



Looking East:

The Islamic Alternative?

by Helen Sanders, Editor

particularly in relation to corporate treasury, and how does it differ from conventional banking? We hear vague mentions about Islamic products carrying no interest, but beyond that, few people, even in the financial sector, are familiar with the scope and principles of Islamic finance.

Furthermore, while Islamic banking is still in its infancy, particularly in the sophistication of its financial products, there are perhaps lessons for the conventional banking market. While Islamic banks have also been downgraded in some cases, due for example to cancellation of projects in which they are invested, many Islamic banking institutions are faring better than their conventional peers during the crisis. However, Surendra Bardia, Cash Management Head, UAE, Citi, explains that it remains a difficult time for all banks,

"Islamic banks are not immune from the current crisis, and like several other banks, they have experienced issues and are finding it challenging to continue to build their asset books. Capital preservation remains key, and as in other markets, the difference between borrowing and lending rates is growing at a rapid rate."

Background to Islamic Banking

Islamic banking is a banking system consistent with the principles of Shari'ah law (spelt variously Sharia, Sharia'a or Shariah in English). It prohibits the payment of interest, or usury (Riba) in favour of a profit-based system, and allows investment only in businesses that provide goods and services consistent with its principles (see Investments below).

As Islamic regions such as the Middle East and parts of Asia such as Malaysia and Indonesia have developed economically, the Islamic banking system has matured and grown at a rate of typically 15% - 20% per year. An increasing number of



Introduction

As the global financial markets continue to be fragile and uncertain, many people are asking if there is an alternative to the market systems and practices on which we have all relied for so many years. While the banking system is likely to see substantial changes in the future, this will take time. In addition to the conventional banking system however, increasing numbers of investors are looking to the Islamic banking market, including those without a religious connection to Islam. But what does Islamic banking mean in practice,

Islamic banks have emerged, not only in these regions, but also in financial centres such as London. The French central bank is also looking at regulatory changes to allow Islamic banks to be established in France.

The first modern Islamic banking experiment took place in Egypt in 1963 in the form of a savings bank based on profit-sharing. By 1967, nine similar banks had been established in Egypt. The first modern commercial Islamic bank was the Dubai Islamic Bank, founded in 1975, initially with relatively basic products based on existing products already provided by the conventional banks, but Islamic banking products have developed significantly in scope, sophistication and in the degree of compliance with Shari'ah principles since then, and continue to do so.

Islamic Banking Participants

There are some banks which operate purely as Islamic banks, particularly in the Middle East and parts of Asia such as Malaysia (although Malaysia operates a dual banking system). In addition, a number of major international banks, such as Citi, Standard Chartered and HSBC have Islamic banking "windows" in addition to their conventional activities. These parts of the bank are held independently of the rest of the bank in terms of assets and governance, as well as the financial products they offer.

Islamic Banking Objectives & Principles

Islamic banks and Islamic windows have a similar purpose to conventional banking: acting as repositories of cash, providing finance and exchanging currencies. Samir Safa, Business Development Manager for Islamic Banking, Misys explains,



Islamic banks and Islamic windows of conventional banks are obliged to invest in ethical enterprises, omitting alcohol, pork, gambling and tobacco etc.



"The Islamic banking industry is really about 30 years old. Over the past 15 years, it has developed significantly, but it is still in its infancy compared with the conventional banking sector. Islamic banking cannot be isolated from conventional banking, as while the solutions may be different, both Islamic and conventional banks aim to provide the same services to customers."

The differences include the principle of how the bank, and the customer, is rewarded for the other's services. In particular, the concept of profit and loss sharing applies, as opposed to payment of interest. Furthermore, there is arguably more of a focus on how the bank's activities contribute to the society which it serves.

To take an example of profit-based financing, a mortgage or vehicle financing arrangement does not take the form of a loan. The bank purchases the asset, and then on-sells it to the customer at a profit, allowing payment to be made in instalments. Although the asset is registered to the buyer from the start of the transaction, it is held as collateral by the bank until the full amount, including the profit element, is paid.

There are variations to this approach, including Eljara wa Eiqtina, a form of property leasing, and the innovative Musharaka al-Mutanaqisa. This involves the bank and the customer forming a partnership entity to which both provide an agreed amount of capital. This entity then charges a floating rate rental amount, linked to a current market rate, which is shared between

the bank and customer. In parallel, the borrower also gradually buys out the bank, at which point the partnership entity is terminated.

There are a variety of other approaches to lending. For example, loans may be provided to companies at a floating rate of interest based on the company's internal rate of return; therefore, the bank's profit is linked to the company's profit. This is known as Masharaka.

Investments

Islamic banks and Islamic windows of conventional banks are obliged to invest in ethical enterprises, omitting alcohol, pork, gambling and tobacco etc. The Shari'ah committee acts in an oversight capacity to check that the bank's investment policy, and that its investment monitoring is appropriate. This oversight committee provides an important role both for ethical and regulatory reasons, including satisfying and knowing your customer and anti-money laundering requirements. Surendra Bardia, Citi explains,

"According to Shari'ah principles, cash cannot be invested in unethical or prohibited industries such as tobacco, alcohol, gambling etc. Looking at indices tracking performance of Shariah-compliant companies (such as The FTSE SGX Asia Shariah 100 Index) these companies have often performed better than the wider market. Banks have an exclusion list of companies and industries which is audited by the bank's board of scholars."

One of the issues faced by Islamic banking participants is the problem that there is no universal agreement about what constitutes acceptable



banking according to Shari'a law. In Malaysia, which operates a dual banking system, the National Shari'a Advisory Council is the central authority for Islamic banking in the country, but no other country has a unified approach to determining appropriate banking policy. Furthermore, with banks, and their clients operating across regions, there is increasing pressure to standardise products and regulation across financial markets.

Reserve Ratios

Islamic banking rules require a 100% reserve ratio i.e. banks must hold collateral to the equivalent value of its loans. This is difficult in practice, but the reserve ratio is typically higher than other banks.

Sukuk

We have already mentioned some of the principles of Islamic financial products. I will not discuss the full range of products here, but will outline briefly some of the issues of Sukuk, which is one of the more familiar instruments from a corporate treasurer's perspective.

Sukuk is the Arabic term for a financial certificate, but this instrument can be seen as the Islamic equivalent of a bond. Essentially, these instruments monetise an asset by transforming its future cash flows into present cash flows. While a conventional bond is a promise to repay a loan, Sukuk constitutes partial ownership in a debt (Sukuk Murabaha), asset (Sukuk Al Ijara), project (Sukuk Al Istisna), business (Sukuk Al Musharaka), or investment (Sukuk Al Istithmar).

Sukuk instruments typically replicate the cash flows of conventional bonds, and are listed on exchanges and made

tradable through conventional organisations like Euroclear or Clearstream. Capital protection for the investor, without amounting to a loan, is a binding promise to repurchase certain assets, e.g. in the case of Sukuk Al Ijara, by the issuer. In the meantime, a rent is being paid, which is often benchmarked to an interest rate such as Libor. Sukuk instruments have aroused some controversy amongst Islamic scholars.

For example, in late 2007, these instruments, with the exception of Sukuk Al Ijara, faced severe criticism by Sheikh Taqi Usmani, followed by a meeting of the Accounting and Auditing Organisation for Islamic Financial Institutions (AAOIFI). In consequence of this, as well as the economic decline more recently, there was a major reduction in Sukuk issuance. Most Sukuk instruments are now of the Al Ijara type.

One of the factors which are likely to revive the fortunes of Sukuk is the development of a secondary market. This relies on the existence of an Islamic repo market which is still in its formative stages.

Demand for Islamic Products

The growth of Islamic banking, both in terms of the number and scale of banks providing Shari'ah-compliant products, and the range of these products, has been driven by a substantial increase in demand. Sulaiman Moolla, Islamic Treasury Sales, HSBC Amanah, outlines how all types of investors are seeking Islamic products,

"Investors in Islamic banking products fall into four main market segments: the retail sector, i.e. individuals including high net worth individuals; corporations; non-bank financial institutions, such as investment and

insurance companies, and financial institutions i.e. the banks."

Sulaiman continues by explaining some of the reasons for this growth in demand,

"Companies' reasons for choosing Islamic banking can vary. In general, many do so for religious reasons; however, some do so due to a perception of the lower risks with Islamic banking. Furthermore, while some companies may not have a particular concern about banking in a Shari'ah-compliant way, it could be more important to their clients. With the constrained liquidity we see in the markets worldwide, Islamic banks are also seen as an additional source of funds."

Surendra Bardia, Citi, concurs,



"There is a substantial base of customers, for example in the Middle East, with a marked preference

for Islamic products and consequently, we recently launched a comprehensive suite of Islamic transaction banking products that we are looking to extend across our whole footprint. Looking at institutional investors, many of these are not mandated to use Islamic products according to their constitution, but they have a view that all other things being equal, they will opt for Shari'ah over conventional banking products. Some institutions, such as Islamic/Takaful insurance and re-insurance firms, are required by their constitution to use Shari'ah-compliant products."



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In addition to retail and institutional demand, governments and public sector bodies have also contributed to demand for Islamic products. Surendra Bardia, Citi continues,

"Governments of countries, where a large section of the population has Islamic beliefs, have encouraged the growth of Shari'ah compliant banking; for example, the public sector is increasingly using these products. While a part of this is for religious reasons, it also promotes job creation and wealth in the country."

Shari'ah Compliant Treasury

Increasing numbers of corporate treasurers are seeking Shari'ah compliant products. As Surendra Bardia, Citi suggests,

"Shari'ah-compliant banking has multiplied manifold over the past few years, and the acceptability of these products has increased amongst corporations as they seek to diversify their funding sources and tap into a new pool of liquidity."

With the growth in demand, the range and sophistication of Shari'ah-compliant products has grown dramatically. In consequence, it has become easier for corporate treasurers seeking to manage the company's finances according to the principles of Islamic banking to access the products they need. In many ways, a Shari'ah-compliant treasury is no different from any other, as a number of the challenges are universal. As Sulaiman Moolla, HSBC Amanah explains,

"Treasurers of companies using Islamic treasury products will have similar cash needs as any other, i.e. they may

have too much, or too little cash. While the solutions they seek to manage these situations are similar to conventional ones, the structures and mechanisms for doing so may be quite different. For example, an Islamic deposit would involve a commodities contract."

Sulaiman continues,

"Products which were available 10-15 years ago seem almost archaic when compared with the Islamic financial products available today. For example, at that time, corporate treasurers did not have Shari'ah compliant interest rate or FX hedging mechanisms available to them. Today, products which achieve the same financial effect are readily available and quite simple in their design."

Surendra Bardia, Citi emphasises how the international banks have contributed to this growing sophistication,

"There is still a lack of depth in some Shari'ah compliant products, particularly for hedging. Few banks have capabilities in this area, so increasingly local banks, with the customer base, and international banks with the product expertise, are working together to provide solutions."

Outstanding Challenges

However, as we discussed earlier, there are still challenges relating to the infancy of the Islamic banking market. Samir Safa, Misys warns of some of the problems which still exist, both for banks and corporate treasurers,

"Islamic banks have tremendous treasury challenges. As well as prohibiting the concept of interest,

Islamic treasurers cannot go short in positions, hedge, or trade in derivatives and futures, so most transactions are asset based. It is very challenging for treasurers to manage their liquidity as there are limited instrument types available to do so."

However, with all types of investors focusing more on managing risk, there is a growing demand for hedging products, which requires consensus amongst Islamic market participants to enhance the current product range a Shari'ah-compliant risk management tools, including liquidity risk. A big issue in recent years has been the difference in interpretation of acceptability under Shari'a law which has resulted in inconsistencies between countries and perhaps some difficulties in introducing new products.

However, Sulaiman Moolla, HSBC Amanah suggests,

"There is increasing convergence in Shari'ah standards and this will create a more cohesive Shari'ah compliant banking sector. For example, Malaysia tends to be more liberal in its application of Shari'ah when compared with the GCC, but this is now changing."

To try and address the problem of standardisation, and to permit the Islamic banking sector to flourish further, the International Islamic Financial Market (IIFM) was founded by central banks and monetary agencies of Bahrain, Brunei, Indonesia, Malaysia, Sudan and the Islamic Development Bank based in Saudi Arabia, as an infrastructure institution with the aim of establishment, development, self-regulation and promotion of Islamic capital and money markets. These efforts, such as work on



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developing a secondary Sukuk market and a repo market, could have a considerable impact on institutional investors, including corporate treasurers.

Lessons for Conventional Banking

However, while there are still some challenges in Islamic banking, primarily borne of its recent development compared with conventional banking, Islamic banks have so far weathered the financial storm better than many others. As the wider banking market seeks to reinvent and reinvigorate itself, are there lessons which could be drawn from Islamic banking? Sulaiman Moolla, HSBC Amanah explains how some of the changes which banks are already making align them more closely with Islamic banks,

"Shari'ah-compliant banking has always advocated investment in the real economy and real assets. While this has meant that aspects of Islamic banking seem less sophisticated, it reflects a "back to basics" approach which both banks and corporates now particularly value. Consequently, there may be lessons in the Islamic banking sector from which the conventional banks could benefit."

With Islamic banking still representing only a small percentage of the total banking market, it is perhaps unlikely that conventional banks are looking directly to Islamic banks for help, but this could certainly come in the future, as Islamic banking continues to grow. In addition, with increasing demands for ethical investment, Islamic banks already have the asset selection and monitoring capability which investors are seeking from other banks and investment companies. With strict seg-

regation between Islamic windows and the remaining activities of conventional banks, it seems unlikely that there will be a blurring of Islamic and conventional banking boundaries in the short term. However, this is another area in which the conventional banking sector could certainly gain the benefit of Islamic banks' experience.

The Future

As Surendra Bardia, Citi emphasises, the future of Islamic banking, and its synergies with conventional banking, will continue to be driven by demand and banks' ability to diversify,

"While there could be some crossovers between conventional and Islamic banking, such as in the area of ethical investment, this is likely to happen in pockets. As with any product, there needs to be a business case. In most cases, international banks have started offering Shari'ah compliant products in order to diversify their product range and customer base."

With no indications that such demand is diminishing, however, Sulaiman Moolla, HSBC Amanah predicts continued growth,

"We see Shari'ah compliant banking continuing to grow across the board in the future, driven by increasing demand, particularly in the retail market. This is the case wherever there is a significant Muslim population, such as UAE and Saudi Arabia, Malaysia and Indonesia, but also countries like the UK."

Samir Safa, Misys continues,

"Many major banks in the UK, for example, are now offering Islamic



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products in parallel with traditional products, and France has or is in the process to regulate Islamic finance/banks. We anticipate corporate demand developing in many regions, particularly in asset based financing, to which Islamic banking products are particularly well-suited, such as financing infrastructure products. A number of US and European infrastructure or leasing products, for example, are funded by Islamic banks, excluding hotels and casinos. Other large infrastructure and transport projects are likely to be funded increasingly through Islamic banking syndicates to cover the lack of sukuk issuance today, or difficulty of issuing sukuk due to liquidity issues."

For corporates seeking new sources of liquidity, Islamic banks could be a valuable source of liquidity particularly for alternative financing such as capital projects. Furthermore, we are already seeing Islamic banking prove a reliable and appropriate alternative to conventional banking for investors with a religious or ethical preference for Shari'ah-compliant products. With more Islamic banks now opening outside the traditional Islamic regions, including London and Paris, it seems likely that the number and range of investors seeking such products will continue to grow. □

We would like to thank the following for their contributions to this article:

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