# Islamic Securities Markets: Prospects & Challenges

Banca d'Italia IF Seminar: Monetary Policy & Liquidity Management

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# Agenda

MENA Financial Structure

Islamic Securities Markets: Prospects & Challenges

Role of Governments & Central Banks

Some Central Bank Initiatives: Malaysia, Bahrain, Kuwait, Sudan

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Action Points & Recommendations

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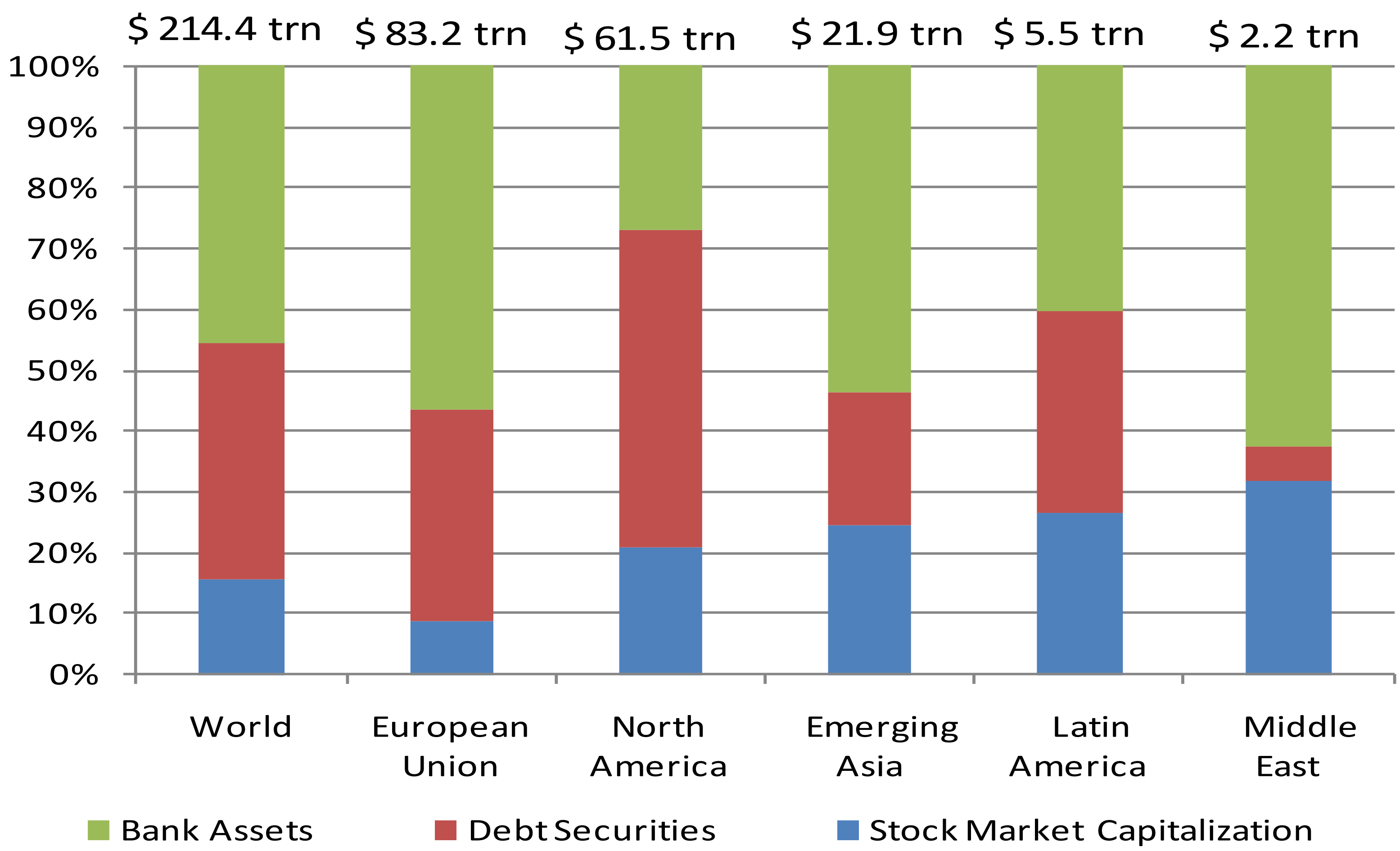
# MENA Debt Markets are still in their infancy

- Financial depth indicators show the relatively low dependence of the Middle East on debt securities as of the end of 2008.
- According to end-2008 data from the IMF, the world capital markets consist of an average 38.9% bond instruments, 15.6% equities and 45.4% bank assets
- In the Middle East region, the capital market is dominated by equities and bank assets, which together make up 94.4% of finance. **Debt securities make up just 5.6% of the Middle Eastern capital markets.**
- MENA bond market remains the weakest among the world's regions in terms of financial intermediation. Bond financing is tilted towards sovereign issuers, as opposed to a relatively more balanced distribution in other regions

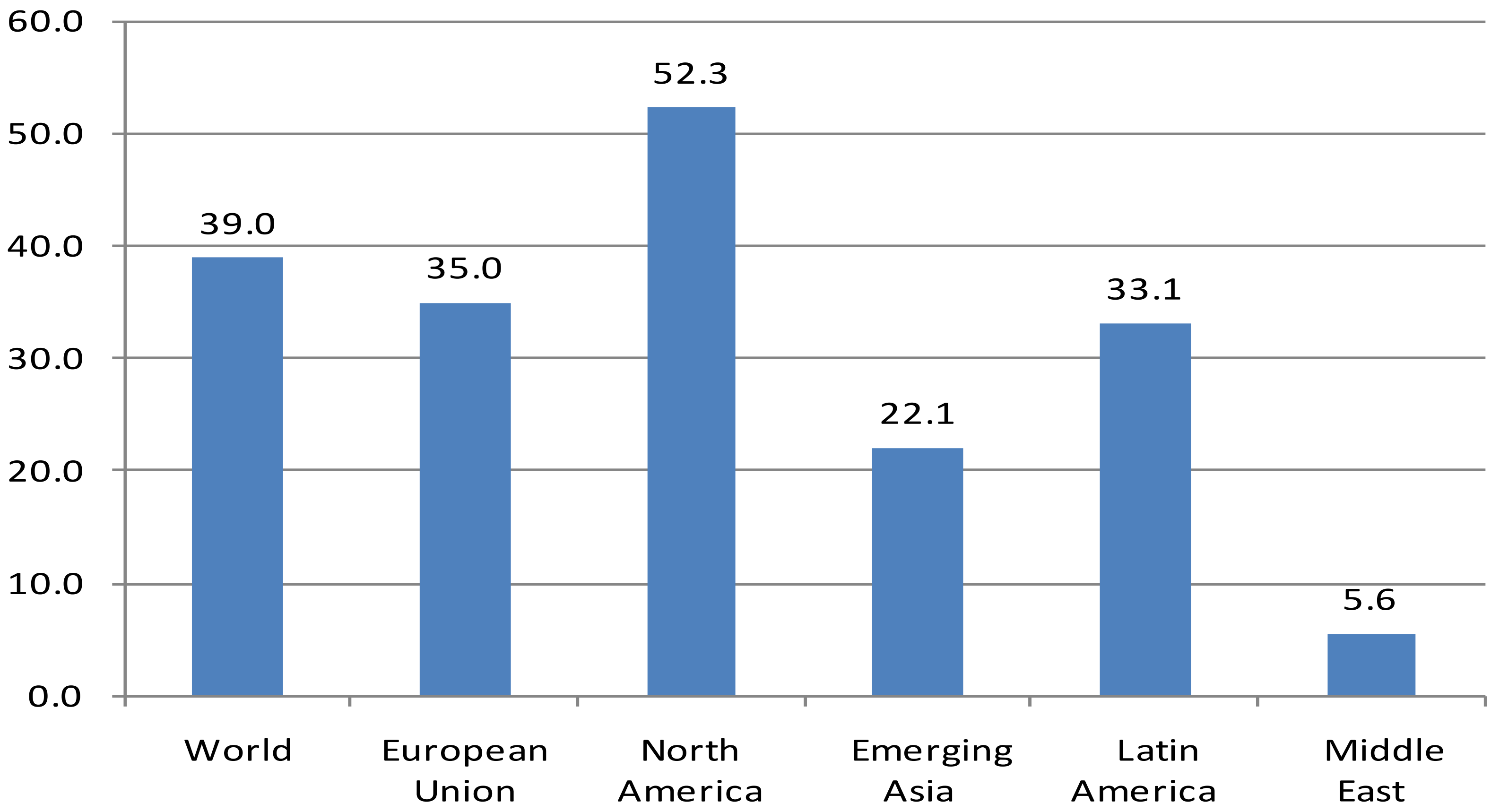
# Financial Size & Structure Across Regions, end-2008






Source: IMF Global Financial Stability Report, Oct09

# Total Debt Securities, end-2008 (as % of GDP)

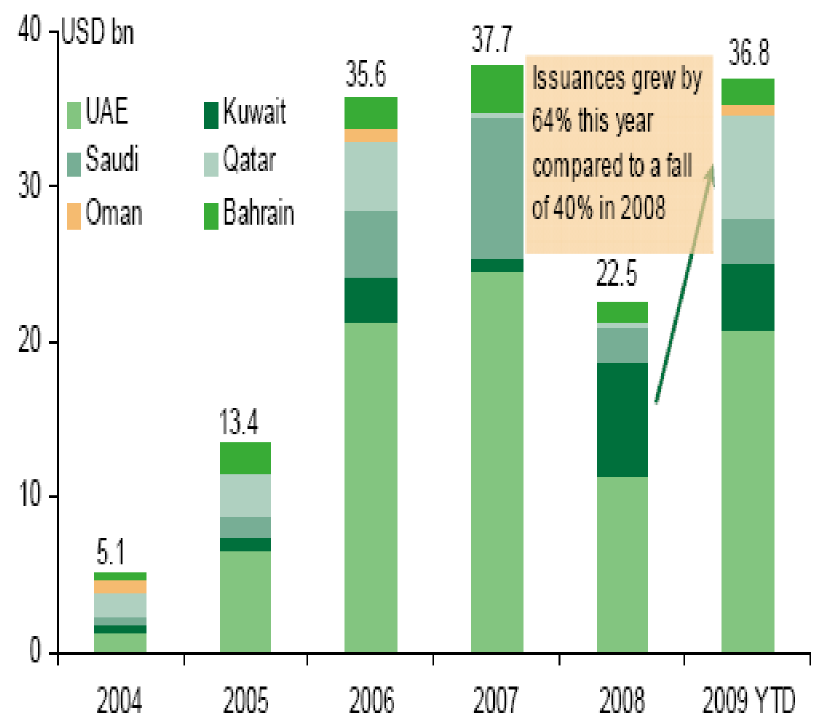





Source: IMF Global Financial Stability Report, Oct09

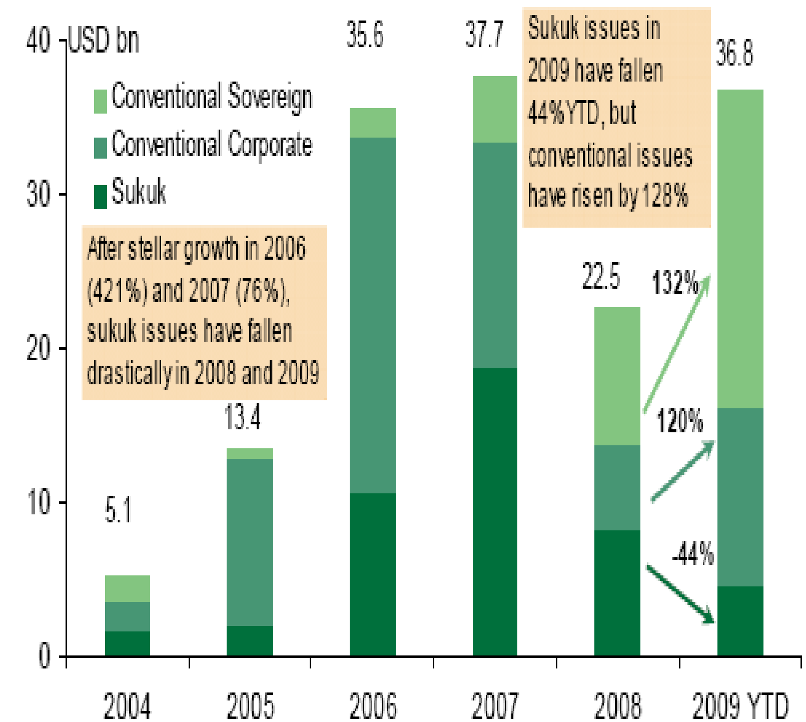
# GCC Debt Markets

## Exhibit 1: GCC debt markets have revived this year…



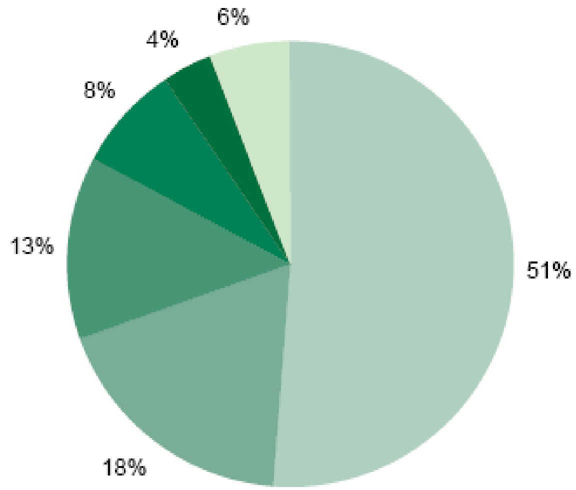

Source: Bloomberg, Zawya, NCBC Research; YTD indicates till 3Q09

## Exhibit 2: …on the back of surge in conventional bond issues




Source: Bloomberg, Zawya, NCBC Research; YTD indicates till 3Q09

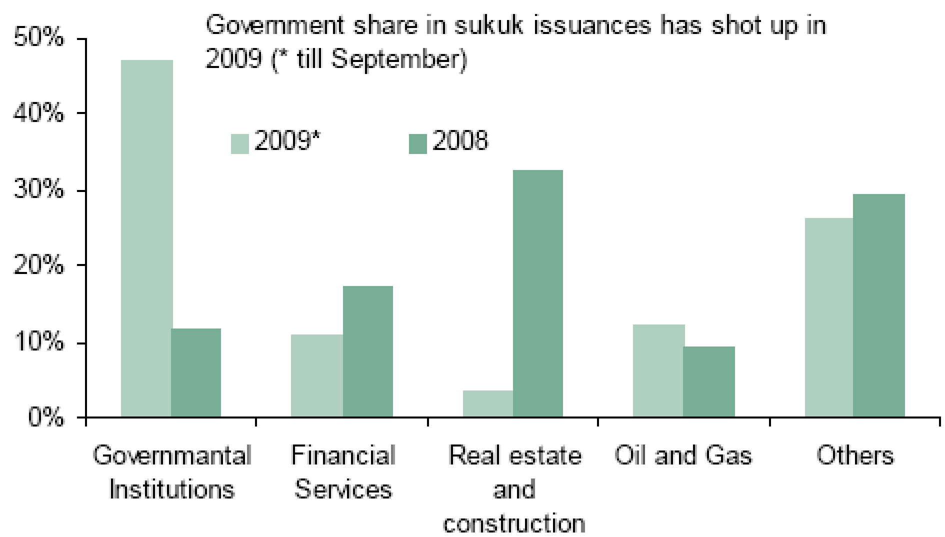
# Sukuk Issuances




Source: Bloomberg, Zawya, NCBC Research

**Malaysia the largest Sukuk issuer…**

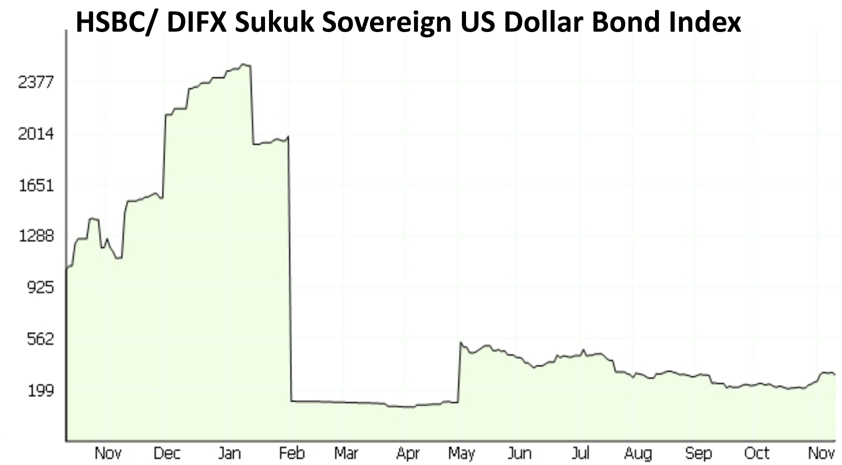
**… while sovereign issues outdo corporate ones**

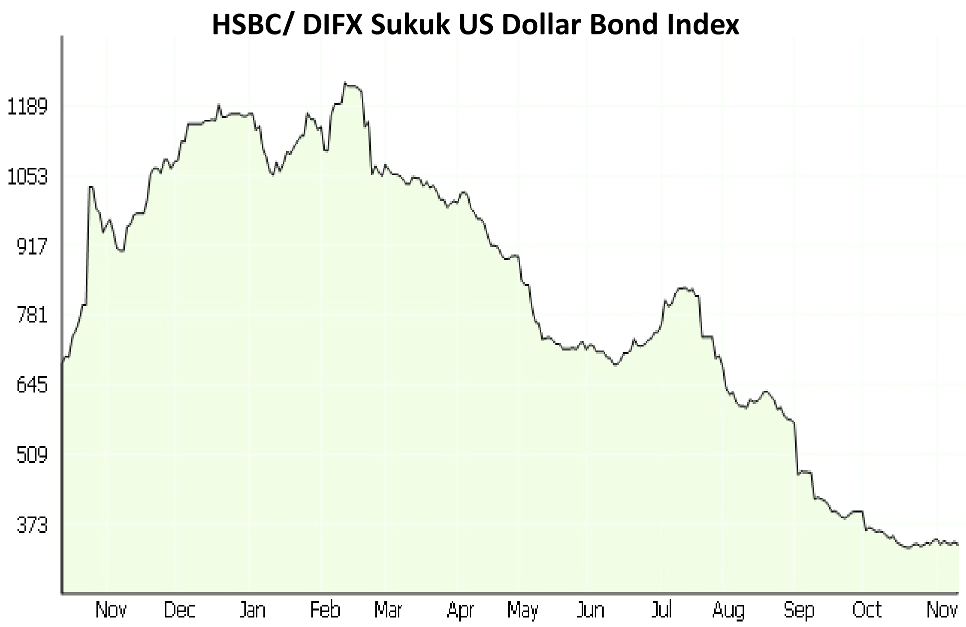


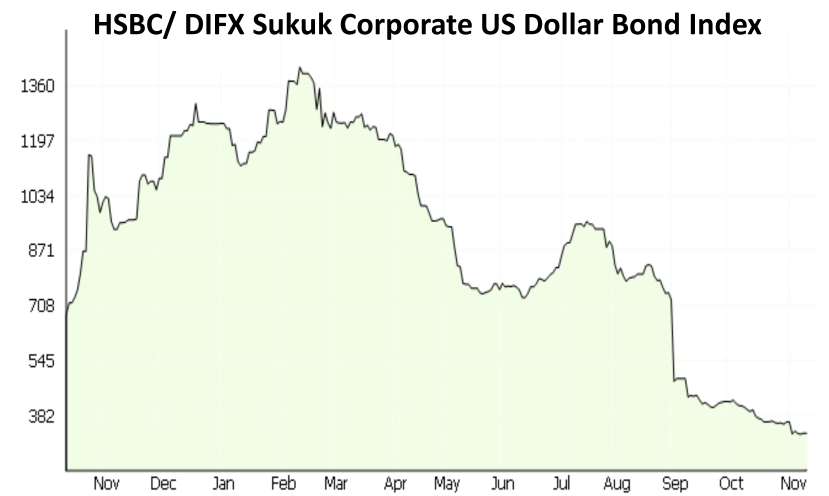

Source: Bloomberg, Zawya, NCBC Research

# Sukuk Spreads: Contagion & Recovery

- The HSBC/DIFX indices track the performance of the International Sukuk and Middle Eastern conventional bonds



# Recent 2009 Sukuk issuance

- Global Sukuk issuance **surged by more than 40% in the first 10 months of this year** compared to the same period in 2008
- **Sukuk issuance started rising in the second quarter compared to the two previous quarters**, in which most of the effects of the crisis had been felt.
- **The third quarter witnessed a genuine recovery in issuance, the first in nearly 12 months,** especially since the collapse of Lehman Brothers and the critical statements by the Accounting and Auditing Organisation for Islamic Financial Institutions on the Sharia compliance of Sukuk
- **Sovereigns and government-related issuers** have now become the most common Sukuk issuers

(Source: Moody's report, 10.11.09)

# GCC Performance: Some Insights

- **Slowdown in GCC Sukuk growth in 2008 and 2009 largely as a result of:**
  - **Tightening of *Sharia*-related rules by Islamic scholars**
  - **Credit crunch which has increased the pricing of GCC issues**
  - **Defaults of number of Sukuk (Saad Group, Investment Dar)**
- **GCC represented only 20% of Global Sukuk issuances in 2009, compared to 38% in 2008 and 43% in 2007**
- **Biggest GCC Sukuk issuers in 2009 were Governments of RAK and Bahrain, Saudi Electricity & IDB**
- **The US$3bn issues each by Abu Dhabi and Qatar in April opened the way to a host of quasi-sovereigns, such as Mubadala Development Company, Aldar Properties and Qatar Telecom.**
- **In 2009, no Sukuk were issued in AED as UAE companies were seeking liquidity from the international markets, with USD Sukuk issuances increasing from 7 to 22% between 2007 and 2008**
- **Lack of standardization: each issue is unique and serves a particular purpose**.

# Primary Market: Major Role in Infrastructure Financing

- EMEs and GCC have major infrastructure/housing investment planned (Gulf ≈ $2 tn.)
- Infrastructure projects with predictable revenue stream over long term is suitable and consistent with the orientation of Islamic Finance towards real underlying assets.
- **Flexibility to offer risk - reward structures** to issuers. Financial institutions can lend - be a partner based on a pre-specified profit sharing arrangement.
- Lenders/investors **can impose restrictions on unethical and speculative** financial activities by the issuer or borrower.
- **Encourage risk management** through explicit disclosure and transparency of the roles and responsibilities of the parties to a contract. Risks are integrated in the economic activities, which must generate sufficient wealth to compensate for such risks. **Risk mitigation matrix is essential.**
- Requires the financing to be **channeled for productive purposes**, such as financing projects, rather than for speculative activities. The risk exposure is therefore to the project and not to the uncertainties or activities that have no real economic benefits.
- Under the Sukuk structure, an asset-backed instrument provides **continuous security to the investors.** This approach discourages over-exposure of the financing facility beyond the value of the underlying asset, given that the issuer cannot leverage in excess of the asset value

# Secondary Market is Struggling to Emerge

## Main Hurdles

- Lack of homogenization in terms of maturity, profit rate, underlying asset and terms & conditions, which prevents the establishment of a reference term structure of the profit rate
- Uncertainty over seniority of Islamic securities backed by physical assets vis à vis conventional securities in case of bankruptcy
- Shortage of high quality paper, which leads to buy & hold strategies by Islamic Financial Institutions (IFIs)
- Risk/liquidity management due to prohibition from investing in hedging instruments
- Lack of short term instruments for liquidity management
- Need for innovation in retail products and services, as well as for liquidity management.

# Islamic Finance: Risks

In addition to common risks like credit risk and market risk, there exist others that are intrinsic to Islamic finance including:

*Concentration risk*

- Real estate assets are the ‘ideal’ Islamic assets. Encouraged by state and central banks

*Asset ownership risk*

- Islamic institutions are the owner of the asset during the life of the transaction

*Reputation risk*

- Islamic finance is about ethical financing - scandals hit them harder than conventional financing

*Perception risk*

- In the West and other secular countries: confusion of religion and daily life; secular/spiritual; private/public.

*Sharia risk*

- Related to the structure & functioning of *Sharia* boards at the institutional & systemic level.
- How *Sharia* compliant are products?
- Are profit and loss sharing instruments really sharing losses?
- Who is responsible for managing Shari’a compliance?

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**Role of Governments & Central Banks**

**Some Central Bank Initiatives: Malaysia, Bahrain, Kuwait, Sudan**

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# Recent Regulatory Reforms

### United Kingdom
- Positioning itself as European hub for Islamic finance
- UK Gov't has introduced legislation to promote IF and has made adjustments to stamp duties on income from Islamic products
- Plans for a sovereign issue denominated in GBP In late 2009/2010.
- Gov't looking to legislate to help develop Islamic corporate debt

### France
- Between 6 and 7 million Muslims in France
- Changes to the tax code  to ensure that Islamic modes of financing do not attract extra tax penalties in relation to conventional transactions.
- At least 2 new Islamic banks reported to be requesting accreditation to operate in France.

### Singapore
- Developed guidelines for Sukuk and introduced a concessionary tax rate on income derived from Sharia-compliant fund management, lending and insurance.
- Targeting the Islamic wealth management space
- Central bank established program to issue the first-ever Singapore-dollar denominated sovereign Sukuk.
- Issued new regulations to ensure equal tax, regulatory and liquidity treatment of Singapore-dollar Islamic bonds with government securities.

### Indonesia
- Largest population of Muslims in SE Asia
- Government has allowed tax concessions for Sukuk and other instruments
- Issued new regulations governing Islamic banks, which include new rules on: minimum reserves; payments clearing; creation of an Islamic inter-bank money market; issuance of Bank Indonesia Wadiah-based promissory notes to provide liquidity to the market.

### Hong Kong
- Government changing tax laws to ensure Sukuk are treated in the same way as conventional bonds (stamp duty, profits tax and property tax)
- Hong Kong said it plans to issue a sovereign Sukuk when market conditions are right.
- Edge in pitching Islamic finance products to China-focused investors

### Other
- China, Japan and Thailand announced intention to issue sovereign Sukuk
- SK is planning to grant tax exemption on return on Sukuk to attract more funds.



*Source: DIFC Team Analysis*

# Government's Role

- Rigorous and well developed **legal, regulatory and *Sharia* framework** => Implementation of the **Islamic Financial Services Board (IFSB) & AAOIFI standards** (equivalent to Basel II for Islamic banks).
- Remove regulatory and tax barriers to ensure level playing field
- Regulatory structure such that MoFs globally recognise Islamic finance products/instruments
- **Recognition of financial standards and products**: To promote greater mutual recognition of Islamic products, Bank Negara Malaysia has initiated the development of *Sharia* Parameters to promote more consistent application of Islamic financial contracts.
- Foster development of **regional/central Sharia boards**
- Help to develop Risk Management Systems.
- Development of **human capital in Islamic finance** => ensure an adequate supply of talent pool of experts and high calibre professionals.

# Role of the Central Bank

- Introduce **Islamic compliant monetary instruments**.
- **Facilitate Liquidity Management** (e.g. the creation of an Islamic Interbank Money market)
    - Malaysia has an active interbank money market and an Islamic cheque clearing system operated by the central bank.
    - Securitization of a pool of lease portfolios could help develop the interbank market, but the volume of transactions may not be sufficient to meet the demand.
- Set up a liquidity management house to internationalize this system which could **ultimately develop into a lender of last resort.**
- **Develop a secondary market** for enhancing liquidity and standardizing contracts to reduce riskiness of asset-backed securities.
- Financial Innovation: Introduce financial market instruments with equity ownership features, Islamic asset-backed securities, the inclusion of permissible forms of credit enhancements as well as *Sharia*-compliant risk mitigating instruments.

# The Malaysian Experience: dual system

Active inter-bank market since 1994 => Percent of deposits in Islamic Banks which stood at 0.1% in Jan94 were close to 10% of total (Mar 08).

Fig. 1: Overall Structure of the IIMM

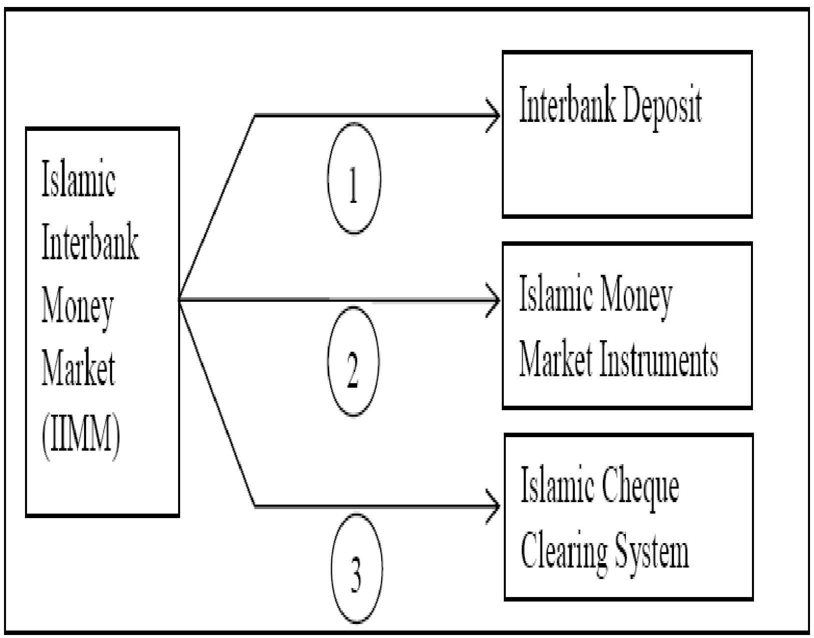
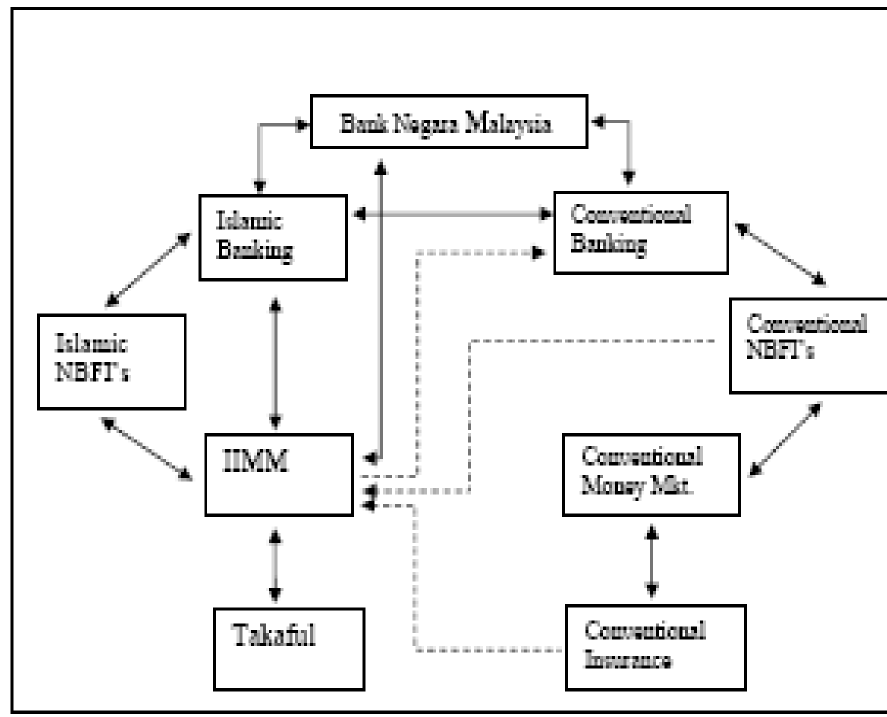



Fig. 2: IIMM within the Banking / Insurance System.



# The Malaysian Money Market

- **BNM has introduced a series of *Shari'a compliant* money market instruments which could be easily replicated and would constitute a standard for short term instruments.**
- **Conventional money market instruments were "Islamised" by replacing the interest-bearing feature with either a profit rate or a mark-up feature (e.g. Banker's Acceptances, were transformed into Islamic BAs, Treasury Bills became Islamic Treasury Bills (ITBs)).**
- **As IMM's instruments and processes have largely been structured using the conventional template, the pricing of these instruments by and large, follows the conventional logic of discounting.**

# An Overview of Malaysian Islamic securities

- Common IMM instruments include:
  - ✓ Government Investment Issue: Malaysian government's non-interest bearing money market instrument
  - ✓Bank Negara Negotiable Notes: traded in the secondary market
  - ✓Cagamas *Mudharabah* Bonds: issued to finance the purchase of Islamic housing debts from financial institutions.
  - ✓The Islamic Accepted Bill - *Sharia* compliant instrument for trade financing
  - ✓Islamic Private Debt Securities – *Sharia* compliant corporate bonds
  - ✓Sell and Buy Back Agreement (SBBA) - bilateral agreement in which an SBBA seller (seller) , first sells assets to an SBBA buyer (Buyer) at an agreed price.
- Established the Bursa Suq Al-Sila' under the concept of commodity murabahah – a multi-currency, multi-commodity electronic exchange traded platform to facilitate the trading and settlement of commodity using crude palm oil (CPO).

# CB Initiatives: Central Bank of Bahrain

- The CBB uses *al-Salam* Sukuk to engage Islamic banks in its monetary operations. Under this, the government agrees to sell forward to Islamic banks a commodity (typically aluminum in the case of Bahrain) against a spot payment. Simultaneously, the Islamic banks designate the Bahraini government as their agent to sell the commodity to a third party upon delivery. The price of the future sale determines the return of the Sukuk, while the initial spot payment from the Islamic banks to the central bank constitutes the liquidity withdrawal.

- **Al Salam Sukuk** are a BHD-denominated debt instrument issued in accordance with Sharia standards. Al Salam Sukuk are issued on a monthly basis through a fixed-rate tender procedure and have a three-month (91 days) maturity.

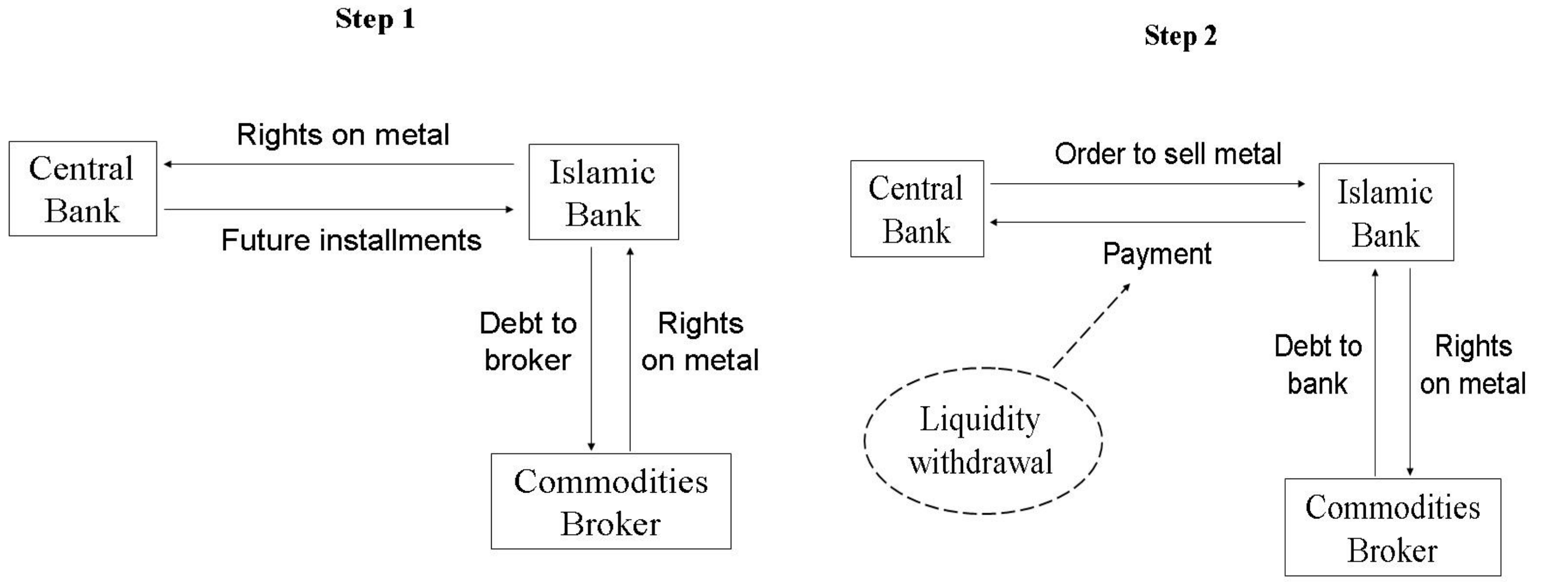
- **Short Term Ijara Sukuk** are a BHD-denominated leasing instrument issued through a fixed-rate tender procedure in accordance with Sharia standards. Short Term Ijara Sukuk are issued on a monthly basis and have a six-month (182 days) maturity.

- **Long Term Ijara Sukuk** are a leasing instrument issued through a fixed-rate tender procedure in accordance with Sharia standards. Long Term Ijara Sukuk are denominated in USD or Bahraini Dinars. They are issued on an ad hoc basis and have a maturity of 3 - 10 years.

# CB Initiatives: Kuwait

- In general the central bank can securitize some of its assets (e.g. gold), but this is capped by the value of the CB's assets

- In **Kuwait** the central bank designed a type of monetary policy operation based on *Tawarruq* - a commodity-based instrument which allows its originator to obtain immediate financing (which is a variation of the Bahrain approach).



# CB Initiatives: Sudan

•**Sudan** has developed instruments to raise financing for the government as well as to manage systemic liquidity. Several types of certificates allow the Sudanese government to raise financing at different maturities:

- **National Participation Paper:** monetary instrument to finance government operations (infrastructure in particular but not tied to a specific project) that can be used in Islamic OMOs.
- **CB Bank Musharaka Certificate** is equity based and issued against government or central bank ownership in commercial banks (or SOEs).
- **CB** has also issued, although in smaller quantities, its own ***Ijara* certificates** (commercially known as *Shijabs*).
- **Government Mudharabah Certificate:** issuance of securities that promise investors a negotiable return linked to developments in government revenue in return for their investment in the provision of general government services.
- Precedent: Qabala system whereby an investor (Taqabul) promised to pay government a fixed sum and in return made on the tax revenue of a certain locality

Source: Monetary Operations & Government Debt Management under Islamic Banking, IMF WP 98/144, V. Sundararajan, D. Marston & G. Shabsigh

## Additional possibilities

- Islamic Money Market Funds would be a natural initiative to foster
- Islamic REITS and Islamic Pension Funds are still extremely rare
- The Islamic Development Bank, is considering establishing an International Islamic Inter-Bank (IIIB), with a capital of at least $10 billion, with the specific purpose of providing liquidity management to the global industry and also act as Lender of Last resort for Islamic banking.

# Actions Required

- Timing is right for governments/central banks/multilateral institutions to create a deep and liquid market in Islamic securities and Shari'a compliant government securities
- Necessary to enact a multi-year plan of sizeable issuances staggered at regular intervals which would constitute the market benchmarks
- Sovereign benchmarks would be the natural reference for pricing all other debt securities
- Challenge: legal issuer needs to be a separate entity that is bankruptcy remote from the sovereign
- Central banks must enable use of these securities for their liquidity operations & collateral as lender of last resort

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# DIFC's Role

- DIFC has a sophisticated framework of laws, regulations and controls to support Sukuk issuance
- The DIFC offers a domicile for the registration of Islamic collective investment schemes, reflecting an increasing investor preference for Sharia-compliant investment products originating and managed in the region.
- The DIFC, through the Nasdaq Dubai offers an electronic platform for the primary listing and secondary trading of sophisticated Islamic financial instruments, such as Sukuk.
- NASDAQ Dubai currently largest global exchange in terms of value of listed Sukuk, with 21 Sukuk, valued at $16.7 bn. (as of 8th Nov09)

# Sukuk Listed on the NASDAQ Dubai

**Nakheel Development 3 Ltd**
AED 3,600,000,000
Trust certificates Due 2010
May 13, 2008

**Almana Sukuk Ltd**
AED 600,000,000
Trust certificates Due 2013
May 20, 2006

**TID Global Sukuk Ltd**
US $ 150,000,000
Trust certificates Due 2011
October 16, 2006

**Nakheel Development Ltd**
US $ 4,270,000,000
Trust certificates Due 2009 & 2011
January 17, 2008 & December 14, 2006

**DIB Sukuk Company Ltd**
US $ 750,000,000
Trust certificates Due 2012
March 26, 2007

**DAAR International Sukuk Ltd**
US $ 600,000,000
Trust certificates Due 2010
May 28, 2007

**IIG Funding Ltd**
US $ 200,000,000
Trust certificates Due 2012
June 14, 2007

**Dubai Sukuk Centre Ltd**
US $ 1,250,000,000
Trust certificates Due 2012
June 18, 2007

**DP World Sukuk Ltd**
US $ 1,500,000,000
Trust certificates Due 2012
July 3, 2007

**Cherating Capital Ltd**
US $ 850,000,000
Trust certificates Due 2012
July 6, 2007

**Dar Al Arkan International Sukuk Ltd**
US $ 1,000,000,000
Trust certificates Due 2010
July 23, 2007

**Ras Al Khaimah Investment Authority**
US $ 325,000,000
Trust certificates Due 2012
December 9, 2007

**Tamweel Sukuk Ltd**
AED 1,835,000,000
Trust certificates Due 2013
July 29, 2008

**Tamweel Funding Ltd**
USD 300,000,000 Trust Certificates due 2013
April 2, 2008

**Paka Capital**
USD 550,000,000
Trust certificates Due 2013
May 20, 2008

**DEWA Funding Limited**
AED 2,000,000,000
Trust certificates Due 2013
June 18, 2008

**JAFZ Sukuk Ltd**
US $ 2,040,000,000
Trust certificates Due 2012
December 9, 2007

**Villamar sukuk Ltd**
US $ 190,000,000
Trust certificates Due 2013
May 20, 2008

# Islamic Finance @ the DIFC

- Nasdaq Dubai has established benchmarks for **measuring and reporting performance of Islamic products.**
  - Nasdaq Dubai joined hands with FTSE to develop the **FTSE Nasdaq Dubai Shari'a Index Series** – a series of indices that represent the performance of the largest and most liquid Shari'a-compliant companies in the GCC.
  - Similarly, Nasdaq Dubai also tied up with HSBC to develop the **HSBC/Nasdaq Dubai family of indices** that track the performance of international Sukuk and Middle Eastern conventional bonds.

- DFSA, DIFC's independent regulator, has created a **'*Sharia* Systems' model of regulation.** DFSA's regulatory regime allows Islamic financial institutions to carry out a number of cross-sectoral activities, conforming to international standards such as risk and capital adequacy requirements, as well as Islamic finance industry guidelines and applications specified by the AAOIFI and the Islamic Financial Services Board (IFSB) for accounting treatment of Islamic transactions.

# Islamic Finance Milestones at DIFC

| | |
|---|---|
| **Jul 2006** | Islamic International Rating Agency (IIRA) established a presence at the DIFC. |
| **Mar 2007** | World's first new Executive MBA specialized in Islamic Finance and Energy delivered in DIFC by Cass Business School |
| **Mar 2007** | DFSA signs MoU with Bank Negara Malaysia in order to facilitate and remove regulatory barriers for Islamic finance transactions between the DIFC and Malaysia. |
| **Mar 2007** | DIFC establishes Islamic Finance Advisory Council to promote the development of Islamic Finance. |
| **Jun 2007** | DIFC Investments issues a US$1.25 billion Sukuk, the largest rated and the largest Straight Sukuk to come out of the region. |

# Islamic Finance Milestones at DIFC

| | |
|---|---|
| **Apr 2008** | DFSA signs MoU with the Securities and Futures Commission of Hong Kong ("SFC") to promote and develop Islamic capital markets, and facilitate the distribution of Islamic funds in the DIFC and Hong Kong. |
| **Apr 2008** | DIFC becomes associate member of the Islamic Financial Services Board (IFSB) |
| **May 2008** | DIFC signed an MoU with the Hong Kong Monetary Authority (HKMA) aimed at fostering co-operation in the development of Shari'a-compliant financial products and the financial infrastructures between the two jurisdictions. |
| **Nov 2008** | Launch of the first standardized Commodity Murabahah Contracts (Master Agreement for Treasury Placement) in association with IIFM |

# The IFC Sukuk listing

On 4th Nov, 2009 the International Finance Corporation, an affiliate of the World Bank listed a Sukuk on the DIFC's international exchange, Nasdaq-Dubai & Bahrain Exchange.

- The IFC Hilal Sukuk is a dollar-denominated $100 million issue, Aaa rated, with a five-year maturity.
- It is the **first time that a non-Islamic financial institution issues a Sharia compliant security** for term funding.
- It is also the first time that a sizeable Sukuk will be **listed exclusively in the Gulf,** i.e. on Nasdaq Dubai and the Bahrain Stock Exchange - an acknowledgment of the progress made by the emerging financial sector in the region, in terms of liquidity, trading, clearing & settlement, and the legal and regulatory environment.
- The Hilal Sukuk will **raise funds for IFC infrastructure and health projects** in Yemen and Egypt, stressing the ideal suitability of Islamic finance for the financing of tangible, real assets. Given the infrastructure projects in the pipeline, this issue underscores the opportunity in project/infrastructure financing.
- So far a **liquid Sukuk secondary market in the region** has struggled to emerge in part due to a shortage of high quality securities compared to the demand by a host of Islamic institutions (which typically buy and hold most of the supply). The IFC issue might help turn the tide!

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## Action Points & Recommendations

# GCC/MENA: Smoothing the economic cycle

- **Contra-cyclical fiscal policy has played a major role in mitigating the effects of global financial crisis**
- **The Gulf/GCC governments have spent heavily to launch infrastructure projects, these should be continued.**
- **Oil price shock implies that governments should manage their debt effectively especially in the current environment**
- **Efficient public debt management policy would allow governments to smooth the boom and bust cycle induced by oil price fluctuations**
- **Reforms in public finance management and transparency in the use of resources would be necessary to efficiently tap the markets**
- **Resort to project financing in the form of Islamic securitization would contribute to create a deep and liquid market**

# Action points & recommendations

- **Developing Islamic Securities Markets is a policy priority & should be viewed as part of structural solutions to resolving current and future global imbalances.**
- **Existing market infrastructure can support ISM**
- **EMEs/MENA/GCC: Infrastructure, public works, development & housing investments can be major drivers of demand for Islamic Securities**
- **GCC & MENA energy exporters are developing IS as part of public debt management**
- **International Financial Institutions (IMF, WB/IFC, BIS) along with regional development banks (EIB, ADB, AfDB, IDB, IADB) should use IS as part of their funding strategy for (a) own Treasury operations and (b) country and regional development finance.**
- **EU opportunity of introducing harmonised legislation & regulations for IF in Europe**

# DIFC-Italy Framework for Cooperation

- The DIFC and Italian Banking and Financial Industry have an opportunity to develop institutional and working relationships between each other.
- DIFC & Development of the Islamic Finance Sector in Italy:
  1. Advise on development of legal and regulatory framework governing Islamic financial institutions in Italy
  2. Assist Italy in joining the ranks of countries –including UK, France, HK, Singapore and Japan- by removing tax, legal and regulatory barriers to Islamic finance.
  3. Facilitate dialogue among Sharia Boards
  4. Exchange of information and best practice
  5. Promote training, professional and educational programs
  6. Facilitate issuance of Government of Italy Sukuk
  7. Facilitate issuance of Sharia compliant securities by Italian banks & companies, including funds and Sukuk

# Annex: Shari'a & Conventional Banking Equivalence

# I. Financing Products (arranged in order of importance)

| Islamic Banking Products | Conventional Banking Products |
|---|---|
| <u>Murabaha</u><br><br>• A Murabaha transaction involves the purchase and resale (generally on installments) of an asset at cost plus an agreed profit margin.<br>• The bank may retain a security interest in the asset being sold to the customer under a Murabaha.<br>• The bank may not charge interest on late payments of installments. Nonetheless, penalty may be levied on late payments provided that the bank spends the penalty proceeds on charitable causes.<br>• A special form of Murabaha, known as **International Murabaha**, is used by Islamic banks as the Shari'a-compliant alternative to placement of interbank deposits. The asset used in this case is generally one of the commodities traded on the London Metal Exchange. To take deposits from other banks, a bank uses **Reverse Murabaha.**<br>• International Murabaha is a variation of a special form of Murabaha known as Tawarruq Murabaha, which is a transaction the sole purpose of which is for a bank to make cash available to its customer. This is accomplished by the bank purchasing a commodity spot, and reselling it to the customer on a deferred payment basis, then helping the customer to sell the same commodity spot for immediate cash.<br>• Twarruq Murabaha is the mechanism underlying the Islamic credit cards that have been recently issued by some Islamic banks. The proceeds generated by the Tawarruq Murabaha are credited to a special purpose account in the name of the credit card holder which acts as the cover account for his credit card transactions (therefore it is called the "covered card").<br>• To simulate financing at a variable rate, a Murabaha transaction is structured to be rolled over at a predetermined frequency whereby each rollover Murabaha is priced at market rates. This structure is also used to simulate conventional bank overdrafts.<br>• Tawarruq Murabaha and Revolving Murabaha have been the subject of increasing criticism by Shari'a scholars. Accordingly, many Islamic banks are restructuring the transactions that use these Murabahas as the vehicle to use Ijara instead.<br>• Murabaha has also been used to finance real estate (residential, commercial, etc.). Although Ijara (at a variable profit rate) is the more popular vehicle for this. | <u>Personal/Commercial Loans</u><br><br>• A Murabaha is generally used as the Shari'a-compliant counterpart to conventional loans extended to customers for personal or commercial purposes. However, the differences between Murabaha and loans are:<br>(i) A conventional bank generally disburses loans to its customers without becoming a party to the transaction involving the asset being financed (other than having a security interest in the asset);<br>(ii) A conventional bank charges interest at fixed/variable rate as opposed to a profit margin, and it charges penalty and interest on late payments;<br>(iii) Conventional banks transacting in the interbank market do not have to go through a commodity to place or take money in the form of bank-to-bank deposits. Instead, money is placed or taken at predetermined interest rates. |

# I. Financing Products

| **Ijara** | **Leasing** |
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| • Ijara involves the purchase of an asset by the bank then letting it to a lessee under either an operating or a capital lease (“Ijara Muntahia Bittamleek”).<br>• Under an Ijara Muntahia Bittamleek, the asset is transferred to the lessee at the end of the lease term in consideration for i) a token price, ii) market value of the asset or iii) payment of the last lease installment. The property may also be gifted to the lessee by the lessor at the end of the lease term.<br>• Risk of loss throughout the Ijara term must rest with the lessor under either Ijara type (but, of course, this is covered by insurance).<br>• Insurance and major maintenance must be borne by the lessor under either Ijara type, but could be passed to the lessee through the lease payments.<br>• If the Ijara assets were to be securitized, the beneficiaries must have ownership of the asset itself or its usufruct and not only the lease payments (i.e. one can not simply securitize only the receivables).<br>• Ijara could be used as a vehicle to provide the customer with cash by simply buying an asset from the customer spot, then letting the same asset to the customer under an Ijara Muntahia Bittamleek that has a term of more than 12 months (to avoid a Shari’a prohibition against wash sale).<br>• Ijara is the preferred vehicle for issuing Islamic bonds (“Sukuk”). The party wishing to avail itself of Sukuk financing simply sells assets to a special purpose vehicle that funds the transaction through issuing participation certificates to investors evidencing undivided interest in the assets and income thereon. The SPV then lets the assets back to the seller or to a third party to generate rental income.<br>• Ijara Muntahia Bittamleek is the primary vehicle for real estate finance of all types (residential, commercial, retail properties, etc.). One of the primary reasons for this is the ability of the lessor to charge variable rent that could be indexed to a market benchmark (e.g. LIBOR). | • Conventional banks are generally limited to capital (or finance) leases.<br>• In a capital lease, the risk of loss is ordinarily passed to the lessee.<br>• In a capital lease, insurance and major maintenance are borne by the lessee.<br>• Securitization could involve only the lease payments (i.e. only the receivables and not the underlying assets).<br>• Conventional bonds do not necessarily have to be backed by specific assets.<br>• Conventional mortgage finance involves a loan supported by a mortgage over the property as opposed to Ijara where the bank owns the property throughout the term of the financing. |
| **Istisna**<br>• Istisna is a contract for financing the construction of capital assets. The bank must enter into two separate and distinct contracts, one with the customer who wishes to avail construction financing (the “**Istisna Contract**”) and one with the builder or contractor (the “**Parallel Istisna Contract**”). An important Shari’a constraint here is that the outcome of the Istisna Contract may not be made explicitly dependent upon the outcome of the Parallel Istisna Contract (i.e. no pass-through).<br>• Once the asset is constructed, the Istisna may turn into an Ijara Muntahia Bittamleek or a Murabaha. | **Construction Loans**<br>• In a typical construction loan, the bank extends funds against some sort of security or mortgage, and does not get involved in contractual arrangements with the builder or contractor.<br>• The construction loan is generally in the form of a bridge loan with interest payable during the construction period. |

# I. Financing Products

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| • A combination of Istisna and Forward Ijara (**Ijara Mawsufa' Fi Al Zima**) is used for construction financing to allow servicing the facility during the construction period and before the asset is completed. The Forward Ijara provides for a current lease of a specified asset under construction (the subject of the Istisna) and calls for advance rental payments that the bank receives during the construction period. | |
| **Asset-side Mudaraba**<br>• In a Mudaraba, the bank is known as Rubulmal (owner of capital) and the customer is known as Mudarib (entrepreneur). The bank and the Mudarib share the enterprise profits in a predetermined manner. However, losses are borne only by the bank (being the contributor of all of the enterprise's capital).<br>• Mudaraba could be used to simulate conventional bank overdraft. Here, the customer has the right to draw funds from the bank up to a certain limit under a Mudaraba agreement. The funds are invested by the customer in his business activities with the bank promising to waive any profits distributable to it in excess of a given rate.<br>• Mudaraba could also be used as the vehicle for asset management whereby the bank entrusts the Mudarib with funds to manage in accordance with set guidelines. | **Commercial/Corporate Loans and Asset Management**<br>• A conventional bank does not ordinarily partner with its customers.<br>• The conventional arrangement that comes closest to a Mudaraba is where a bank hires an asset manager to manage an investment portfolio under a contract whereby the manager is entitled to a share of the profits to the extent the calculated returns exceed a certain rate or benchmark (i.e. incentive fee). |
| **Musharaka**<br>• In a Musharaka, the bank becomes a partner in a certain economic activity with its customer(s). Both the bank and the customer(s) contribute capital to the business enterprise.<br>• The bank takes direct ownership/business risk and shares in the profits or losses.<br>• Profits generated by the business enterprise are allocated pro-rata among partners (or in any manner they see fit).<br>• Losses can only be shared in proportion to each partner's share in capital (this is a Shari'a constraint).<br>• A special form of Musharaka known as **Diminishing Musharaka** is used to finance real estate and other capital assets. Here, the bank's share in the Musharaka declines overtime through amortizing payments by the customer-partner who promises, at the outset, to buy out the bank's equity gradually over time.<br>• Musharaka is not a widely used form of doing business in Islamic banking, primarily due to the higher degree of risk associated with it. | **Commercial/Corporate Loans**<br>• A conventional bank does not ordinarily partner with its customers.<br>• The bank would generally act only as lender to the business enterprise.<br>• The lending rate (i.e. interest) is generally pre-determined and is fixed or floating (i.e. there are no profit sharing arrangements).<br>• Business losses are the sole responsibility of the borrower. |

# II. Deposit Products

| Liability-side Mudaraba | Deposits |
|---|---|
| • Typically, an Islamic bank takes deposits from its customers either in the form of **Qard** (i.e. non-interest bearing loan) or Mudaraba. Current account deposits are taken as Qards, while savings and term deposits (known as "Investment Deposits") are taken under a Mudaraba agreement designating the customer as Rubulmal and the bank as Mudarib. The bank is fully indebted to the customer for the Qard, but the customer bears the risk of loss with respect to Investment Deposit Accounts.<br>• A term deposit may take the form of either "Restricted Investment Account" or "Unrestricted Investment Account", with the former being invested by the bank in a specific investment vehicle in a separate account (i.e. not commingled with other customers' deposits) while the latter becomes part of the common pool in which both depositors and shareholders' funds are commingled and invested collectively as the bank sees fit.<br>• Subject to certain adjustments and exclusions, the bank's periodic net profit is allocated between shareholders on one side and Savings and Unrestricted Investment Deposit Account holders on the other (current accounts are excluded and Restricted Investment Accounts get their profits credited directly outside the common pool) based on their respective weighted average balances. However, in practice, most Islamic banks distribute to depositors a share of the profit calculated at a rate that is very close to the conventional market rates and reserve the difference for future use or take the difference from the reserve. | • Conventional bank depositors are creditors and the bank is a debtor.<br>• A conventional bank pays its interest-bearing accounts a predetermined interest rate. |
| **Wakala** | **Fiduciary Arrangements** |
| • In a Wakala, the bank may act as agent ("Wakil") or principal ("Muwakil"). When the bank is entrusted with customer funds for investment, the bank as a Wakil acts in a fiduciary capacity. On the other hand, the bank may entrust another party with funds for investment.<br>• Wakala is being increasingly used by some Islamic banks to accept deposits from institutional customers or to place funds with other banks (i.e. interbank). This is primarily because i) under a Wakala, the profit rate that the funds would earn could be determined in advance with a high level of certainty and ii) the Wakala agreement is much simpler than the International Murabaha agreement (for placing with other banks) or the Mudaraba (for taking deposits from customers). | • Conventional banks act as fiduciaries under a variety of arrangements. They also occasionally entrust others with funds for management in a fiduciary capacity (e.g., asset managers).<br>• Conventional bank s place and take deposits at predetermined interest rates. |

## III. Investment and Derivative products and Waqf (trust) - arranged in terms of frequency of use

| Product Description | Conventional Banking Products |
|---|---|
| **Equity Investments**<br>• Equity funds come with different objectives (e.g., growth, income, small cap, large cap, etc.) and different scope (e.g., global equities, US equities, local equities, private equities, Takaful (Islamic insurance), healthcare, etc.). Also, equity funds may take the full equity investment risk or may be structured as capital protected funds.<br>• Many Islamic equity investments today are screened for Shari'a compliance using the criteria of the Dow Jones Islamic Market index. These criteria deal with the nature of business which the company undertakes, its total indebtedness, total receivables and its level of income from prohibited assets. Screened equities that are eligible for investment from a Shari'a standpoint are, of course, further screened to ensure that they meet the investment objectives and guidelines of the investor.<br>• Prohibited income that would inevitably be produced by some of the Shari'a screened stocks must be cleansed by the investor by spending it on charitable causes. | • Other than Shari'a screening and the cleansing of prohibited income, there are no major differences between investing in equity conventionally vs. investing in compliance with Shari'a. |
| **Shari'a Alternatives to Money Market Funds**<br>• Funds for short-term liquidity and cash management (these are more or less the equivalent of the conventional money market funds). Most of these funds invest in International Murabahas although some of them use Ijara as the basis. | • See comments under Murabaha and Ijara in the Financing Products table above. |
| **Income Producing Investments**<br>• Ijara (leasing) funds are the equivalent of conventional fixed income funds. These funds generally invest in capital assets that are let to end-user lessees. These include vehicles, computers, construction cranes, agricultural equipment, earthmoving machines, cars, trucks, special purpose factory equipment, etc.<br>• Real estate funds are also a subclass of the Ijara funds. Also, Ijara is the preferred vehicle for issuing Sukuk or Islamic bonds (see description of Sukuk under Ijara in the table for Financing Products above). | **Fixed Income Investments**<br>• Conventional fixed income funds and bonds pay interest at fixed or floating rates, as opposed to the rental income distributed by Ijara funds and Sukuk. |
| **Bai Al Salam**<br>• Bai Al Salam is the Shari'a counterpart to a forward contract. Under a Salam contract, a party could sell a specified commodity that he does not own at the time of sale. However, as opposed to a conventional forward contract, the seller receives the full amount of the sales proceeds from the buyer at the time of sale. | **Forward Contracts**<br>• In a forward contract the buyer (with the possible exception of a small margin deposit and mark to market adjustments) does not have to pay the full amount of the underlying until delivery takes place.<br>• Forward contracts are used to buy and sell foreign currencies and precious metals at future dates. |

# III. Investment and Derivative products and Waqf (trust) - arranged in terms of frequency of use

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| • The seller may enter into a "Parallel Salam" contract simultaneous with the sale under the Salam contract for the purpose of acquiring the assets being sold (i.e. matched purchase and sale).<br>• Salam may not be used for the sale of foreign currencies or precious metals as these must be paid for spot. Currencies and precious metals have many restrictions placed on their sales and exchanges as they are considered as means of payment (i.e. money) that could not be bought or sold on a deferred payment and/or deferred delivery basis, since the purchase or sale of money for deferred payment or delivery is Shari'a objectionable as it is deemed a form of paying or receiving interest. | |
| **Bai Al Arboun**<br>• Bai Al Arboun is the Shari'a counterpart of call options. A Arboun contract provides for one party paying a down payment (Arboun) to another in return for the right to purchase a particular underlying(s) at an agreed upon price at a future date. If the holder of the right does not exercise it, his Arboun is forfeited. If he exercises his right, the Arboun is considered part of the purchase price. | **Options**<br>• In a conventional option, the premium paid by the option buyer is considered the price of the option as opposed to a down payment on the price of the underlying. Therefore, even if an option is exercised, the premium would not be taken into consideration in determining the purchase price to be paid by the option holder. |
| **Profit Rate Swaps**<br>• Shari'a-compliant Profit Rate Swaps (PRS) have been developed by simulating the two legs of a conventional IRS using International Murabaha. The fixed rate leg is simulated by a term International Murabaha contract, while the floating rate leg is simulated by a revolving International Murabaha contract.<br>• Although few PRS transactions have been executed so far, the rules of entering and unwinding the swap are still being hammered out in order to bring them to full compliance with Shari'a requirements. In this regard, there are some ongoing attempts by international law firms to rewrite the ISDA rules specifically for Islamic banking.<br>• It should also be noted here that some Islamic banks have succeeded in simulating Credit Default Swaps through a structure involving a Murabaha with zero profits (called "**Bai Al Tawlia**") extended to a special purpose vehicle, where the proceeds of the Murabaha remains credited to an account for the SPV with the bank and where the account used as margin for a bank guarantee issued by the bank benefiting a third party to whom the SPV sells protection. Similar structures, more or less, are used to invest in CDOs and CLNs. | **Interest Rate Swaps**<br>• Interest Rate Swaps (IRS) involve the payment by one party (A) of a fixed rate to another party (B) and the simultaneous payment by party (B) of a floating rate to party (A), or vise versa.<br>• Interest Rate Swaps are governed by the International Swap Dealers Association (ISDA) rules. |

# III. Investment and Derivative products and Waqf (trust) - arranged in terms of frequency of use

| **Waqf** | **Trust** |
| --- | --- |
| • A Waqf involves the transfer of assets by a grantor (Wakif) to a trustee (Mutawalli) who administers these assets for the benefit of others.<br>• The Mutawalli may not sell the Waqf assets without the permission of the Shari'a court.<br>• A Waqf may continue to exist indefinitely.<br>• A Waqf may not be revoked.<br>• A Wakif may not have beneficiary interest in the Waqf once created.<br>• Some assets may not be eligible for transfer to a Waqf.<br>• Waqf assets must be invested in a Shari'a-compliant manner. | • In a conventional trust, the trustee owns the assets and may dispose of them as he deems appropriate.<br>• Trust assets must vest in the ultimate beneficiaries within a certain time period.<br>• A trust may be revocable or irrevocable.<br>• A grantor may be a beneficiary of the trust he grants. |

## IV. Takaful (Islamic Insurance)

| Takaful | Conventional Insurance |
|---|---|
| • A Takaful operator collects premiums from policyholders in the form of donation (Tabarru) to a common pool of funds intended for the mutual protection of all policyholders.<br>• The Takaful operator manages the Takaful pool pursuant to a Mudaraba or a Wakal contract (i.e. the operator becomes a Mudarib or a Wakil – see definition of Mudaraba and Wakala in the Deposit Products table above).<br>• Investment income is shared by the operator (Mudarib/Wakil) and policyholders (Rubulmal/Muwakil) as specified in the Mudaraba/Wakala contract. Furthermore, the operator may be compensated from the Takaful pool surplus in the form of a management fee or in the form of reimbursement of actual expenses.<br>• Investment of the Takaful pool surplus funds may only be done in compliance with Shari'a (see Investment and Derivative Products and Waqf table above).<br>• There are two major types of Takaful, i) Family Takaful which is the equivalent of conventional life insurance and ii) General Lines Takaful which is the equivalent of non-life insurance. | • There are two types of conventional insurance companies, i) stock insurance companies and ii) mutual insurance companies. Stock insurance companies are purely "for profit" and, accordingly, their aim is to maximize shareholders' wealth. Mutual insurance companies are more in the nature of cooperatives in the sense that they aim to serve the policyholders interest. |

*Thank You*

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