In your interest

Banking has seen one of the more interesting side skirmishes in the 'clash of civilisations' between Islam and the West. As Western banking rubs up against the religious points of difference proffered by Islamic banking, industry bastions from England to Switzerland are seeing their Islamic counterparts enjoy growth figures four times their own.

Ever since the first modern experiment with Islamic banking in the Egyptian town of Mit Ghamr in 1963, Islamic banks have evolved into specialised, complex entities such as Islamic mutual funds, Islamic index funds, the Islamic Development Bank and Islamic or takaful insurance. Like conventional Western banking, modern Islamic banking provides three main functions: an efficient payment system, a channel for funnelling household savings to businesses and government and financial products like mortgages.

However, in addition to standard banking and prudential laws, an Islamic bank is supervised by a shari'ah board that bans the payment of interest, the financing of anything not in the long-term interest of society and high-risk financial products. The sector is supervised by a number of institutions: the Accounting and Auditing Standards Organisation for Islamic Financial Institutions (AASOIFI) standardises accounting treatments and the General Council for Islamic Banks and Financial Institutions (GCIBFI) promotes homogenisation.

Ever since the first modern Islamic banking experiment in

1963

they have evolved into specialised entities, writes *Mohamed Ariff.*

THE FINE PRINT

1

No profit to be derived from fixed interest payments. Ancient world religious practice considered profit from trade in goods and services as acceptable but not from money. The first recorded use of the word 'interest' appeared in Babylon in 2400 BC. Traditionally, Islam frowned on usury or interest (*riba*) and Muslim jurists, lay scholars and a long line of commentators from Aristotle to Benjamin Franklin have argued about what is interest and what level of interest payment is too much. Catholicism took a dim view of interest in the Middle Ages until it entered the banking business itself. The upshot of all this is that today's Islamic bank replaces interest income with a pre-agreed profit-share formula conditional on the outcome of the end-result of a loan. For example, on an Islamic mortgage transaction, instead of lending money to purchase property, the Islamic bank may buy the item itself from the seller and re-sell it to the buyer at a profit, who pays back the bank in instalments. To protect itself against default, the bank enters into an arrangement called *murabaha*, which is a contract of sale between the bank and its client for the price of goods plus an agreed profit margin for the bank. Islamic banks handle loans for vehicles in a similar way (selling the vehicle at a higher-than-market price to the debtor and then retaining ownership of the vehicle until the loan is paid).

2

No finance for anything not in the long-term interest of society. An Islamic bank will not engage in financing activities considered illegal (*haram*) for an adherent to Islam; hence, an Islamic bank will not finance activities considered anti-social such as alcohol or prostitution. According to the Dow Jones Islamic Index, 40 per cent of US companies fail this test.

3

Avoidance of extreme risk. Under the third principle, financial products that carry a high level of risk (*garar*) for the customer (that border on gambling) are not permissible. This arises from the mandate in Qur'anic law that requires contracted parties to avoid extreme risk. However, there have been several new products that have been introduced inside more innovative bank circles including truly risk-sharing instruments.

From just a handful of institutions, mostly in the Arab countries in the 1960s, Islamic banking's revisionism has slowly but surely found a public and today is growing at 15 per cent per annum, about four times faster than conventional banking. Importantly, it has innovated itself to be accepted by venerable institutions with HSBC, UBS, Dresdner Bank and ABN-Amro developing Islamic compliant products.

Today there are about 400 Islamic banks with total assets estimated at US$7 trillion (A$8.9 trillion) and an equity capital base of US$400 billion. Pakistan, Saudi Arabia and Sudan have adapted their domestic banks to become full Islamic banks with foreign banks operating as conventional banks for international transactions. In other countries, Islamic banks exist side-by-side with conventional banks, some of which offer Islamic financial products as well - examples include Indonesia, the Persian Gulf countries, Malaysia and Thailand.

Despite this, at this early stage of the market growth, Islamic banks will not account for more than 1 to 2 per cent of the total assets of all banks. If full potential is reached in the future, it will be about a quarter, however, business is picking up fast as more of the world's resource-rich banking groups get involved. This is partly because it not only appeals to Muslims but also non-Muslims. Plus, broader indicators of financial performance show that the banks studied enjoy a good return on assets, equity and other measures. Studies of production efficiency show that the banks have positive total factor productivity scores, although the size of the scores is small because of the lack of scale economies in such banks, given their infancy.

With the exception of Indonesia, Malaysia and the Islamic Development Bank, the provision of Islamic finance expertise training in banking, finance and insurance has been inadequate. In 2006, the establishment of the International Centre for Education in Islamic Finance (INCEIF) represented an investment in human capital to support the global development of Islamic banking. About 20 institutions and some universities, mostly in the Arab region as well as Malaysia, Indonesia, the UK, Switzerland and Singapore, provided small-scale introduction to the specialisation. It is expected that there will be a boom in this subject area as the market grows in coming decades.

Existing products can be simply classified by looking at what is the core of a conventional bank and how conventional banking items have different meanings in light of *shari'ah* regulations. What a bank is as a business is represented by the balance sheet on Chart 1 (over page).

On the left are assets with loans marked A that deliver conventional interest income and profit-share income to an Islamic bank; those marked B are fixed assets. While a conventional bank would call a loan an earning asset from making loans, an Islamic bank would call it financing or profit-share agreements to avoid any connotation of interest being attached. Together these add up to the total assets of any bank and are classified according to relevant accounting standards.

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Item C is deposits from the public. In a conventional bank, deposits earn interest but an Islamic bank pays a profit share at the end of each month. If the deposit is a cheque account, then an Islamic bank ensures its safekeeping and return, but does not pay any interest; however, it may make ex gratia payments. Item D is capital. In conventional banking this consists of interest-based borrowed capital; in an Islamic bank this will be the same borrowed capital but based on profit sharing. A major part of item D is in fact the share capital (*musharaka*), which is exactly the same in both conventional and Islamic banks. In that case, in a conventional bank, a time deposit will earn a small interest pre-agreed with the depositor while, in an Islamic bank, the depositor receives a profit share declared at the end of each month on the basis of profits made on the deposits by the bank depending on whether the loan is a profit-share basis or joint venture. A point to remember here is that by engaging in profit-sharing funding/financing agreements, funds provided by Islamic banks become an 'investment', unlike a conventional bank.

Sukuk and the bonding of Islamic finance

Before Muhammad (peace be upon him) began to spread the message of Islam in 610 CE, Arabia was in the midst of *Ayyam al-Jahilliyah*, "the Age of Ignorance".

Within this setting, Muhammad, the last Prophet of Islam, taught the divine revelations of God to those willing to listen, advocating not only *tawheed* (monotheism) and submission to God, but also ethical responsibilities towards each like the prohibition of *riba* (interest/usury) which was seen as a wicked financial entrapment to the needy. "O ye who believe! Fear Allah, and give up what remains of your demand for usury, if ye are indeed believers." (2:278, Qur'an, Yusuf Ali translation). With the coming of the 20th century, however, this edict began to punish 20th century Muslims who set about finding innovative ways to conduct financial transactions within *shari'ah* law. Most successful among these, and of increasing interest to western investors, is *sukuk*, the Islamic bond.

THE SUKUK

In the conventional financial market, a bond is a debt-based instrument but in the Islamic financial market, it's an asset-based one. Because bonds involving interest are against the *shari'ah*, Islamic bankers invented the *sukuk*: a non-interest based security providing investors with the ownership of an underlying asset.

The Accounting and Auditing Organisation of Islamic Financial Institutions (AAOIFI) acknowledged 14 standard types of *sukuk* bonds, categorised by tradability. These include *musharaka* (equity participation), *mudaraba* (profit-sharing) and *ijara* (leasing) and the non-tradable bonds include *murabaha* (cost-plans or mark up), and *istisna* and *salam* (both types of contracts involving advanced cash payment).

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SUKUK'S RISING MARKET

The Malaysian government pioneered Islamic finance globally when it issued the first *sukuk* in 2002 for US$600 million. The Malaysian government effectively offered to finance custom-selected assets to customers for an agreed period of time by purchasing the assets and leasing them.

In Australia there are two major Islamic finance and investment companies, and the NAB is presently offering scholarships in Islamic Finance that will lay the ground work for the Australian *sukuk*.

The *sukuk* caught on fast and soon after the Durrat Al Bahrain issued a US$120m *sukuk* for a real estate development project, the government of Pakistan issued a US$600m *sukuk*. The Emirate Airline *sukuk* sale in 2006 was the largest ever launched by an airline. Last year, the Ports, Customs and Free Zones Corporation (PCFC) of Dubai launched one for US$3.5 billion that reached a subscription value of more than US$8bn, the largest at that time. Western interest was tweaked and shortly after, the State of Saxony-Anhalt issued a US$100m *sukuk* to widen its investment prospects. According to one estimate, *sukuk* investments tripled in 2004 to US$6.7bn and are expected to tip US$10bn this year, giving the market a total of US$70bn (*The Financial Times* 28 February, 2007).

There are more than 265 Islamic banks or institutions operating in 40 countries with total assets estimated at US$262bn. Western banks such as Citibank, HSBC and National Australian Bank (NAB) are tapping into the market while the UK and Australia's Victorian government have made legislative changes to allow Islamic banks to operate under *shari'ah* law with the US expected to follow. Further advancements towards the development of *sukuk* structures are encouraging the current Islamic financial surge.

According to *The Daily Telegraph*, 30 January 2007, the UK will soon be the first western country to allow banks to sell Islamic bonds as part of a new drive that gives priority to the expanding area of Islamic banking. "I am able to set out the next stage in our reforms to ensure the tax and regulatory system will encourage the development of *shari'ah*-compliant products," Ed Balls, the Economic Secretary to the Treasury, told the sixth Euromoney Annual Islamic Finance summit.

In Australia there are two major Islamic finance and investment companies, the Muslim Community Co-operative Australia and Balance Finance, and the NAB is presently offering scholarships in Islamic Finance that will lay the groundwork for the Australian *sukuk*.

The *sukuk* bond is growing rapidly. Its diversity and categories allows it to adjust to a variety of investment scenarios and its unique appeal to the shari'ah conscious investor ensures its on-going successes. It would be foolish for the West not to recognise its impressive growth rate. As long as Islamic nations are developing, investments are inevitable. To exploit this, particularly in the rapidly growing and expanding Gulf region, Western banks would do well to tap into their rich resources using *sukuk* as the medium.

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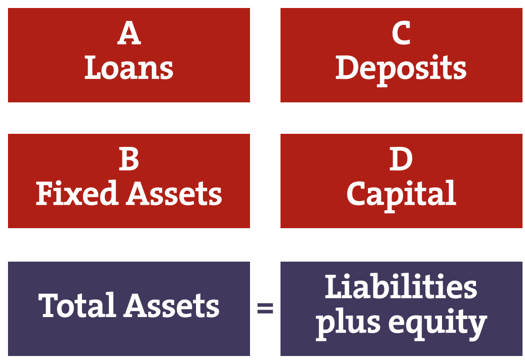
Chart 1: Sample balance sheet of a banking business



TERMINOLOGY

For the purpose of illustration, terms of a conventional bank are used to drive the point that Islamic banking is a variation of this. In reality, the actual terms an Islamic bank uses are peculiar to them. For example, an Islamic bank profit and loss statement may have an entry *mudaraba* financing which is a loan based on a profit-share agreement or *musaraka* financing which is a loan contract also based on a profit share agreement but with joint ownership.

A conventional bank reports net income on loans net of interest paid to depositors and loan capital providers. An Islamic bank does not accept or pay interest but reports net income from profit-share agreements and fee incomes from sale-like or banking services fees. Profit-share income may be from different forms of lending activities such as profit shares (*mudaraba*) or joint venture (*musaraka*) or some specialised form of lending. Or it may be from services fees for safe-keeping (*wadiah*), cost plus services (*murabaha*) and leasing of assets (*ijarah*).

Of the other items in Panel A, all are similar, but for the noted exception that the entire report is conditional on income reporting without interest, financing projects that are not in the long-term interest of society and prohibitions of financial products with extreme risk. An Islamic bank would have the same type of entries as Panel B but consistent with the three principles discussed earlier. For example, a bank may hold a bond, but it is called a *sukuk* bond as it is issued with no pre-agreed coupons as in conventional bonds. There are finer points to consider here. The issuer of *sukuk* (say, a central bank) has some real assets, providing rental incomes, which provide investor returns in a *sukuk* bond. Similarly, the equity may be referred to as the *musaraka* fund but it means exactly the same as equity.

Islamic banking is yet another specialised bank offering new products just like investment banking when it started to offer opportunities for securitisation of assets some decades ago. Islamic banks provide clients the secular satisfaction that their financial activities are carried out in a manner consistent with their beliefs and the nature of profits therefore takes a different form from the pre-agreed, pre-fixed, non-risk-shared rewards. Historically, banks have sought profits by distancing their monitoring function by going from fixed to variable interest, and from engaging in monitoring aggressively to securitising their risky products and taking such products off the balance sheet. The result is firms with bank loans relaxing their management or in some famous cases engaging in outright fraud. These modern innovations have seen banks become less socially responsible and more profit-focused without considering the end-use to which humanity's accumulated scarce capital is being deployed.

Although this article may give an impression that the contemporary Islamic banks have the flavour of a true prototype, Islamic banking at this early stage is considered by some to be merely an approximation bordering on a legal fiction (*hiyal*) of what they should truly be. Further, there have been several new products introduced inside more innovative bank circles, and truly risk-sharing instruments are being designed and offered.

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