BOYADJIAN & ASSOCIATES

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New Trends in Islamic Finance

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Islamic finance is developing at a remarkable pace. Since its inception three decades ago, the number of Islamic financial institutions worldwide has risen from one in 1975 to over 300 today in more than 75 countries. They are concentrated in the Middle East and Southeast Asia (with Bahrain and Malaysia the biggest hubs), but are also appearing in Europe and the United States. Total assets worldwide are estimated to exceed $250 billion, and are growing at an estimated 15 percent a year.

Islamic financial products are aimed at investors who want to comply with the Islamic laws (*Sharia*) that govern a Muslim's daily life. These laws forbid giving or receiving interest (because earning profit from an exchange of money for money is considered immoral); mandate that all financial transactions be

What is Islamic Financing?

The fact that Islamic laws prohibit paying and receiving interest does not imply that they frown on making money or encourage reverting to an all-cash or barter economy. They encourage all parties in a financial transaction to share the risk and profit or loss of the venture. Depositors in Islamic banking can be compared to investors or shareholders, who earn dividends when the bank makes a profit or lose part of their savings if the bank posts a loss. The rationale is to link the return in an Islamic contract to productivity and the quality of the project, thereby ensuring a more equitable distribution of wealth.

Islamic financial instruments take the form of contracts between providers and users of funds to manage risk. On the asset side, Islamic banks engage in investment and trading activities according to the various contracts available. On the deposit side, funds are mainly mobilized on the basis of a *Mudaraba* contract or an interest-free loan contract (*Qard Al Hasan*). Overall, Islamic banks offer their depositors four classes of accounts: current, savings, investment, and special purpose investment accounts.

A Range of Islamic Financial Instruments:

While the main types of Islamic financial instruments are conceptually simple, they may become complicated in practice as some banks combine aspects of two or more types of instruments to suit customer requirements.

Debt instruments include *Murabaha*, a purchase and resale contract in which a tangible asset is purchased by a bank at the request of its customer from a supplier, with the resale price determined based on cost plus profit markup; *Salam*, a purchase contract with deferred delivery of goods (opposite to *Murabaha*), which is mostly used in agricultural finance; *Istisna*, a predelivery financing and leasing instrument used to finance long-term projects; and *Qard al-Hasan* (benevolent loan), an interest-free loan contract that is usually collateralized.

Quasi-debt instruments include *Ijara*, a leasing contract whereby a party leases an asset for a specified rent and term. The owner of the asset (the bank) bears all risks associated with ownership. The asset can be sold at a negotiated market price, effectively resulting in the sale of the *Ijara* contract. The *Ijara* contract can be structured as a lease-purchase contract whereby each lease payment includes a portion of the agreed asset price and can be made for a term covering the asset's expected life.

Profit-and-loss-sharing instruments include *Musharaka*, an equity participation contract under which a bank and its client contribute jointly to finance a project. Ownership is distributed according to each party's share in the financing. They also include *Mudaraba*, a trustee-type finance contract under which one party provides the capital for a project and the other party provides the labor. Profit sharing is agreed between the two parties to the *Mudaraba* contract and the losses are borne by the provider of funds except in the case of misconduct, negligence, or violation of the conditions agreed upon by the bank.

based on real economic activity; and prohibit investment in sectors such as tobacco, alcohol, gambling, and armaments. Islamic financial institutions are providing an increasingly broad range of many financial services, such as fund mobilization, asset allocation, payment and exchange settlement services, and risk transformation and mitigation. But these specialized financial intermediaries perform transactions using financial instruments compliant with *Sharia* principles.

What are the reasons behind the recent growth in Islamic finance? One is the strong demand from a large number of immigrant and nonimmigrant Muslims for *Sharia*-compliant financial services and transactions. A second is growing oil wealth, with demand for suitable investments soaring in the Gulf region. And a third is the competitiveness of many of the products, attracting Muslim and non-Muslim investors. Yet despite this rapid growth, Islamic banking remains quite limited in most countries and is tiny compared with the global financial system. For it to take off and play a bigger role, especially in the Middle East, policymakers must tackle enormous hurdles—notably on the regulatory front. Islamic banking has so far been spared from a serious financial crisis, with the exception of a few small cases (such as the Dubai Islamic Bank in 1998 and *Ihlas Finans* in Turkey in 2001). Nevertheless, building confidence in a new industry is fundamental for the development of Islamic finance.

In countries where Islamic banking is operating, its coverage and extent vary significantly from situations where the sector is entirely Islamic (Iran and Sudan), to others where conventional and Islamic systems coexist (Indonesia, Malaysia, Pakistan, and the United Arab Emirates), to countries where there are one or two Islamic banks. The current trend seems to be toward separation between Islamic and conventional banks. Some countries have opted for a clear separation between these banks, while others have allowed conventional banks to set up Islamic windows, opening the way for some of the largest multinational banks to participate. Even large conventional banks in the United States and Europe have opened Islamic financing windows.

The Islamic debt market—both foreign and domestic—has been the most rapidly growing segment of Islamic finance. In Malaysia, for example, Islamic securities accounted for 42 percent of total outstanding private debt securities by end-2004, and Islamic securities accounted for 25 percent of total outstanding bonds.

The international Islamic bond market is divided into sovereign (and quasi-sovereign) and corporate *Sukuk* (or Islamic note) markets—a particularly innovative, rapidly growing area. These asset-based bonds of medium-term maturity have been issued internationally by sovereign and corporate entities. *Sukuk* paper has the advantage of competitive pricing as a risk-mitigation structure. In 2001, the Bahrain Monetary Agency was among the first central banks to issue this paper, in its case in three- and five-year maturities, with most issues oversubscribed. Qatar issued Qatar Global *Suku*k with a seven-year maturity (the largest issue ever at $700 million).

The German State of Saxony-Anhalt became the first non-Muslim issuer to tap the global Islamic debt market in 2004, raising some 100 million euros via a *Sukuk* issue in an innovative effort to appeal to a broader range of investors. More recently, the Islamic Development Bank created the first program for repeat issues of *Sukuk*. Widespread *Sukuk* paper issuance could lay the groundwork for the emergence of Islamic capital markets. But while the *Sukuk* market is developing

Risk Reward Issues:

With many of the larger project finance transactions in the Middle East, it is arguable that the commercial customer is still more concerned with the overall cost of the transaction rather than strict compliance with *Sharia* principles.

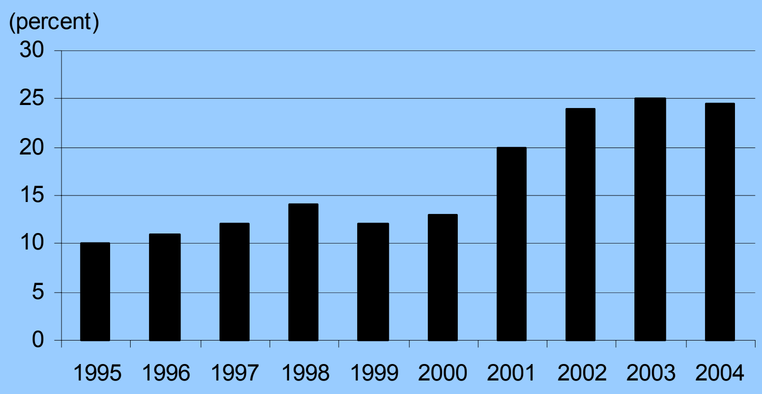
A fundamental principle in relation to Islamic finance is that, at some stage in the transaction, the financial institution will be an owner of all or part of the asset that is being financed and that under *Sharia* principles, many of the risks associated with being an owner cannot be passed on to the customer or a third party. It is the existence of ownership rights coupled with on-going ownership risks that is the most striking difference with conventional project finance. These additional ownership risks become more acute when the transaction involves complex capital assets, such as a power plant or an aircraft, as the potential exposure faced by the Islamic financier as an owner, can be very significant.

While a conventional bank will undertake a due diligence exercise on an asset or business that is being financed, this due diligence exercise is even more critical for an Islamic institution because of the potential risks attaching as an owner which, if *Sharia* principles are to be strictly applied, should not in many cases be passed on to the customer. It is unlikely that an Islamic institution will have the necessary in-house expertise to undertake this type of detailed due diligence on every asset that it may consider financing.

There is often a tendency for customers to compare the cost of Islamic finance with that being offered by conventional banks. With a financing that is structured strictly in accordance with the *Sharia*, the risk reward allocation should not be exactly the same as with a conventional financing. While an Islamic financial institution should be willing to participate in greater risks than a conventional bank, this should in turn lead to a greater reward. However this may not necessarily be the case. Commercial customers invariably still use as their benchmark the rates that are charged by conventional banks (i.e., by reference to LIBOR or other similar rates). Many commercial customers are not amenable to the argument that, as the Islamic institution is taking on more risks, it should receive a greater reward. Accordingly, an Islamic financier will not usually be willing to take on additional risks for no additional reward, not least because it also has a responsibility to its depositors and investors. Often, therefore, an Islamic institution may be forced to compromise the structure of its financing so that the risk: reward matrix is, to a large extent, the same as with a conventional financing. However, this can result in unfortunate consequences. Firstly, the need to refer to conventional finance funding costs (i.e. LIBOR) results in the general public being confused as to what is the real difference with conventional financing, especially in the context of the prohibition on *riba*. Secondly, strategies must be adopted when drafting the documents to shift the risks that strictly should be borne by the Islamic financier as owner but in a manner that, on the face of the documents, is not *Sharia* repugnant. Drafting the documentation to achieve this result can be a complex and time consuming exercise.

A Rapid Rise:

The net asset value of Islamic investment funds as a share of all Malaysian investment funds more than doubled over the past decade.



Source: Investment Organization of Securities Commissions.

rapidly, it remains primarily a market where holders keep bonds to maturity with limited secondary market trading.

On the equity side, two indices were launched in 1999 to provide a benchmark for equity prices for investment by Islamic financial institutions: the Dow Jones Islamic Market (DJIM) Index in Bahrain and the Financial Times Stock Exchange Global Islamic Index Series (GIIS). Although these indices have since been published worldwide, Islamic indices remain in their infancy and play a limited role in Islamic financial markets.

Many Islamic financial institutions, particularly in Bahrain, Malaysia, and Sudan, have been gearing up for further expansion by continuing to develop, refine, and market innovative Islamic financial instruments, on both the asset and liability sides. In recent years, many new Islamic financial products have been developed and are increasingly used in financial market activities, including equity and bond trading and investment, Islamic insurance and reinsurance (*Takaful*/re-*Takaful*), Islamic syndicated lending, and investment in Islamic collective investment schemes and other wealth and asset management products.

In recent years, Islamic investment funds have prospered in the Gulf countries and Malaysia. Among the different categories are equity funds, real estate and property funds, *Murabaha* funds, commodity funds, and leasing funds. Islamic equity funds are the most common, and total assets worldwide grew more than 25 percent over the 1997–2003 period. In Malaysia, the number of Islamic investment funds reached 71 in 2004, up from 7 in 1995, and their share of net asset value as a percentage of total funds more than doubled over this 10-year period (see chart).

A range of Islamic instruments is also in use in several countries for financing specific government projects and procurement of goods and services. In recent years, several countries, such as Sudan and Iran, have introduced short-term government securities based mainly on participation principles for funding government operations and liquidity sterilization.

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