using an *ijara*.⁵⁴ The airline will pay rent to the SPV at the agreed value, and the SPV will pay the

⁴⁹ AviaAM, *supra* note 17; Lutfullah Saqib and Saira Afzal, "Sukūk as Negotiable Instrument in Islamic Commercial Law: Shari'ah Appraisal, Applicability and the Issues (A Realistic Approach)" (2018) 19 Pakistan Journal of Islamic Research 15 at 25

⁵⁰ AviaAM, *supra* note 17.

⁵¹ Abdul Sattar Abu Ghuddah, "Ijarah (Lease)", online: *Al Baraka* <www.albaraka.com/media/pdf/Research-Studies/RSIJ-200706201-EN.pdf> at 95 *et seq*; Ijara CDC, "What is Ijara wa Iqtina", online: *ijara Community Development Corp.* <ijaracdc.com/what-is-ijara-wa-iqtina/>

⁵² Mara Abols et al, "Structuring Aircraft Financing Transactions" (2019) at 9, online: *Holland & Knight* <www.hklaw.com/media/files/insights/publications/2019/02/structuring-aircraft-financing-transactions-w0016292.pdf?la=en>; di Mauro, et al, *supra* note 26 at 61.

⁵³ Serap Zuvin, Mehmet Ali Akgun & Ugur Toprak, "Turkey: Islamic Financial Leasing (Sukuk Al-Ijarah) Implementations in Aircraft Financing" (Mondaq, 23 February 2015) online: mondaq <www.mondaq.com/turkey/islamic-finance/376684/islamic-financial-leasing-sukuk-al-ijarah-implementations-in-aircraft-financing>

⁵⁴ Mara Abols, et al, "Structuring Aircraft Financing Transactions" (2019) at 9, online: *Holland & Knight* <www.hklaw.com/media/files/insights/publications/2019/02/structuring-aircraft-financing-transactions-w0016292.pdf?la=en>.

investors through coupon, often on a semi-annual basis. When the *sukuk* arrives at maturity, the airline might buy the aircraft, depending on the initial agreement. At the dissolution of the SPV, upon maturity of the *sukuk*, the amount paid by the airline is in fact the purchase price of the aircraft plus managing or service fees, which is paid to the *sukuk* holder through the SPV.⁵⁵ Another solution is that the airline purchases the aircraft that it then sells to the SPV which leases it back to the airline, also called sale and leaseback. The SPV still acts as a trustee for the *sukuk* holder, after the certificates are issued.⁵⁶ For instance, in 2014 a US\$ 5 billion Shariah-compliant aircraft leasing fund was launched by International Airfinance Corporation, Airbus and the Islamic Development Bank. This fund was used to buy aircraft from Airbus which were then leased to Saudia.⁵⁷

B. SUKUK MURABAHA (COST-PLUS FINANCING)

The *murabaha* is commonly used as a buy-and-sell technique also known as cost-plus financing.⁵⁸ With this kind of transaction, the client seeks to finance the purchase from a financial institution. In this case, the financial institution will purchase the asset and acquire the necessary title, either directly or through an agent that can be the initial client.⁵⁹ Then the institution will disclose the cost and the profit margin for the financing to the initial client. The financial institution then sells the asset to the client, after having agreed to payment terms, creating a debt unlike under the *ijara*.⁶⁰ Typically, a fixed price is agreed at the start of the transaction, to avoid the transaction being affected by *gharar*,⁶¹ which refers to uncertainty, speculation or excessive risk and

⁵⁵ AAOIFI Shari'ah Standard, "Exposure Draft G2/2018 (ver.8) of the Governance Standard for Islamic Financial Institutions", point 36, online: AAOIFI <aaofi.com/wp-content/uploads/2018/12/Sukuk-Governance-Exposure-Draft-Final-for-Publishing-1.pdf>.

⁵⁶ Abd Rahman, *supra* note 42.

⁵⁷ Bloomberg, "Saudia mega deal spurs Shariah aircraft finance", *Gulf Times* (23 June 2015), online: *Gulf Times* <www.gulf-times.com/story/444418/Saudia-mega-deal-spurs-Shariah-aircraft-finance>.

⁵⁸ Alvi et al, *supra* note 32, point 2.2.4

⁵⁹ Kabir Hassan, & Mervyn K. Lewis, (Eds) *Handbook of Islamic Banking*. (Edward Elgar Publishing, 2007); Usmani, *supra* note 37, at 73-74

⁶⁰ Sukuk France, "Sukuk Al-Ijara", online: *Sukuk France* <www.sukuk-france.fr/types-de-sukuk/sukuk-al-ijara/>.

⁶¹ See: The Holy Qur'an, chapter 5, verse 90. The word "gharar" is a fairly broad concept that literally means deceit, risk, fraud, uncertainty or hazard that might lead to destruction or loss. Hanafi scholars have defined Gharar as "something which its consequence is undetermined". While Shafi'I scholars have described it as "something which in its manner and its consequence is hidden". According to Al-Sarakshi, "anything that the end result is hidden or the risk is equally uncommon, whether it exists or not". James M Garner, "A Critical Perspective on the Principles of Islamic Finance Focusing on Sharia Compliance and Arbitrage" (2013) 1 *Leeds Journal of Law*

forbidden by *Shari'ah*. Lewis and Algaoud elaborate on the latter and state that “in business terms, *gharar* means to undertake a venture blindly without sufficient knowledge or to undertake an excessively risky transaction”.⁶²

In essence, because transactions are inherently risky, one requires a cost-benefit type of analysis to determine whether a transaction involves excessive *gharar*.⁶³ The prohibition is a matter of degree and, for example, precludes future trading, short selling and many types of insurance.⁶⁴ The concept of *gharar* is open to interpretation in its application to particular products and requires judgment as to the degree of risk and uncertainty involved, such as divergent opinions and an associated loss of confidence. As Garner once rightly commented, there is:

an element of flexibility within the prohibition of *gharar* that is not present within *riba*. This flexibility has allowed for a greater diversity of Islamic financial products to arise through innovation.⁶⁵

To avoid such prohibition, the risk is assumed by the financier, which simultaneously entitles him to profit while selling the good. In 2015, the National Bank of Abu Dhabi PJSC (NBAD) together with the Arab Banking Corporation were mandated by the International Airfinance Corporation (IAFC) “as underwriters, bookrunners and lead arrangers on a \$400 million (Dh1.47 billion) senior secured Murabaha loan transaction”.⁶⁶ The deal served as financing the five Airbus on an operating lease to Kuwait Airways.

C. SUKUK MUDARABAH (SWEAT CAPITAL)

Mudarabah is a type of profit-sharing and trust financing whereby many investors pool their funds together to become shareholders in major financial projects.⁶⁷ This transaction can be regarded as a partnership whereby one partner provides the capital (*rabb ul amal*), usually the beneficial owner, while the other party manages the investment and is responsible for the operation and management of the business, the *mudarib*.⁶⁸ The profits must be

and Criminology 69 at 69

⁶² Lewis & Algaoud, *supra* note 32 at 30.

⁶³ M. El-Gamal, *Islamic Finance: Law, Economics and Practice* (Cambridge: Cambridge University Press, 2006) at 59.

⁶⁴ Lewis & Algaoud, *supra* note 32 at 30

⁶⁵ Garner, *supra* note 61 at 74

⁶⁶ “NBAD to underwrite \$400m aircraft leasing deal”, *Gulf News* (24 May 2015) online: *Gulf News* <gulfnews.com/business/banking/nbad-to-underwrite-400m-aircraft-leasing-deal-1.1520898>.

⁶⁷ “The Sukuk Handbook: Guide to Structuring Sukuk”, *supra* note 37 at 8 and 15.

⁶⁸ Sunil Thacker Rekha, “United Arab Emirates: Leasing of Aircraft(s) Per Islamic

distributed by a fixed and pre-determined ratio.

This form of financing was used by Al Hilal Bank to finance an Airbus A340-600 for Etihad. The investors entered an "Investment Agency Agreement", which appointed Al Hilal Bank as the Investment Agent. Acting as the investor of the capital (*rabb ul amal*), the Investment Agent entered into a *Mudarabah* Agreement with a SPV formed in the Cayman Islands. In this case, the SPV was the *mudarib*, which under the investment plan would use the finance to buy the Airbus aircraft and then lease it to the airline Etihad under an *ijara*.⁶⁹ In such a scenario and financing setup, the SPV is not responsible for any losses unless such losses are caused by its misconduct, fault or negligence.⁷⁰

D. SUKUK IJARA WA-IQTINA (HIRE PURCHASE)

Ijara wa-iqtina is often used and constitutes a combination of the *murabahah* and *ijarah*.⁷¹ This type of contract is a hire-and-purchase mode of financing, whereby the Islamic financial institution finances the acquisition of a reusable merchandise, such as an aircraft, and then leases it to the client in return for an agreed rental fee and an agreement that the client will purchase the good at the end of the lease period.⁷² The lease fees are considered to constitute part of the price or consideration for the purpose of sale. For this transaction to be valid, the contract must comply with three conditions: first, the lease agreement and the transfer of ownership must be done in two separate documents; second, there cannot be any pre-condition to the *ijarah* that a transfer of ownership will occur; and finally, the promise to transfer ownership under the *murabahah* can only come from the lessor, and it is only binding for the lessor, not the lessee.⁷³ To be *Shari'ah*-compliant and according to the normal practice of *ijara*, the lessor retains the right to re-negotiate the amount payable at every agreed interval in order to ensure that the rental fees is in line with the market value of the asset. Thus:

The *ijarah wa-iqtina* gives the lessor the ability to make a profit for its work and risk-taking on this transaction. The terms of the

Finance", *Mondaq* (29 September 2017), online: *STA Law Firm* <www.stalawfirm.com/en/blogs/view/boarding-complete-an-islamic-rendering.html?utm_source=Mondaq&utm_medium=syndication&utm_campaign=LinkedIn-integration>.

⁶⁹ Richard de Belder, "Using Islamic finance techniques in aircraft finance", *Lexology* (21 October 2009), online: *Lexology* <www.lexology.com/library/detail.aspx?g=d3fb466d-6ca6-4a5d-b63a-d758c5bf223c>.

⁷⁰ "The Sukuk Handbook: Guide to Structuring Sukuk", *supra* note 37 at 8, 15.

⁷¹ Angelo Luigi Rosa, "Harmonizing Risk and Religion: The Utility of Shari'a Compliant Transaction Structuring in Commercial Aircraft Finance" (2004) 13 *Minn J Global Trade* 35 at 45.

⁷² *Ijara CDC*, *supra* note 51.

⁷³ *Ibid.*

profit from the leasing transaction need to be included in the leasing agreement, and the terms of the profit from the transfer of ownership need to be contained in the sale agreement.⁷⁴

The main difference between *ijara* and *ijara wa-iqtina* lies in the rights of the owner. Under the *ijara wa-iqtina*, the ownership remains jointly held until the lessee has paid the last instalment. Another manner to obtain aviation financing is by using the *Bay 'al-mu'ajja*, which is a type of credit sale. Under this structure, the buyer agrees to pay the price of the asset at a specified time in the future.⁷⁵ *Murabahah* can also be used in aviation financing where the lender actually buys an aircraft or any component needed and then sells it to the lessor,⁷⁶ offering the lessor the possibility to make smaller payments.⁷⁷

E. SUKUK MANAFA'A

Finally, airlines can also use the *manafa'a* financing structure, whereby the underlying asset is the capacity or rights of commercial activities, including, therefore, intangible assets. For instance, if an airline is unwilling or unable to use tangible assets as guarantees, this structure might be helpful. Emirates, relying on this structure, used its "passenger revenues as the underlying asset for its US\$ 1 billion, 10-year amortising *sukuk*", while the Saudi Arabian General Authority of Civil Aviation issued a SAR 15 billion (US\$ 4 billion) *sukuk* "which was partly based on a sale of its rights to charge and collect fees from airlines".⁷⁸ This structure demonstrates the flexibility of Islamic finance's product.

Interestingly, although Islamic finance is said to be in line with moral requirements, all these various types of *sukuk* instruments can be and has been used as a business strategy because at the end of the day, all of the agents are still receiving profits and interests over the asset that is lent. The financing by the Al Hilal Bank of an Airbus A340-600 for Etihad Airways described above is a prime example of *mudarabah*. This example is striking because the SPV repays the rent minus its profits, which is then redistributed to the bank and to the Islamic financier.⁷⁹ Moreover, SPVs are often incorporated in the Cayman Islands,⁸⁰ which shows a wish to evade taxation. For this reason, such a financing arrangement seems morally questionable.

⁷⁴ Urban, *supra* note 18 at 342.

⁷⁵ di Mauro et al, *supra* note 26, 17.

⁷⁶ "The Sukuk Handbook: Guide to Structuring Sukuk", *supra* note 37.

⁷⁷ Mohieldin, *supra* note 14 at 6

⁷⁸ "The Sukuk Handbook: Guide to Structuring Sukuk", *supra* note 37.

⁷⁹ Yeterian, *supra* note 5.

⁸⁰ de Belder, *supra* note 69.

III. PROSPECTS FOR ISLAMIC AVIATION FINANCING

Islamic financing forces banking institutions to look after their own interest as well as the best interests of their clients. Indeed, according to the interpretation of *Qur'an* 7:128, a transaction must benefit all parties involved, and as already discussed earlier the trading of money for money is prohibited under the rules of *riba*.⁸¹ Consequently, as much as *sukuk murabahah* is acceptable, its trading is not because the sale of documents representing money is equated to the trading of money. This built-in constraint on the part of the financier and lender makes a situation like the 2008 Financial Crisis in United States, which had repercussions around the world, very unlikely.

A. ISLAMIC AVIATION FINANCING IN PRACTICE

The 2008 Financial Crisis has led airlines to search for alternative sources of funding. Indeed, for airlines to experience continued growth, it is of utmost importance that they have access to an assortment of different financing options.⁸² *Sukuk*, which is structured so that it offers a fixed return, seems to be the most frequently used alternative. A large number of international airlines rely on different types of *sukuk* to purchase or lease aircraft, among them Emirates, a pioneer in the Islamic capital market, as well as Etihad Airlines, Royal Jordanian, Air Arabia, Saudi Arabian Airlines, Turkish Airlines, Malaysian Airlines, Pakistan International Airlines, SriLankan Airlines, Ethiopian Airlines and AirAsia.⁸³ For instance, Air Arabia ordered 44 Airbus aircraft in 2007 through the use of financing arrangement with the Dubai Islamic Bank.⁸⁴ Even GE Capital Aviation Service (GECAS), the world's largest aircraft leasing company, makes use of *sukuk*.⁸⁵ An overview of various *sukuk* aircraft finance deals is displayed in Table 1, at the end of the article.

Although *sukuk* is widespread among airlines, only a few airlines are fully *Shari'ah*-compliant,⁸⁶ and these include airlines such

⁸¹ E Bafra, "Prohibition of "Riba" Over against Time Value of Money in Islamic Banking" (2004) 2 *Izmir Review of Social Sciences* 75

⁸² Yeterian, *supra* note 5.

⁸³ See Table 1

⁸⁴ "Dubai Islamic Bank signs US\$ 230 million aircraft financing deal with Air Arabia", (19 November 2014), online: *AirArabia* <www.airarabia.com/fr/dubai-islamic-bank-signs-us230-million-aircraft-financing-deal-air-arabia>

⁸⁵ AviaAM, *supra* note 17.

⁸⁶ Fully *Shari'ah*-compliant airlines are airlines that strictly follows *Shari'ah* rules. For instance, in addition to alcohol being strictly forbidden, any food and beverages must

as Iran Air, Royal Brunei Airlines, Saudi Arabian Airlines and Rayani Air.⁸⁷ The aforementioned 2014 launch by the International Airfinance Corporation of a US\$ 5 billion *Shari'ah*-compliant aircraft leasing fund with Airbus represented the first exclusive utilisation of an Islamic finance structure for aircraft financial leasing operations.⁸⁸

In 2015, Emirates issued a *sukuk* worth US\$ 913 million for the financing of aircrafts, which was priced on 25 March at 2.471% and “guaranteed by Her Britannic Majesty’s Secretary of State acting by the Export Credits Guarantee Department of the UK Government”.⁸⁹ The *sukuk* certificates are due by 2025 and are listed on both the London Stock Exchange and NASDAQ Dubai. The certificates are in line with Regulation S and Rule 144A of the US Securities Act 1933, which means that they could be sold directly to investors based in the US.⁹⁰ The transaction used a new structure based on a combination of *ijarah* and *manfa’a* in order to overcome the issue of ‘tangibility’ during the pre-funding period.

Indeed, since Islamic finance only allows funding of tangible things, the pre-funding of aircraft that are not yet manufactured would be against the definition of *sukuk*. Consequently, in order to guarantee the funding of these aircraft, Emirates had to find a way around the problem by using a combination of *ijarah* and *manfa’a*. This structure is known as Emirates ECA Sukuk, as the transaction relied on the Export Credit Agency (ECA). The certificates were issued by Khadrawy Limited, incorporated in the Cayman Islands, which served as SPV. The *sukuk* was used to pre-fund the financing of four Airbus aircraft, which were subsequently leased and operated by Emirates.⁹¹ This transaction was the largest capital markets offering in the aviation sector to benefit from an ECA guarantee. Similarly, Etihad

be *halal*. In a fully *Shari'ah*-compliant, prayers are said before takeoff. Muslim flight attendants are required to wear the *hijab* (headscarf) while non-Muslim members must wear “decent clothing”, and movies with certain content may be censored. In contrast, Emirates, for instance, only complies with some *Shari'ah*, laws including the prohibition to serve pork on its flights, while Etihad provides a prayer before take-off.

⁸⁷ Megan Ray Nichols, “Why Malaysia’s Islamic Airline Rayani Air was Banned”, *Airways Magazine* (30 June 2016), online: [Airways Magazine <airwaysmag.com/airlines/rayani-air-banned/>](http://airwaysmag.com/airlines/rayani-air-banned/)

⁸⁸ “International Airfinance Corporation launch a new shariah compliant aircraft leasing fund with Airbus” (14 June 2014), online: *International Airfinance Corporation* <www.iairfinance.com/news/international-airfinance-corporation-launch-a-new-shariah-compliant-aircraft-leasing-fund-with-airbus/>.

⁸⁹ Sukuk, “Emirates Airlines 2025”, online: *Sukuk* < www.sukuk.com/sukuk-new-profile/khadrawy-limited-3935/>

⁹⁰ Emirates, “Emirates set to close US\$913 million Sukuk, marking a world’s first for utilising UKEF-backed Sukuk for aircraft financing”. Online: <www.emirates.com/media-centre/emirates-set-to-close-us913-million-sukuk-marking-a-worlds-first-for-utilising-ukef-backed-sukuk-for-aircraft-financing/>

⁹¹ Gregory Man, Emma Giddings, & Thomas Burke, “United Arab Emirates: Islamic Finance- Aviation and Innovation”, *Mondaq* (5 January 2017), online: *Mondaq* <www.mondaq.com/x/557554/islamic+finance/islamic+finance+aviation+and+innovation>

Airlines issued a *sukuk* in 2016 worth US\$ 1.5 billion priced at 3.86%,⁹² while Lufthansa issued a hybrid bond for 500 million Euros priced at 5.125%, which would mature in 2075.⁹³ These issuances demonstrate a real interest from global investors in such type alternative forms of financing to minimise risks.

Islamic finance does not only create opportunities for airlines, but also for capital-intensive airport infrastructure. For instance, both the Kuala Lumpur International Airport (KLIA) and the new International Terminal at Istanbul's Ataturk Airport involved large Islamic financing tranches. The construction of the new King Abdul Aziz International Airport in Jeddah, Saudi Arabia, estimated at SR 27.1 billion, is in part finance through the SR 15 billion *sukuk* issued by the state-owned General Authority of Civil Aviation (GACA).⁹⁴

B. BENEFITS OF ISLAMIC FINANCING

The boom of the Middle East aviation market, with Dubai International Airport titled the world's busiest airport for international travel,⁹⁵ renders the market even more attractive to international investors. According to Charles Yeterian:

This expansion is particularly important from the perspective of Islamic financing as Boeing is forecasting around two-thirds of commercial aircraft deliveries to the Middle East region will be supported by debt sourced from locally-based banks with a natural inclination to promote Islamic lease and financing structures.⁹⁶

Sukuk is beneficial for international companies because it allows for the tapping into a growing base of liquidity, and the finding of new investors, which in turn diversifies risk. Therefore, for international

⁹²"Etihad Airways prices \$1.5 bln sukuk with 3.86 percent profit rate - leads", *Reuters* (23 November 2016), online: *Reuters* <www.reuters.com/article/etihad-sukuk/etihad-airways-prices-1-5-bl-sukuk-with-3-86-percent-profit-rate-leads-idUSD5N1D7030>

⁹³ Lufthansa Group, "Bonds", online: *Lufthansa Group* <investor-relations.lufthansagroup.com/en/share-bonds/debt-capital-rating/bonds.html>.

⁹⁴Sara Hamdan, "Saudi Arabia Issues Its First Sovereign Islamic Bond", *New York Times* (26 January 2012), online: *New York Times* <www.nytimes.com/2012/01/26/world/middleeast/26iht-m26-saudi-sukuk.html>.

⁹⁵Jennifer Newton, "Dubai Airport is the world's busiest for international travel for the sixth year in a row, with Heathrow in second place" (5 February 2020) online: <www.dailymail.co.uk/travel/travel_news/article-7968539/Dubai-airport-remains-world-s-busiest-international-travel.html>. However, the world's busiest airport by domestic and international passenger volume is Atlanta. See: Katia Hetter, "This is the world's busiest airport", *CNN* (17 September 2019), online: *CNN* <edition.cnn.com/travel/article/worlds-busiest-airports-2018/index.html>.

⁹⁶Yeterian, *supra* note 5 at 12.

companies to continue enjoying this diversification, they have to adapt to the local necessities and customs. This is one of the reasons why Boeing Capital Corporation, which finds financing solutions for customers purchasing its aircraft, has been exploring opportunities for tapping the *sukuk* market for aircraft finance.⁹⁷

The use of *sukuk* or other *Shari'ah*-compliant instruments allow airlines new aircraft acquisition and fleet expansion. *Sukuk* is ideal for the expansion of the aviation industry because of the balance between the long-term nature of the assets, the regular income stream from passenger traffic and the structure of the securities. *Sukuk* financing facilities are also relatively more competitive than conventional loans, which results in better deals for airlines. Finally, due to the difficulties for airlines to be granted conventional loans, with fewer bank lending, Islamic finance becomes an alternative for aircraft financing.⁹⁸

In some cases, instead of the lessor having the ownership of the aircraft, a SPV may be put in place to hold the aircraft subject to a *mudharabah*, which is a form of investment management agreement, which is very similar to the concept of trust. Under the *mudharabah*, the funds are passed to the *mudarib*, which is a type of investment manager for receiving a share of profits.⁹⁹ The *mudarib* is not responsible for losses except losses resulting from its own negligence. Such structure allows some distance between the lessor and the ownership risks.¹⁰⁰ As already noted earlier, an example of this structure is the financing by Al Hilal Bank of an Airbus A340-600 for Etihad Airways, which won the Airfinance's Award for the deal of the year in 2008, and involved both an *ijara* and a *mudarabah*. The proceeds received by the SPV minus its profits' percentage was paid to Al Hilal Bank, because of its investment agent status under the *mudarabah*. The SPV also entered into an *ijara* with Etihad Airways appointing it as its service agent.¹⁰¹ To get around the prohibition of *riba*, the parties to this transaction have used some ingenious mechanisms which at the end of the day allow each party in this transaction to make some profit by charging interests in a disguised form.

C. DEFICIENCIES OF ISLAMIC FINANCE

Though Islamic finance provides major benefits for aviation, it does also have some deficiencies. As Man, Giddings and Burke pointed out:

⁹⁷ Ambrose, Boeing Looks to Islamic Finance and Sukuk for Funding, online <www.islamicfinance.com/2017/04/boeing-looks-islamic-finance-sukuk-funding/> (accessed 20 January 2019)

⁹⁸ Roberts, *supra* note 3, 30.

⁹⁹ di Mauro et al, *supra* note 26 at 16.

¹⁰⁰ "The Sukuk Handbook: Guide to Structuring Sukuk", *supra* note 37, 15.

¹⁰¹ Yeterian, *supra* note 5.

Islamic debt finance generally remains a more expensive source of funds than conventional debt finance and the term of the financing typically falls short of the 10 to 12 year loan terms available from conventional lenders.¹⁰²

Moreover, one of the biggest concerns of financing according to Islamic finance relates to how potential conflict can be resolved as the law is based on the interpretation of the religion.¹⁰³ This lack of standardisation creates particular problems for syndicated loan deals, and may lead to separate tranches of finance subject to (slightly) different structures.¹⁰⁴ This disadvantage, however, may also be an advantage as airlines can search for a financial instrument that offers an interpretation in line with their vision. This practice could be compared to forum shopping, except that in this case, interpretation can vary even within the same country or city. Indeed, every Islamic bank has a *Shari'ah* Board, the duty of which is to certify the bank's financial products and give a *Fatwa*¹⁰⁵ on each deal to confirm that it adheres to Islamic law.¹⁰⁶

Even though Islamic finance has some deficiencies, such an approach to financing allows airlines to grow and renew their fleet much more often than if they would rely on other conventional financings. For instance, Alitalia (AZ) was three times on the edge of bankruptcy and became an unattractive investment to other airlines due to an obsolete and a very diverse fleet.¹⁰⁷ Alitalia mainly survived because of the money injected by the government in the company,

¹⁰² Man, Giddings, & Burke, *supra* note 91.

¹⁰³ Urban, note 18 at 337.

¹⁰⁴ Bashar H. Malkawi, "Shari'ah Board in the Governance Structure of Islamic Financial Institutions" (2013) 61 *The American Journal of Comparative Law* 539; Nurfarahin M Haridan, Ahmad FS Hassan & Yusuf Karbhari, "Governance, religious assurance and Islamic banks: Do Shariah boards effectively serve?" (2018) 22 *Journal of Management and Governance* 1015; and Emily Samra, "Corporate Governance in Islamic Financial Institutions" (2016) *Law School International Immersion Program Papers*, No. 22.

¹⁰⁵ A *fatwa* is essentially a legal opinion issued by a qualified scholar on a question of Islamic Law.

¹⁰⁶ Hans Visser, *Islamic Finance: Principles and Practice*, 3rd ed (Northampton, MA: Edward Elgar Publishing, 2019); Karim Ginea and Azhar Hamid, *Foundations of Shari'ah Governance of Islamic Banks*, (John Wiley & Sons, 2015); and Mohammad Azam Hussain, "The Independence Of The Shariah Committee Of Islamic Financial Institutions In Malaysia: Legal Analysis" (2018) ILC 2017 - 9th UUM International Legal Conference.

¹⁰⁷ Marco Ponti, "Dov'è il valore di Alitalia", *LaVoce* (31 May 2007), online: *La Voce* <www.lavoce.info/archives/24290/dove-il-valore-di-alitalia/>; CAPA, "The no-change business model case study: Alitalia" (13 July 2017), online: *Centre for Aviation* <centreforaviation.com/analysis/airline-leader/the-no-change-business-model-case-study-alitalia-350054>; Paolo Beria, Hans-Martin Niemeier & Karsten Frohlich, "How Liberalisation Can Go Wrong: The Case of Alitalia" in Peter Forsyth, et al, eds, *Liberalisation in Aviation: Competition, Cooperation and Public Policy* (Farnham: Ashgate, 2013); Liz Alderman, "Alitalia Files for Bankruptcy, but Italy Balks at a Third Bailout", *New York Times* (2 May 2017), online: *New York Times* <www.nytimes.com/2017/05/02/business/italy-alitalia-airline-bankruptcy.html?mcubz=0>.

which was not curing the problem but instead was only giving the company a deferral. In 2014, with the company once again on the verge of bankruptcy, the Italian Government stepped in and helped to close a deal with Etihad Airways which obtained 49% of the company. Etihad Airways issued a plan which included to make AZ profitable by 2017, but the plan seemed too optimistic. Indeed, although at the beginning the results under Etihad Airways' regency looked bright, the terrorist attacks in Europe and downward pressure on fares negatively affected Alitalia's shy recovery.¹⁰⁸ Had Alitalia obtained Islamic financing, it may have better been able to renew its fleets and get out of the vicious circle it entered at the beginning of the year 2000. Moreover, it could have had relied on its passenger revenues using a *sukuk al-manafa'a*.

Islamic finance is becoming a better alternative to aircraft financing because of the willingness of the banks to loan larger sums of money and the liquidity of the market. It also allows airlines to tap into a reservoir that is largely unexploited. The fact that Emirates arrived to issue a *sukuk* guaranteed in the United Kingdom demonstrates the growing interest in Islamic finance elsewhere outside the Islamic world.

IV. ISLAMIC AIRCRAFT FINANCING AND THE CAPE TOWN CONVENTION

The Convention on International Interests in Mobile Equipment and Protocol thereto on Matters Specific to Aircraft Equipment (Cape Town Convention and Protocol)¹⁰⁹ has received a high level of ratification by Middle East countries. This Convention is considered as the most significant treaty pertaining specifically to international aviation financing and leasing. The main aim of the Convention was to aid the financing of mobile equipment while granting property rights and legal certainty to financier, lessors and operators through the establishment of an International Registry system. The very nature of aircraft leasing and financing requires special protection for creditors as aircraft often move between jurisdiction, making

¹⁰⁸ Terrorist attacks mainly refer to the 2015 Paris attacks and 2016 Brussels attacks. See: J. Politi, "Etihad pays the price for its misjudged Alitalia endeavor", *Financial Times* (2 May 2017), online: *Financial Times* < www.ft.com/content/f5deb440-2f46-11e7-9555-23ef563ecf9a >; Sean Cronin, "Etihad reports \$1.87bn loss on Airberlin, Alitalia impairments", *Arab News* (27 July 2017), online: *Arab News* < www.arabnews.com/node/1135506/business-economy >.

¹⁰⁹ *Convention on International Interests in Mobile Equipment*, 16 November 2001, 2307 UNTS 285 (entered into force 1 March 2006) (*Cape Town Convention*); *Protocol to the Convention on International Interests in Mobile Equipment on Matters Specific to Aircraft Equipment*, 16 November 2001, S. Treaty Doc 108-10 (entered into force 1 March 2003).

repossession more difficult. The Convention has increased the predictability of the financiers' rights and minimised the risks and costs of aircraft finance transactions.¹¹⁰ Consequently, the Convention is beneficial to both creditors and debtors. Indeed, its provisions grant protection to creditors in case of debtors' default.¹¹¹

The Convention has also partially helped solving some persistent uncertainties in the Gulf Region. According to Paul Jarvis and Andrew McMullan:

Historically, the effectiveness of mortgages in the UAE has been somewhat problematic. This stems from the fact that an aircraft is considered a moveable asset. Accordingly, under UAE law, the appropriate form of security over a moveable asset is a possessory pledge.¹¹²

By applying the Convention, mortgage can be registered with the International Registry and searched by third parties. The Convention makes it, therefore, possible to 'circumvent' national restriction, allowing major airlines in the United Arab Emirates (UAE) to profit from it.

The major conflict between the Convention and Islamic finance in general is the prohibition of *riba*. For a transaction to be considered *Shari'ah*-compliant, it will depend on how the lender obtains a profit and how such profit affects all the parties involved.¹¹³ However, the lack of uniform interpretation of *Shari'ah* is one of the biggest concerns in aviation financing. Moreover, the risk of conflict between provisions of a specific legislation and *Shari'ah's* rules creates uncertainty. For instance, there are no specific aircraft mortgage provisions in UAE aviation law. Therefore, to circumvent such type of problem, and comply with the Cape Town Convention, the mortgagee's interest in the aircraft is registered as an international interest under the UAE Federal Law No. 18 of 1993.¹¹⁴ Risk-sharing is also addressed in the UAE's Civil Code creating a presumption that the lessor is primarily responsible "for ensuring the continued

¹¹⁰ Nettie Downs, "Taking Flight from Cape Town: Increasing Access to Aircraft Financing" (2014) 35 U. Pa. J. Int'l L. 863

¹¹¹ HFW, "The Cape Town Convention: A Summary" (2015), online: HFW <www.hfw.com/downloads/HFW-The-Cape-Town-Convention-a-summary-June-2015.pdf>

¹¹² Paul Jarvis and Andrew McMullan, "What does the Cape Town Convention mean for the UAE?" (18 June 2015) online: <www.expertguides.com/articles/what-does-the-cape-town-convention-mean-for-the-uae/ardmairz>

¹¹³ Luigi Rosa, *supra* note 47, at 44

¹¹⁴ UAE, *Federal Law No. 18 of 1993 Issuing the Commercial Transactions Code*, article 5(6) in conjunction with article 164(1).

According to Article 165(1), the mortgagee must have possession over the aircraft. While the Commercial Code is silent as to the manner in which the possession test would be satisfied, such consideration is ultimately a question of fact

enjoyment of the leased asset by the lessee".¹¹⁵ This shows that although Islamic finance may conflict in some respects with international treaties, legislators have already found a solution that allows to have the best of the two worlds.

V. CONCLUSION

Until recently, Islamic financing has not been considered a mainstream alternative to conventional finance. However, as discussed in this article, Islamic finance for aviation is not only a great opportunity for investors to diversify their portfolios, but it also provides a form of certainty. Indeed, the profit- and risk-sharing model oblige banks to seek their best interests as well as their client's best interest.

Sukuk is the most commonly used instrument in aircraft financing. To comply with the rules and prohibitions imposed by Islamic law, some different investment vehicles have been developed over the years, such as *murabaha* (cost-plus financing), *ijarah* (lease), *musharakah* (partnership) and *mudharabah* (sweat capital). Many of the *sukuk* are based on an underlying *ijarah* transaction, where the stream of income generated from a sale-leaseback of a real property asset funds the payments to the *sukuk* holders. All of these instruments offer an alternative to conventional finance in aviation. The prohibition of speculative risk or *gharar* plays the role of a safeguard by avoiding airlines to enter into transactions that might be detrimental. As *sukuk* cannot be backed by a pool of *murabaha*, a situation as the 2008 Financial Crisis is very unlikely.

The benefits of *sukuk* financing have made it an attractive source of capital for issuers outside of the Muslim world who are seeking to tap into the liquidity that Islamic investors currently enjoy. Despite their recent history, airlines have been able to raise billions of dollars through *sukuk*. Whenever *sukuk* are backed by assets not already governed by Islamic law, special considerations arise. Companies influenced by Western legal systems should gain a good understanding of the complex legal principles involved before entering into such transaction. Indeed, the *sukuk* must abide all the limitation provided by *Shari'ah* while facing the challenge of operating in a system that is traditionally not accustomed to Islamic finance. Such challenge partially explains why none of the major Western airlines is using *sukuk*. Boeing is starting to gain interest in *sukuk*, but this is more to accommodate its Middle East clients rather than to

¹¹⁵ Urban, *supra* note 18 at 345.

extend this type of financing to more conventional airlines. There are examples of *sukuk*-backed on assets outside the Muslim world such as oil and gas assets in the United States. This, in turn, demonstrates that Islamic finance could be used as an alternative type of financing in the Western world.¹¹⁶

Islamic finance definitely contributes to the growth potential of Middle East airlines, because of the easier access to loans and the amount of such loans. Overall, Islamic finance should be considered by companies seeking aviation financing and leasing, as it offers other opportunities as accompanied by access to a greater pool of investors. The growing interest for European banks in Islamic finance has become noticeable, while some European airlines have adopted hybrid financing instruments.

Not so long ago, the vast majority of *sukuk* were issued by institutions within the Muslim world, supported by assets located in jurisdiction embracing Islamic principles. However, Western governments and financial institutions are beginning to embrace *sukuk*, as was the case with the *sukuk* issued by Emirates. Airlines might in the future want to look more closely at Islamic finance as it might give them the flexibility needed for their company to grow.

¹¹⁶ Christopher F Richardson, "Islamic Finance Opportunities in the Oil and Gas Sector: An Introduction to an Emerging Field" (2006) 42 Tex Intl L J 120.

Table 1: Overview of various *sukuk* financing structures

Airline	Year	Amount	Type	Tenure	Purpose
Emirates	2015	US\$ 913 billion	<i>sukuk Al-ijara</i> guaranteed by Her Majesty's Secretary of State acting by the Export Credits Guarantee Department of the UK	10 years	Aircraft financing ¹¹⁷
Etihad Airways	2016	US\$ 1.5 billion	<i>sukuk Al-ijara</i>	5 years ¹¹⁸	
Royal Jordanian	2016	US\$ 275 million	Hybrid structured debt instrument : IATA-based conventional tranche with Islamic Wakala facility	5 years	Pay existing debt and modernise fleet ¹¹⁹
Air Arabia	2014	US\$ 230 million	<i>sukuk Al-ijara</i>		Aircraft financing (6 Airbus A320) ¹²⁰
Turkish Airlines	2016	US\$ 3 billion	Hybrid structured debt instrument: 85% of financing of Boeing aircraft	12 years	Financing the purchase of Airbus and Boeing aircraft ¹²¹

¹¹⁷ Sukuk, *supra* note 89

¹¹⁸ "Etihad Airways prices \$1.5 bln sukuk with 3.86 percent profit rate – leads", *Reuters* (23 November 2016), online: *Reuters* <www.reuters.com/article/etihad-sukuk/etihad-airways-prices-1-5-bln-sukuk-with-3-86-percent-profit-rate-leads-idUSD5N1D7030>.

¹¹⁹ "Case Study: Financing Royal Jordanian Airline's big ambitions", (4 April 2016), online: *Bond and Loans* <www.bondsloans.com/news/article/601/case-study-financing-royal-jordanian-airlines>.

¹²⁰ "Dubai Islamic Bank signs US\$230 million aircraft financing deal with Air Arabia" (18 November 2014), online: *AirArabia* <press.airarabia.com/dubai-islamic-bank-signs-us230-million-aircraft-financing-deal-with-air-arabia/>.

¹²¹ Archana Narayanan, "Turkish Airlines seeks up to \$3 bln in loans for aircraft financing", *Reuters* (15 July 2015), online: *Reuters* <www.reuters.com/article/turkish-airlines-funding/turkish-airlines-seeks-up-to-3-bln-in-loans-for-aircraft-financing-idUSL5N0ZVIGL20150715>.

			guaranteed by the European Export Credit Agency (EECA) and 85% of a General Electric spare engine guarantee from the Export-Import Bank of the United States		
Malaysian Airlines	2016	+/- US\$ 750 million	Sukuk structured under the Wakalah principle. Coupon oversubscribed by 50% at a profit rate equivalent to US five-year Treasuries plus 178 basis points	5 years	Aircraft financing ¹²²
Pakistan International Airlines	2002	US\$150 million	Murabaha contract		Aircraft financing, 8 Boeing 777. ¹²³
Ethiopian Airlines	2014	US\$100 million	Hybrid structured debt instrument: Ibdar Bank financed \$22 million of the deal through	12 years	Aircraft financing, 4 Bombardier Q400 NextGen planes. ¹²⁴

¹²² Sherilyn Goh, "Malaysia's Khazanah issues US\$750 million sukuk to refinance MAB", *Asia Asset Management* (25 February 2016), online: *Asia Asset Management* <www.asiaasset.com/post/5944-khazanahsukuk-sg2402-dm#:~:text=The%20Malaysian%20government's%20sovereign%20wealth,purpose%20vehicle%20Danga%20Capital%20Berhad.>

¹²³ H Visser, *Islamic Finance: Principles and Practice*, 1 ed, (Northampton, MA: Edward Elgar Publishing, 2006).

¹²⁴ Reuters, "Ibdar Bank, Ethiopian Airlines close \$100mln Islamic financing deal", Reuters (1 December 2014), online: Reuters <www.reuters.com/article/ethiopian-air-financing/ibdar-bank-ethiopian-airlines-close-100mln-islamic-financing-deal-idUSL6N0TL02P20141201>

			sukuk Al-ijara, with US\$ 78 million secured through a funding agreement with Export Development Canada		
SriLankan Airlines	2012	US\$ 175 million	<i>Sukuk</i> ¹²⁵	4 years	
AirAsia	2012	US\$ 304 million	<i>Sukuk mudaraba</i> structure	No set maturity	Aircraft financing and refinance of debt ¹²⁶

¹²⁵"SriLankan Airlines gets \$ 175 m Islamic loan from Gulf banks", *Financial Times* (2 July 2012), online: *Financial Times* <www.ft.lk/front-page/srilankan-airlines-gets-175-m-islamic-loan-from-gulf-banks/44-95822>.

¹²⁶ Simon Harvey, "AirAsia Joins Growing Band of Companies Selling Perpetual Sukuk", *Bloomberg* (30 October 2014), online: *Bloomberg* <www.bloomberg.com/news/articles/2014-10-30/airasia-joins-growing-band-of-companies-selling-perpetual-sukuk>.