DEMYSTIFYING ISLAMIC BANKING AND FINANCE

by Warren Edwardes, CEO, Delphi Risk Management

IN BRIEF

There are sufficient Muslim investors and borrowers in both Islamic and non-Islamic countries to warrant the attention of traditional banks who seek to serve such clients and capture a potentially profitable slice of a still relatively untapped market.

The author clears away some of the mystery and shows how some such Islamic products can fit alongside a conventional banking system and thereby serve a Western bank's retail and wholesale clients or help a corporation that is offered Islamic funds. Some non-Islamic financial or exporting institutions may also find it prudent to use Islamic finance so as to gain favour in Islamic markets, in order to ease entry or enhance business.

London-based Delphi is a financial instrument innovation and risk management consulting and training firm. It assists financial institutions in the design of new retail and wholesale financial products; corporates in the valuation, use, negotiation and re-negotiation of structured products; and lawyers as a derivatives expert witness.

THERE are two basic principles in Islamic banking: the absence of interest, usury or *Riba* used interchangeably is prohibited on the principle of no pain no gain; plus social and ethical features avoiding undesirable investments and enhancing trade.

The prohibition of *Riba* is akin to the usury laws in many Western countries or a ban on excessive interest. What I would call 'pure' Islamic banking appears to be similar to venture capital finance, non-recourse project finance or ordinary equity investment. The investor takes a share in the profits, if any, of the venture and is liable to lose his capital. It involves investing but not lending. But some products are more Islamic and than others. Just as in tax management, numerous products have been developed to meet the letter but not necessarily the spirit of the regulations. Just as in the process of converting interest into capital gains for tax purposes, early Islamic investors were content to enter into zero-coupon bonds or discounted Treasury bills and receive the interest foregone in the form of capital gains. In the mid-1980s I dealt foreign exchange and deposit packaged transactions. The 'Islamic' client bought a low interest rate currency or even gold from the bank. This was placed on deposit interest-free. Simultaneously, the currency or gold was sold forward with the forward reflecting the fact that no interest is paid on the deposit. Such locked-in capital gain is now usually regarded as interest for tax purposes. Similarly many such devices of converting interest to capital gains are increasingly unacceptable to the Islamic authorities.

Nevertheless, in my observations, 85 per cent of Islamic banking as practised involves some form of pre-determination of profit or 'mark-up' that, while acceptable to individual Islamic authorities, would now be regarded as capital gains by most fiscal authorities. For some institutions, appearances are important in terms of being seen to be Islamic in the eyes of their customers, shareholders and regulators. And even when there is a guaranteed return generated through a "mark-up" scheme, the linking to an underlying trade transaction is deemed 'a good thing'. Just as there is no central, global fiscal authority, there is no Islam-wide authority that determines what is *Hallal* (acceptable) and what is *Haram* (prohibited) and there is a danger that some will go around 'opinion-hunting' to get Islamic approval for their schemes, just as Western banking business moves from one tax jurisdiction to another.

The ethical issues

Beyond the question of interest are the ethical issues. Islamic investments exclude tobacco, alcohol, gaming and other 'undesirable' sectors. Islamic investors, by and large, are motivated in their choice of investments by much the same criteria as their Western ethical counterparts. The search for acceptable investments is balanced by natural risk-aversion. Islamic borrowers also demonstrate a reluctance to give away a share in the profits of their enterprise. It is therefore not surprising that most Islamic banking takes the form of one type of mark-up or other rather than profit sharing. But Islamic banking is still very much a fledgling industry with only 20 years of practice.

Key Islamic financial instruments

Mudaraba
Under the principle of no pain no gain, no one is entitled to any addition to the principal sum if he does not share in the risks involved. The capital provider or *rabbulmal* may 'invest' through an entrepreneur borrower or *Mudarib*, hence the name of the structure. Profits are shared on a pre-agreed basis; however, losses, if any, are wholly suffered by the *rabbulmal*. This financing structure is called *Mudaraba* and to me looks like non-recourse project finance. Profits can be divided in any proportion between the two contracting parties as agreed upon at the time of the contract; but losses, if any, will fall on the financier only. *Mudaraba* is similar to *Shirka*.

Shirka
Shirka is a partnership between two or more persons. There are two types, *Shirka al-milk* (non-contractual) and *Shirka ul-uqud* (contractual). In the case of the contracting partnership, bounds are set. If the entrepreneur falls beyond these bounds, then he is liable for the loss.

Musharaka
Financing through equity participation is called *Musharaka*. I remember the name by likening it to share holdings. Here the partners or shareholders use their capital through a joint venture, limited partnership to generate a profit. Profits or losses will be split between the shareholders according to some pre-agreed formula linked but not solely linked to the investment ratio. Technically there are no fixed rules, though the use of the investment ratio is deemed fair. But again, this has to take into account the resources contributed by each party, not necessarily financial, such as experience and expertise.

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Mudaraba and *Musharaka* represent the desired forms of Islamic banking even though their current use is not dominant.

Murabaha (or Morabaha)
The majority of Islamic financial transactions do not involve a share of profit but incorporate a locked-in return. Most are 'mark-up' structures such as *Murabaha*. I liken it to the similar sounding 'repo' or sale and repurchase agreement used in the West.

In a *Murabaha* transaction, the bank finances the purchase of an asset by buying it on behalf of its client. The bank then adds a 'mark-up' in its sale price to its client who pays for it on a deferred basis. The 'cost-plus' nature of *Murabaha* sounds very much like the interest into capital gains structures of tax avoiders. But Islamic banks are supposed to take a genuine commercial risk between the purchase of the asset from the seller and the sale of the asset to the person requiring the goods, and it is argued that the services provided by Islamic banks are substantially different from those of money-lenders.

Many organisations pragmatically use Libor as the reference basis for their mark-ups as being the market rate for funds with a small percentage for the firm's profit.

Ijara
An Islamic form of leasing is called Ijara. Here the bank buys machinery or other equipment and leases it out under instalment plans to end-users. As in Western leasing there may be an option to buy the goods built into the contracts. The instalments consist of rental for use and part-payment.

Baisalam
When a manufacturer seeks to finance the production of goods he seeks *Baisalam* financing. This involves the

bank paying for the producer's goods at a discount before they have been delivered or even made. It is thus similar the Bankers' Acceptance financing in the West.

Baisalam involves the advance payment for goods to be delivered later. There is no sale unless goods exist at time of deal except where the goods are defined and a date is fixed. This sounds like commodity futures with a difference. But a central condition is the advance payment and parties cannot reserve the option of rescinding the contract. However if there is a product defect on delivery then there is redress. *Baisalam* is typically used to fund agricultural production to help a farmer to buy seed, receiving a portion of the crops to sell at market.

Key features of Islamic banking

There are five key features: free of interest; trade related and a perceived 'genuine' need for the funds; in its purest form, it is performance and therefore equity related; it is meant to avoid exploitation – no usury; ethically directed.

Interest free

The avoidance of interest has been abused by those who merely seek to be seen to be Islamic bankers. Many convert interest into capital gains and find a Koranic justification. The rules have been tightened progressively as they have been in tax avoidance.

Trade related

I am not going to criticise devices converting interest to capital gains as all such instruments have to show some underlying commercial need and therefore probably go some way towards the Islamic objectives. There are Western parallels with commercial paper and Bankers Acceptances which also have to be trade related. Many emerging markets, under their exchange control regimes, insist that all overseas financing or foreign exchange transactions have to be trade related.

Equity related

'Pure Islamic banking' involves profit and loss sharing or equity participation in the *Mudaraba* and *Musharaka* forms. There is no pre-determined interest income for the lender, or in this case, the investor. The investor's return is uncertain. Sounds good and just the sort of venture capital financing many in the West have been demanding of their risk-averse banks.

No exploitation

Devices can be created so that pre-determined 'interest' can be made to look like pre-determined capital gains and also a tiny bit of uncertainty can be introduced into the equation. But there is also a requirement to avoid exploitation. What if under a profit sharing arrangement, because of the entrepreneur's poor bargaining position and the banker's monopoly status, the bank received 95 per cent of a venture's profits? Would this be deemed Islamic? Perhaps. There do not appear to be hard and fast rules that determine fair profit sharing ratios.

Ethical investments

Islamic investments have to avoid undesirable sectors. In that this aspect of Islamic banking is little different from many Western 'ethical' investment funds. There is a considerable overlap between such funds' objectives and those of many of the Islamic investment funds.

Conclusion

While Islamic bankers have sought to avoid excessive risk through *Murabaha*, *Ijara* and *Baisalam*, the essential element of most such deals is the linking to a genuine identifiable trade transaction. Islamic finance seekers thus have to open themselves up to their banks even more then their Western counterparts and can only obtain finance for genuine needs. Firms or individuals cannot borrow to repay another bank. General-purpose finance or borrowing for consumption purposes, overdrafts and swing lines do not exist. Profit and loss sharing *Musharaka* and *Mudaraba* are more difficult to obtain. Such business is not unknown in Western banking. It is called investment banking.

There are counterparts in almost all forms of Islamic banking in Western banking. There are Islamic versions of repos, leasing, unit trusts, hire purchase, equity investments, venture capital and non-recourse project finance. There are also non-Islamic parallels with ethical investment fund management.

Perhaps replacing Arabic terminology, such as *Ijara* with 'leasing' or *Musharaka* with 'equity participation', will lead to a greater understanding of Islamic banking. And it appears that given a choice between a pure Islamic bank and a highly rated reputable international bank providing the same service, Islamic clients would rather go to the one that has a brand name than the one that provides Islamic-only services, without the brand name and rating. I see Western banks increasingly and successfully providing Islamic banking and financial services. □

This article is an abridged version of Appendix 4 of Key financial instruments: understanding and innovating in the world of derivatives *by Warren Edwardes, published by Financial Times Prentice Hall, reproduced here by permission of the publishers.*

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