

# An introduction to Islamic finance

## Sharia background

Islamic finance is a way of performing financial and banking transactions while respecting Islamic or 'Sharia' law.

Sharia law is derived from both the Qur'an, Islam's central text, and *fatwas*, which are the rulings of Islamic scholars.

In recent years, the global financial market has witnessed an increased appetite for Sharia-compliant investment structures – either as stand-alone fully compliant instruments or as part of a wider structure involving non-Sharia investors too. As a result, financial products have become increasingly sophisticated.

The three main tenets of Sharia law that are typically relevant to financial investments are:

- (a) the prohibition of *riba* (meaning interest)
- (b) the prohibition of *gharar* (meaning unacceptable levels of risk or uncertainty)
- (c) the prohibition of investments in sectors prohibited by Sharia law, like gambling, tobacco and alcohol.

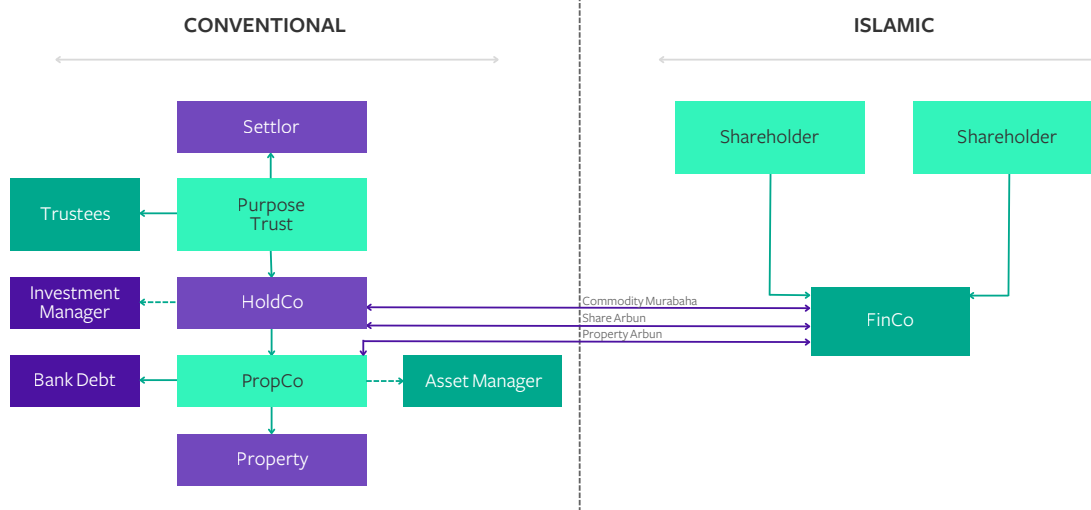
## Islamic finance: a case study

There are numerous techniques to achieve Sharia-compliant investments, all of which have at their core an interest-free component.

In many cases, the goal is to allow Sharia investors to indirectly invest into a traditional/Western target fund (e.g. real estate or private equity) in a manner that complies with Sharia principles whilst also treating the investor, from an economic perspective, as if they were a direct investor in the fund.

A common approach is to transmit such investments into the target fund using one or more Sharia-compliant holding companies. The structures can be complex and depend on the requirements of each investor's Sharia adviser (whose opinions can vary, meaning there may be different routes for different investors into the same target).

In the real estate example below, the company (FinCo) acts as a financier and enters into a Sharia-compliant financing with a second holding company (in this case, a commodity *Murabaha*). This latter company (HoldCo) then applies the proceeds of the Sharia-compliant financing (via PropCo) towards an investment in the underlying asset.



## How does the commodity *Murabaha* agreement work?

Using the above real estate structure as an example, HoldCo serves a notice on FinCo requesting to purchase certain commodities. The consideration is deferred and comprises the cost of the commodities (being equal to the amount of the call) plus a pre-determined profit amount (being an arbitrary amount reflecting potential returns from the underlying investment).

FinCo then purchases the commodities from a commodity broker; simultaneously, FinCo sells the commodities to HoldCo.

HoldCo immediately sells the commodities to a commodity broker, providing HoldCo with the requisite funds to make the investment. As a result of netting-off, no funds are actually transferred to the commodity brokers besides transaction fees.

## Other considerations

In fund scenarios, the FinCo and HoldCo also typically enter into a commodity *Musawama* agreement. Such an agreement allows flexibility in situations where the pre-determined profit amount payable under the *Murabaha* is unlikely to track the actual investment gains or losses from the target (resulting in over or under payments between HoldCo and FinCo under the *Murabaha*).

The *Musawama* agreement is similar to the *Murabaha*, but allows greater flexibility on pricing and provides a mechanism by which the HoldCo can make payments to the FinCo corresponding to returns generated in excess of, or any shortfalls in, the aggregate amounts payable under the *Murabaha*.

## Importance of appointing a trusted partner

Because Sharia-compliant structuring often involves interposing various holding companies between the investor and the target, there is a lack of direct contractual nexus between investors and the underlying assets. It is therefore usual to prepare and enter into side letters between the investor and the target fund or HoldCo so that the target fund or HoldCo may enforce its rights directly against the investor in the event of a failure to pay called amounts.

As Sharia-compliant structures (such as the example above) often anticipate HoldCo being an 'orphan' entity (meaning they are 100% owned by a non-charitable purpose trust and remain 'off balance sheet' for the investor and the sponsor), it is important clients work with trusted, experienced service providers such as IQ-EQ.

IQ-EQ works closely with advisers to ensure that Sharia principles are honoured, assets safeguarded and repayment dates under *Murabaha* (or other) contracts are aligned – and that cash is passed up the structure efficiently.

Different Islamic markets often apply different approaches to Sharia law. For this reason, when sourcing financing within a particular market or from a particular bank or financial institution, it is important to partner with professionals who have a close appreciation of the prevailing customs and practices within that market and of that bank or financial institution.

As well as a thorough understanding of Sharia requirements and cultural sensitivities, IQ-EQ also has experience of the varying degrees or levels of Sharia application that sometimes apply, with some clients following strict Sharia principles and others taking a 'Sharia-lite' approach (where permissible).

## We`re a global corporate administration business with specialist expertise in Islamic finance

With offices in 25 jurisdictions and almost 5,900 employees worldwide, is ideally equipped to provide services to UK and international clients looking to establish offshore Sharia-compliant structures.

Jersey, Guernsey and the Isle of Man are each a preferred destination for Islamic finance structures because of their:

- (i) political and economic stability;
- (ii) trusted legal system and tax neutrality;
- (iii) pragmatic and proportionate regulation;
- (iv) world-class legal, accounting and administration service providers.

Both the Channel Islands and Isle of Man provide flexible legal solutions, allowing Sharia-compliant investment using any of the typical legal structures such as investment funds, limited companies, protected/incorporated cell companies, unit trusts and limited partnerships.

Combined with their rich real estate heritage, the jurisdictions are all ideal locations for structuring vehicles used to acquire real estate or private equity assets in the UK, Europe, the U.S. and beyond – and with well-established and highly-regulated financial services sectors, clients are able to rely on superior quality advice and responsiveness from a large pool of experienced lawyers, accountants and administrators.

## Speak to our experts

We possess the knowledge, experience and capability to assist with all Sharia and Islamic finance matters. To learn more about IQ-EQ's Sharia credentials or to speak to one of our Sharia experts, please do not hesitate to contact any of our team below:

## Key contacts

If you would like to know more about our solutions please contact Mirek, Simon, Matt or Mark.



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