Risk Reward
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New Standards for Risk Management

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ISLAMIC FINANCE – AN INTRODUCTION – PART III

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INVESTMENTS

Whilst the terms "loan" or "lending" are commonly used, even by Islamic banks, they are not strictly correct in an Islamic context because an Islamic bank is engaged in mutual trading both with and alongside its clients on both sides of the balance sheet. An Islamic bank has a direct interest in the outcome of all these trading transactions, sharing both profits and losses with its partners/clients. Unlike a conventional bank where depositors are creditors and borrowers are debtors and there is almost no mutuality at all, an Islamic bank has partners, investors, principals and agents at every level.

So an Islamic bank does not "lend", it "invests"!

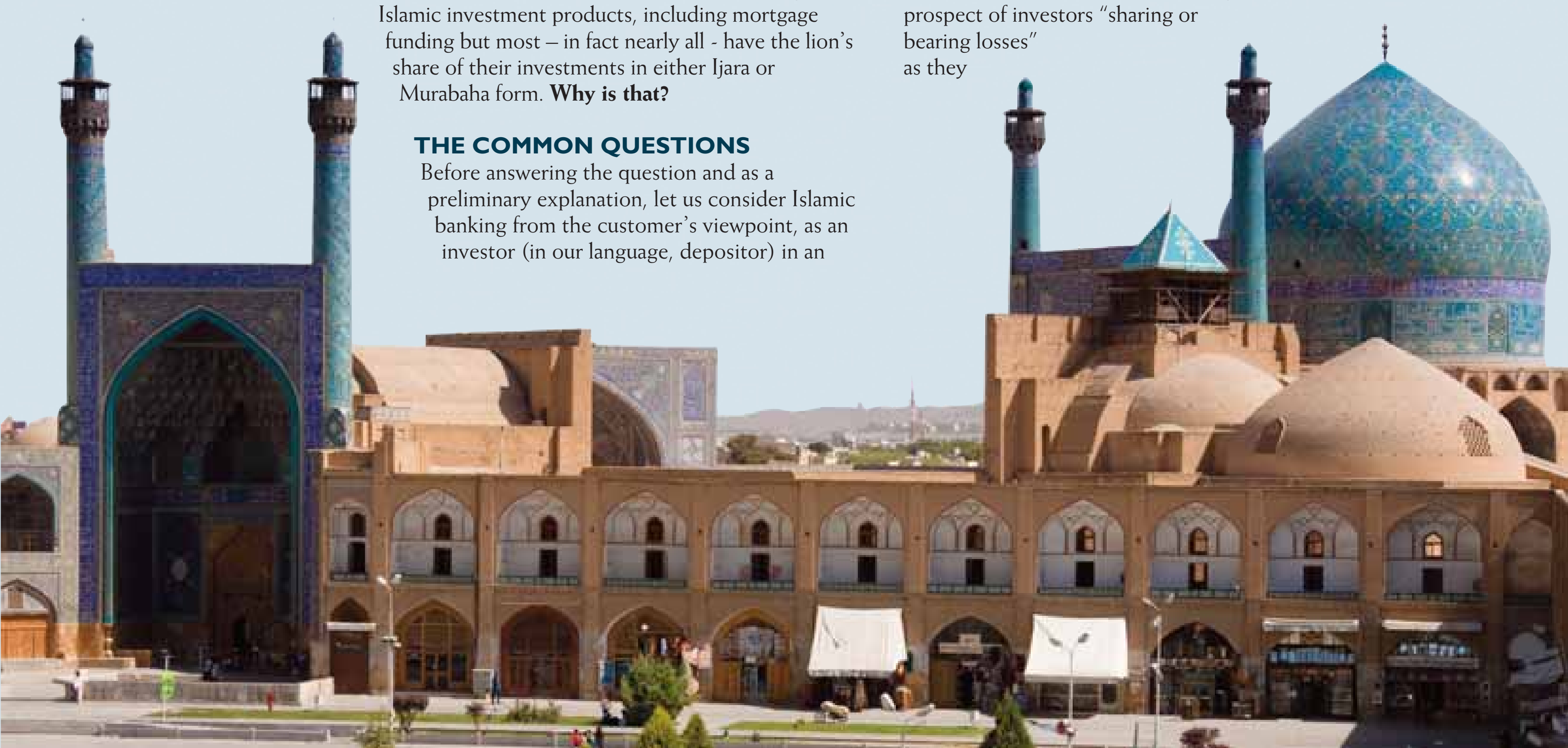
So how does an Islamic "invest" its funds? The answer is "very carefully" and for this reason only a handful of the Islamic products available are actually used in practice. This has caused Islamic banks – on the investment side at least – to become rather narrow specialists, dealing mainly in two products; split between Murabaha (akin to a loan) and Ijara (akin to leasing operations). Most Islamic banks will advertise a wide range of Islamic investment products, including mortgage funding but most – in fact nearly all - have the lion's share of their investments in either Ijara or Murabaha form. **Why is that?**

THE COMMON QUESTIONS

Before answering the question and as a preliminary explanation, let us consider Islamic banking from the customer's viewpoint, as an investor (in our language, depositor) in an Islamic bank. During the author's informal discussions with Islamic banking staff, especially those dealing regularly with clients, three questions emerge that are nearly always asked by every prospective investor (depositor) in the bank.

The first is **"Promise me this is an Islamic Bank?"** This is a particularly common question when a "windows" or "branches" approach is being used by the bank but is also asked of wholly Islamic institutions. Some Islamic banks have questioned the wisdom of operating "windows" as a result of this constant scrutiny and to be frank, there is something "other worldly" about entering a conventional bank and following signs for "Islamic banking, this way!"

The second question is **"Is my money safe?"** which is interesting, given that for those of us banking with conventional banks, the prospect of an Islamic bank failing would mean we are probably all doomed! In nearly every Islamic jurisdiction either the State or the Regulator has made it clear that investors will not be allowed to lose their money and whilst nothing is impossible, it is hard to imagine an Islamic bank in the GCC in particular, being allowed to fail. The prospect of investors "sharing or bearing losses" as they



agreed when they signed up (most don't realise this by the way!), seems as remote as it can ever be.

The last question is **"Am I getting the best return?"** to which the answer is invariably "yes, of course", because the answer "no, the bank down the road is more competitive than us!" might be career limiting!

Once these three common questions are satisfied, most clients, I am told, are then happy to take nearly everything else on trust. Is this any different from a conventional bank? Probably not in the case of the last two questions and it means that just like any financial institution, an Islamic bank's cost of funds has to be set at a high enough level to attract new and retain existing investments. This obviously means that on the other side of the balance sheet the bank must make investments (loans) at a higher level of projected return than it pays for its source funds (deposits), to make a profit. So far, so good. But what is the easiest way in risk/reward terms to achieve this? Well, by using the simplest and most remunerative products which just so happen to be Murabaha and Ijara!

MURABAHA – AN ANCIENT CONTRACT

Murabaha and Ijara are two of six ancient trading contracts, which predate Islam itself and are reckoned to be thousands of years old. Both have underpinned trading in the Middle and Far East for millennia and were adopted by the Prophet (PBUH) because they worked so well and still do.

Because Muslims may not charge interest but can make a profit, the basic trade deal, the Murabaha, is a "cost plus" transaction in which the seller supplies goods to the buyer at a price which includes his disclosed costs plus a disclosed profit. When accepting the goods, the buyer agrees to the selling price and is aware of how much profit is being made (the argument being he can choose not to buy if he dislikes the price). If the buyer requires time to pay, then this can be granted, usually in return for a higher price including a bigger profit. This is one of the ways that the time value of money can be covered under Islam without charging interest.

Before the reader cries "fiddle", let us consider some of the Islamic rules surrounding Murabaha transactions which are designed to encourage fair trade. First the seller must own and possess the goods which must be under his control. The goods must have a fungible value and there must be no uncertainty about quantity, quality or delivery dates. The seller may not take advantage of the buyer, may not cheat, deliberately mislead, overcharge or be anything other than scrupulously honest with him or her. Delivery and transfer of ownership must take place when the transaction is concluded. Once the deal has been done, it cannot be amended without the express approval of both sides. There is also the usual prohibition on trade in haram items (alcohol, guns, pork products etc.)

These ancient Murabaha trading rules are clearly framed to avoid disputes or problems and no doubt evolved over time. They were adopted by the Prophet (PBUH) because they worked so well. In fact a deal in which the seller has to be scrupulously honest and reveal both his cost price and his profit margin is remarkably refreshing to Western eyes where usually neither is disclosed.

INTERNATIONAL DIFFERENCES

Provided the rules set out above are followed, a Murabaha can be for almost any amount and in theory any time period although the range is usually 6 months to 10 years depending on the bank which will also set minimum and maximum loan amounts.
So Islamic Banks provide Murabaha facilities for clients who want to purchase almost any item that qualifies. But there are some complications as a result of differing interpretations between Scholars which make the process slightly different even between banks based even in the same country. Take an example of a client wanting to purchase a car for US$ 30,000 and being offered 100% funding on a Murabaha over a 4 year period.

For the transaction to be Islamic, the Islamic bank must be the owner and supplier of the car which means it must purchase and take delivery from the supplier before selling to its client. This creates a delivery risk as the client could walk away before the transaction is complete. Some banks insist on a promise to complete from their client, others go further and ask for a non refundable deposit (Arbun). Some Islamic Scholars are happy with either a promise or an Arbun or both, others are not saying it is not Islamic. (Luckily and at the risk of spoiling the story 99.99% of clients applying for funding do not walk away once the deal has been agreed!)

The second point of difference is delivery. Some Scholars insist the Islamic bank takes physical possession and in our example must store the vehicle in a warehouse prior to delivery. Others are happy for ownership to pass on paper, in other words there is constructive delivery only.

RETURNS ON MURABAHA – USUALLY HIGH

Despite these differences, Murabaha s are priced at the higher end of the consumer funding scale and use as benchmarks the appropriate EIBOR, SIBOR or other medium/long term rate measurement. The risk/reward profile is at the better end of the scale for the bank, the transactions are simple (albeit document hungry), easy to establish, can be used for almost any purpose, are simple to manage and normally well secured. So from the Bank's viewpoint this is relatively easy high coupon lending.

The only serious drawback is that the banks reward (profit margin) must be fixed at the outset, when the Murabaha is agreed and delivery concluded, so the returns have to be set high enough to absorb rate movements against the bank. Either that or the portfolio must be turned over regularly so that the impact is diluted.

NEXT ISSUE – PART 4

In the next article we will consider Commodity Murabaha – a controversial product in some areas, but not in others and Ijara.

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