

Islamic Finance

Context

An article in the Economist (Savings and Souls 4/9/2008) states that according to the Islamic Financial Services Board, 'the amount of Islamic assets under management stands at around \$700 billion'. In addition, the article quotes Standard & Poors as estimating that 'the industry could control \$4 trillion of assets' and presents a general opinion that whereas 'Muslims account for 20% of the world's population', Islamic finance accounts for less than 1% of its financial instruments.

This glaring gap is fast being recognised in the west and a number of companies are now offering what have been termed 'Sharia'a Compliant Hedge Funds'. Most people in the west have vague notions about what the term 'Sharia'a Compliant' means, but clearly the secret to winning management opportunities for this vast pool of wealth, is to understand in *detail* what the term means, not only in terms of its context within the teachings of the Qur'an, but in particular in the context of the personal faith of millions of Muslims worldwide. This factsheet attempts to lay out the basic principles as a basis for further study.

General principles of Sharia'a Law

Islamic finance rests on the application of Islamic law, or Sharia'a, whose primary sources are the Qur'an and the sayings of the Prophet Muhammad. Sharia'a emphasises justice and partnership. In the world of finance, this translates into a ban on speculation (or gharar) and on the charging of interest (riba). The idea of a lender levying a straight interest charge, regardless of how the underlying assets fare in an uncertain world, offends against these principles.

In addition, companies that operate in immoral industries, such as gambling or pornography, are also out of bounds, as are companies that have too much borrowing (typically defined as having debt totalling more than 33% of the firm's stock market value). Such criteria mean that Sharia'a-compliant investors steer clear of highly leveraged conventional banks.

In practice, the decision as to what is and is not allowed under Sharia'a law is made by boards of scholars, many of whom act as a kind of spiritual rating agency. These scholars work closely with lawyers and bankers to create instruments and structure transactions that meet the needs of the market without offending the requirements of their faith. There is general fear that the supply of qualified and authorised scholars could act as a bottleneck for the industry and this has led Malaysia to create a national Sharia'a board; in Bahrain, bodies such as the Accounting and Auditing Organisation for Islamic Financial Institutions (AAOIFI), are also working towards common standards. However, global standards could be a long time in coming due to different attitudes and emphasis, in much the same way that individuals will put different emphasis on aspects of personal belief.

Islamic Transactions

Any financial instrument can be thought of as a contract, whose terms and conditions define the risk and return profile of the instrument. In accordance with the principles described above, a contract is deemed legal and lawful under Sharia'a law if the terms of the contract are free of any prohibition, i.e. free of interest or speculation and provided it does not violate any other rule or law e.g. investing in an immoral industry.

Islamic finance recognises a set of core contracts, which serve as building blocks for designing more sophisticated and complex financial instruments. These can be grouped into four categories according to their function and purpose:

• Transactional Contracts

Exchanges or transactions for the sale and trade of goods and services. Exchanges can be on the spot or on a deferred basis.

• Financing Contracts

Are ways to create and extend credit, facilitate financing of transactional contracts, and provide channels for capital formation and resource mobilisation between investors and entrepreneurs. The distinguishing feature of such contracts is the absence of a debt structure. Financing contracts are meant for the financing of transactions in the form of asset-back securities or for providing capital through equity partnership.

Some terms used in Islamic finance

- Amanah – Trust. Placing something valuable in trust with someone for custody or safe-keeping.
- Ariya - Lending for gratuitous use.
- Bay' - Sale of a property or commodity for a price
- Bay' al-'Arabun - Payment of a portion of full price paid in good faith
- Bay' al-Muaajil - Sale contract where the price is agreed but lump sum or deferred payment is at a future date
- Bay' Bithamin Ajil (BBA) – Sale contract where payment is made in instalments after delivery of goods
- Bay'al-Salam – Sale by immediate payment against future delivery. Similar to forward contract but requires full payment at the time of contract.
- Fiqh al-Muamalat - Islamic rules on transactions
- Ijarah wa 'iqtinqa' - A hire-purchase contract which is similar to conventional lease-purchase agreements. In addition to regular contracts of Ijarah, another contract is added which includes a promise by the leaser / owner to sell the leased asset to the lessee at the end of the agreement
- Ijarah - A sale contract which is not the sale of a tangible asset but rather a sale of the usufruct (the right to use the object) for a specific period of time
- Ijima' - Consent on legal opinion
- Jo'ala - An agreement with an expert in a given field to undertake a task for a pre-defined fee or commission (as in a consultancy agreement or contract).
- Kifala - Suretyship. Assuming someone's liability in case the principal fails to meet obligations.



Some terms used in Islamic finance (cont.)

- **Mudarabah** - An economic agent with capital (*rabbul-mal*) can develop a partnership with another agent (*mudarib*), with skills to form a partnership, with the agreement to share the profits.
- **Mudarib** - Economic agent, with entrepreneurial and management skills, who partners with *rabbul-mal* (owner of capital) in a Mudarabah contract.
- **Murabahah** - A cost-plus-sale contract where a financier purchases a product, i.e. commodity, raw material for an entrepreneur who does not have capital to do so. The financier and the entrepreneur agree on a profit margin which is added to the cost. The payment is delayed for a specified period of time.
- **Musharakah** - Equity partnership. It is a hybrid of *Shiraka* (partnership) and *Mudarabah*, combining the act of investment and management.
- **Musharakah Mutanaqisah** - Diminishing partnership
- **Qard-e-Hasna** - Charitable loans with no interest and low expectancy of return of principal
- **Rabbul-mal** - Provider of funds / capital in *Mudarabah* contract
- **Sarf** - Sale by exchange of money-for-money on the spot
- **Takaful** - Insurance contract through mutual or joint guarantee.

Citisoft Services

Citisoft is a specialist consulting firm focused on investment management. With a client base of more than 75% of the top 50 global investment managers, Citisoft is the foremost supplier of strategic planning and implementation services to the institutional, wealth management and alternative investment sectors.

Established in 1986, Citisoft offers complete end-to-end solutions. Although expert in all market systems, Citisoft is totally independent of all suppliers and service companies.

• Intermediation Contracts

Facilitate an efficient and transparent execution of transactional and finance contracts. They provide economic agents with the tools to provide financial intermediation and to offer fee-based services. These contracts include *Mudarabah* (a trustee finance contract), *Musharakah* (equity partnership), *Kifala* (guarantee), *Amanah* (trust), *Takaful* (insurance), *Wikala* (agency) and *Jo'ala* (a fee based service).

• Social Welfare Contracts

Are contracts between individuals and society.

Financing Contract Examples

Murabahah (Cost-plus sales)

This is a contract of sale used for purchasing commodities and other products on credit. The contract is based on the concept of a financier purchasing a product and then supplying it to a client who does not have the capital to purchase it himself. A profit margin is agreed between the two and a payment schedule is agreed. The financier takes ownership of the commodity, the client takes delivery and payments are made according to the payment schedule. The financier might ask for additional collateral, usually another asset.

Islamic Bonds – Sukuks

The word *Sukuk* (plural of the Arabic word *Sakk* meaning certificate) reflects a contract that grants participation rights in a set of underlying assets. The prohibition of interest by *Sharia'a* virtually prohibits the creation of pure debt securities, but participation in the performance of real assets is acceptable. The design of a *Sukuk* is very similar to a cash flow Collateralised Debt Obligation (CDO).

A *Sukuk* is set up in the following way. An agent, acting on behalf of a capital providers, uses a contract of *Mudarabah* to create a Special Purpose *Mudarabah* (SPM), an entity similar to a conventional SPV, which is able to acquire assets and issue certificates against them (the assets acquired have to be *Sharia'a* compliant). The SPM then issues certificates which are bought by investors, and the proceeds are used to by the SPM to purchase the underlying asset pool. The *Sukuk* can be granted a credit rating based on the asset pool, and the investors receive regular cash flows based on their performance. The SPM can then either sell the assets or lease them in return for a future cash payment. The lease payments are paid to the investors and are similar to coupon payments but legally not the same. At maturity, the asset pool is liquidated and the investors receive back their cash; the price will have been pre-contracted to avoid capital loss to the investors.

Company Screening

The process of screening a company for compliance to *Sharia'a* law can be generalised to 5 main steps:

- **Check whether the company is engaged in prohibited business activities.** Examples of prohibited business are: Alcohol; Tobacco; Pork Related; Financial Services; etc.
- **Check whether the company is exhibiting prohibited financial ratios.** Compliant companies do not derive significant income from interest or have excessive leverage.
- **Determine the company's dividend purification ratio.** Most companies will derive some of their income from interest income, the dividend purification ratio (the portion of the dividend that should be donated to charity to make ownership of stocks compliant with *Sharia'a* law) is calculated is the greater of the two following calculations:
(operating and non-operating interest income / gross profits)
(prohibited revenue / total revenue).
- **Exclude the company if more than 5% of its income originates from prohibited activities.**
- **Exclude the company if it provides insufficient information.** Companies which do not provide information on which to assess the previous criteria are considered non-compliant and are excluded.

Current Challenges and Initiatives

Compliance checking functionality commonly available in the market can be leveraged to check a fund's status against *Sharia'a* law. Citisoft is experienced in helping clients, not only to identify and implement such systems, but in helping to set up the rules correctly in identifying and implementing the required reference data feeds, including *Sharia'a* indices (Standard & Poors, MSCI, Dow Jones and FTSE).

In addition, Citisoft is expert in the way Islamic finance is conducted and can present its knowledge and experience to organisations looking to move into this area. Citisoft has just opened an office in Dubai.

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