

Introduction to Islamic Banking: Islamic Banking & Conventional Banking

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- ***Financial News* inaugural Islamic Finance conference**
- **London on 8 November 2007**

Islamic Finance in London

- Every Londoner practices Islamic Banking
- Discounts for annual season tickets
- This is *Salam*
- Used for financing crops
- British Gas Savings stamps



Quotes

Happy the man who far from schemes of business, like the early generations of mankind, ploughs and ploughs again his ancestral land with oxen of his own breeding, with no yoke of usury on his neck.

Roman philosopher, Horace

Julius Caesar limited interest to 8 1/3 %



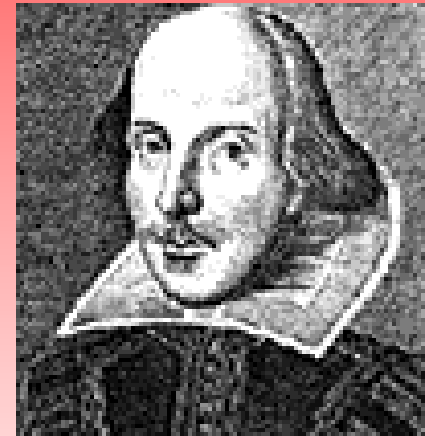
Quotes

Neither a borrower nor a lender be; For loan oft loses both itself and friend and borrowing dulls the edge of husbandry.

Shakespeare's «hamlet», a Danish father advising his son

UK usury laws on excessive interest abolished in 1854

South Africa and US (except Virginia and Delaware) have usury laws



Quotes

Those who devour usury will not stand except as stands one whom the evil one by his touch hath driven to madness. That is because they say: "trade is like usury but Allah hath permitted trade and forbidden usury."

The Koran: Surah 2, verse 275



Overview

- Hallal vs. Haram
 - Only if it is banned is it banned
 - Substance over form?
- Essentially 5 dimensions of Islamic products
 1. Prohibition of *riba* free (usury = interest)
 2. Al-bay (trade is permitted and encouraged)
 3. Avoidance of gharar (ambiguities)
 4. Prohibition of maysir (gambling)
 5. Prohibited activities

Three families of Islamic financial products

1. Profits and loss sharing PLS
 - Equity investment
 - Fund management
 - Venture capital
2. Mark up
 - Trade finance similar to Bankers Acceptances
 - Leasing
3. Ethical dimension - (no liquor, pork, banking, insurance, pornography)

Overview – Profit & Loss Sharing (PLS)

- Profit & Loss Sharing (PLS)
 - basically, no pain no gain
- Venture capital, non-recourse project finance, equity investment versus lending
- US , UK banking versus German, Japanese, Spanish banking
- Private Equity Funds

Overview - Markup

- Mark up - predetermined profit.
 - Predominates 87% Pakistan, 63% Iran
 - Investors' risk aversion
 - Borrowers' protection of equity interests
- Tax similarities - interest versus capital gains tax
- Interpretations change
 - Treasury bills, foreign exchange, zero coupons, circular transactions.
- Various jurisdictions / opinions
 - Gulf, Malaysia, London

Overview - Ethics

- Ethical dimension - undesirable investments sectors
 - Alcohol
 - Armaments
 - Gambling
 - Tobacco (not specifically banned) – so different from ethical funds
 - Riba tainted
 - No banking and insurance stocks
 - No stocks with more than 30% gearing Enron. avoided
- Charitable aspects
 - Interest donated to charity
 - Can the borrower afford to repay?
 - Faith does not mean soft option.

Riba is more than Usury

- US, South Africa, UK
 - Excessive interest
 - Early repayment penalty
- Active versus passive lending
- Pawn broking versus money lending
- No distinction between fair and unfair interest
- Trade is allowed

Warren Edwards • Repayment only if borrower is able to? risk management

Key Islamic Financial Instruments PLS

- Mudaraba / Modaraba
 - PLS no pain no gain
 - Rabbulmal - capital provider / investor
 - Mudarib - entrepreneur / borrower
 - Profits split between Rabbulmal and Mudarib as agreed
 - Losses only to financier.
- Looks like non-recourse project finance

Key Islamic Financial Instruments PLS

- Shirka
 - Generalised Mudaraba
 - More than 2 parties
 - Non contractual - Al Milk,
 - Contractual Ul Uqud
- Looks like syndicated non-recourse project finance

Key Islamic Financial Instruments PLS

- Musharaka / Mosharaka
 - Equity investing
 - Limited partnership
 - Profits distributed according to pre-agreed formula
 - Fair share of profits? 95% to investor?
- Looks like normal equity investments or fund management
- Sounds like “shares”
- Loss sharing? Limited liability to investment.

Key Islamic Financial Instruments PLS

- Al- Wadiah
 - Retail savings account
 - Cheque books bill payments, debit and now credit cards etc.
 - Dividend paid subject to profits through the year
 - Only profits no loss of capital
 - Short term accounts
- Looks like with profits bonds – but don't mention Equitable Life!
- Other retail
 - Prizes, gifting of interest to charity, no transaction fees

Key Islamic Financial Instruments – Mark-up

- Murabaha / Morabaha / Al Bay Bithaman Ajil
 - Mudaraba / Musharaka on bank liability side
 - Murabaha / Morabaha on asset side.
 - Locked-in return
 - Bank buys asset on behalf of client / borrower and then sells it for deferred payment
 - Title transfers at outset or on payment at maturity
 - Interest into capital gains? Use of Libor
- Sounds like “Repo”
 - a sale and repurchase agreement
 - Similar to Bankers Acceptance – BAs

Key Islamic Financial Instruments - mark-up

- Baimuajjal
 - Property financing on a deferred basis
 - Payment in instalments or lump sum with mark-up
 - Predetermined profit.
- Ijara
 - Leasing type transaction
 - Title stays with lessor
 - Option to buy goods on maturity of contract
 - Ijara wa iqtina is renting then purchase

Key Islamic Financial Instruments - Mark-up

- Baisalam
 - Manufacturers financing of production
 - Bank buys and pays for goods at a discount before manufacture
 - Basis for Commodity futures contract? A derivative?
 - Trade not debt



Key Islamic Financial Instruments - Mark-up

- Sukuks - Islamic bonds – \$30 billion and growing
- Sachsen-Anhalt issued a Sukuk in July 2004
- UK Government plans to issue Sukuks in 2008
- Hedge fund investors seeking exposure to Mid East

Key Islamic Financial Instruments - Sukuks

- SPV buys asset and leases it (Ijara) back to borrower
- SPV issues Sukuks
- Borrower pays a stream of lease payments to SPV
 - Libor based or fixed
- SPV pays investors Libor based or fixed

Summarise: Key Features of Islamic Banking

- Interest free
- Trade related and perceived need for funds
- equity related - desired form of Islamic Banking?
- Avoids exploitation
- Ethical investments
 - Alcohol, tobacco, gambling, armaments, pornography etc

Conclusion: Islamic Finance in the UK

- Islamic retail banking in The UK
 - Direct via the internet avoids local training and distribution issues
- Islamic retail clients are risk averse
- Top banking brand names have an advantage
 - Growth market for strongly capitalised banks
- Attracting Middle East Capital to The UK
- Financing Trade and encouraging UK exports to The Middle East / Malaysia etc.
- There is indeed a political dimension
 - Travel inconveniences in the US
 - Dubai Ports World Case.