Risk Reward riskupdate
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# The Changing Face of Regulation

## Also in this issue

- THE BRIBERY ACT 2010, CORPORATE OFFENCES AND THE "ADEQUATE PROCEDURES" DEFENCE
- AUDITING SOLVENCY II FOR INSURANCE COMPANIES: SOME PRELIMINARY CONSIDERATIONS
- THE MANAGEMENT OF OPERATIONAL RISK IN MARKET RELATED ACTIVITIES
- ARE BANKS BUILDING UP A DEADLY PORTFOLIO OF UNDERPERFORMING LOANS? – PART II PREPARING FOR SIGNIFICANT LEVELS OF RESTRUCTURING
- ISLAMIC BANKING & FINANCE – CURRENT DEVELOPMENTS
- SHOULD THE U.S. BE CONCERNED ABOUT I.F.R.S.?
- CORPORATE LOAN PORTFOLIOS: AFTER THE CRISIS

# ISLAMIC FINANCE – CURRENT DEVELOPMENTS

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In this fourth article we will look at some interesting current Islamic developments, we will continue to consider how an Islamic Bank "raises" its funds, or in old fashioned banking terms, where it "gets its money from". We will look again at the Murabaha, which still accounts for the lion's share of most Islamic banks "lending" or more correctly, investment activities – but will concentrate on Commodity Murabaha at one time a controversial product, now widely accepted.

### Summary of Source of Islamic Bank Funds

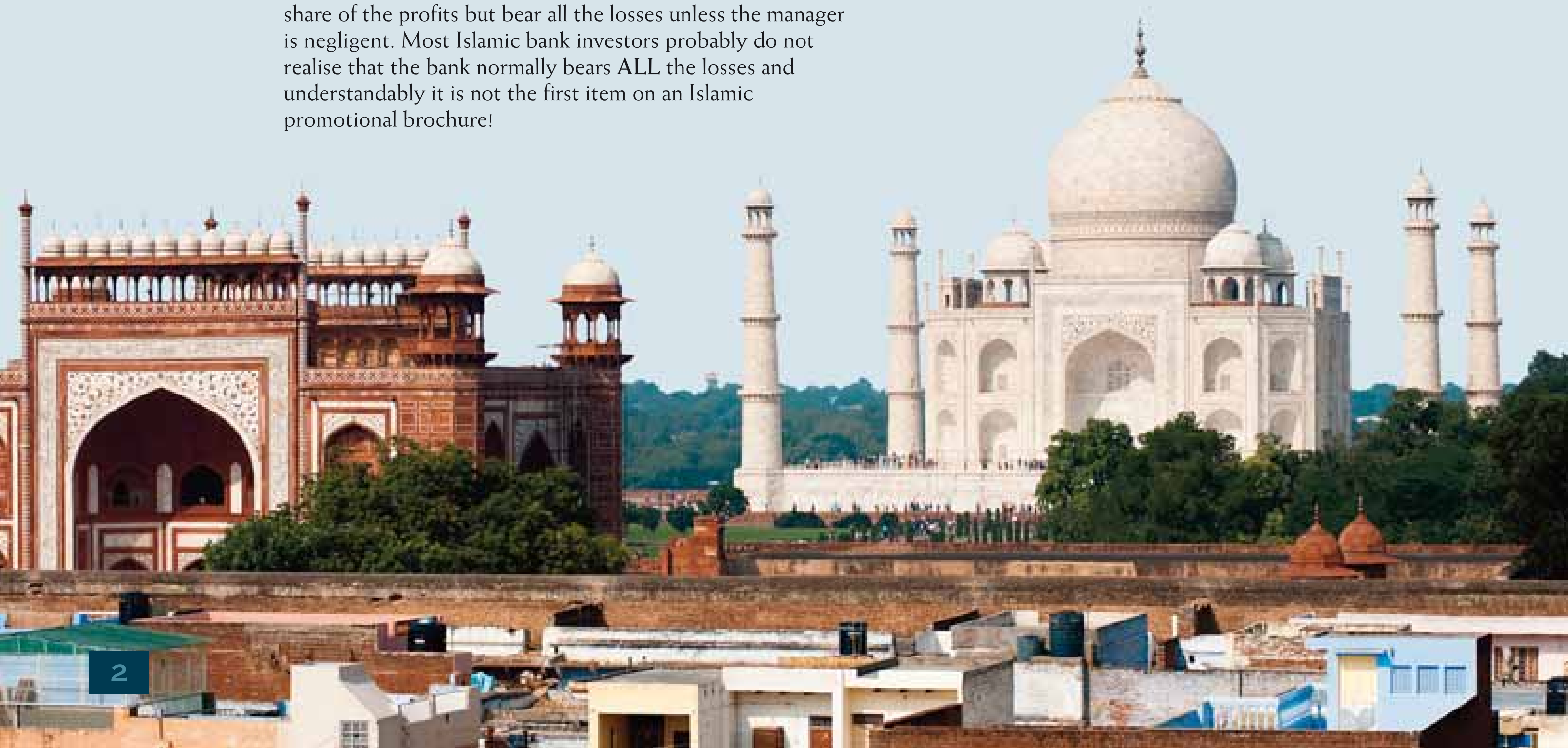
It might first be helpful to summarise the source of the Islamic Banks funds (their liabilities) which are all mainly short term and are usually a mixture of current accounts (*Amanah, Wakala and Wadia – Amana is rare despite being the name of HSBC's impressive Islamic operation*) and deposit or term account equivalents, mainly Mudaraba with some Musharaka.

A Mudaraba is an investment for profit where the investors entrust their money to a professional manager, in this case the Islamic Bank. Under a Mudaraba the investors take an agreed share of the profits but bear all the losses unless the manager is negligent. Most Islamic bank investors probably do not realise that the bank normally bears ALL the losses and understandably it is not the first item on an Islamic promotional brochure!

### Safety and Islamic Banks

However, before you withdraw your money you need to recognise that Islamic banks have proved to be far safer and far more conservative than conventional banks because their activities are restricted, allowing them to build up impressive reserves, including profit equalisation reserves. Equalisation reserves are available to make up any shortfalls in indicative profit returns on Mudaraba investments, which to the writer's knowledge, have never been negative or even nil. This is combined with the bank not taking high levels of risk and avoiding gearing.

In practice, it is almost inconceivable (but not impossible!) that an Islamic bank would make such huge losses that it had to pass these on entirely to investors in the form of negative returns and that it would actually do so. The reputational risk consequences are obvious and most commentators believe the regulatory bodies would step in long before this happened. Money invested in an Islamic bank in a stable country is probably as safe as an investment anywhere.



ISLAMIC FINANCE – CURRENT DEVELOPMENTS CONTINUED

**Restricted v Unrestricted Mudaraba**
The interesting features of Mudaraba vehicles is that they are short term, usually repayable quickly or on demand and are unique to Islamic banks. Customers are neither depositors nor shareholders and the regulation of the products has challenged some authorities. This is because they can be "restricted" investment account holders (RIAH), or "unrestricted" (UIAH). A RIAH defines the range of Sharia compliant investments that can be acquired. This investment

by the bank on behalf the investors can be separated easily from other Bank funds and usually has a clear and definable audit trail

On the other hand, UIAH allow the bank to invest the funds as it sees fit in ANY Sharia compliant scheme so the risk profile is usually much higher and is not clearly defined. Worse still from a regulatory viewpoint, client's money is co-mingled with the Bank's own money and auditing or identifying the funds in a separate "bucket" is usually not possible. This is prohibited in many jurisdictions including Saudi Arabia.

However at the risk of labouring the point ANY investment in an Islamic bank is probably safer than in a conventional counterpart because they do not engage in such risky activities and as an industry have not made significant losses.

**Current Islamic Developments**
Dubai still hits the headlines with worries about the timing of the property recovery although perhaps the bottom of the markets has still not been reached. The market probably will recover eventually as Dubai has established itself successfully as a "playground" and does indeed potentially have a long term future. When, is the real issue, plus who can survive the necessary wait!

On the regulatory front, there is some encouraging evidence of a coming together between the GCC, dominated by Saudi Arabia and the Far East, especially Malaysia with several recent high level meetings taking place. The almost universal adoption of the IFSB (a Malaysian initiative) by the leading Islamic players is a move towards the goal everyone wishes for but cannot yet see how to achieve. Namely a supreme Sharia "college" so the variations and contradictions in Fatwa rulings, even in the same country, can be either eliminated or better managed.

Insiders say the Fatwa contradictions make Islamic Banking "challenging & interesting". To an outsider at the very least, it looks unhelpful.

**Islamic Bank outlooks**
The Dubai Islamic Bank, the oldest Islamic Bank established in 1975 recently disclosed that 8.7% of its assets (loans) are non-performing. This is an exceptionally high figure but is less surprising given its 35% shareholder, the Emirate of Dubai itself, will have expected the Bank to pioneer many of the prestigious and flagship developments in the Emirate, especially during the recent boom.

What an outsider cannot tell is how many loans are either in the "delay and re-issue" category or are "Zombie" loans – already dead but the bank dares not crystallise them yet.

First Gulf Bank on the other hand, the Abu Dhabi based Islamic bank, which has significant links with the ruling Zayed family, continues to announce spectacularly impressive figures. First quarter returns for 2010 are up across the board and with only 2% of assets (loans) provisioned but not all considered lost.

**New Products**
To the astonishment of some, Dubai Islamic Bank (DIB), which has a reputation for being very strict in its Sharia Compliance where new products are concerned, has just launched a Salam product using salt to provide finance to personal individuals. Basically with some clever but Sharia compliant manoeuvring the client gets unencumbered money now in return for an agreed future liability using salt as the Shariah vehicle to accommodate this. More information is available on their web site.

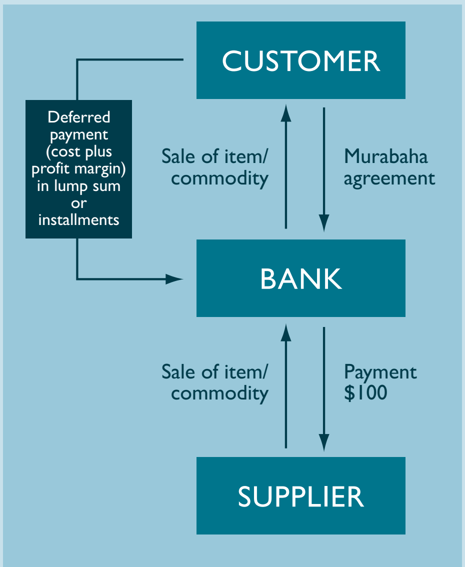
Two consequences flow from this. Firstly other banks are surprised that the DIB Sharia board has agreed the product is Sharia compliant. Secondly, that DIB is targeting high ticket personal lending, presumably to replace property and construction where its books must be all but closed in practice if not publicly. Personal finance to HNW borrowers is not especially risk free.

**Murabaha – The Islah Product Briefing**
Dealt with in the last article but in summary it is a cost plus contract with all elements disclosed, Shariah compliant, with no uncertainty etc. 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.

## ISLAMIC FINANCE – CURRENT DEVELOPMENTS CONTINUED

The attraction for Islamic Banks who provide Murabaha facilities is the returns are high, it is a relatively simple product to market and sell and the risk profile is low. The main drawback is rates are fixed at the outset and the average term is 5 years. This creates an immediate mismatch with funding sources (nearly all short term) and leaves the bank vulnerable to increases in the cost of funds (interest rates). A large portfolio of well spread and maturing Murabaha protects partially against interest rate fluctuations as new, higher return products replace maturing lower return deals, but not completely. In addition a Murabaha cannot be turned quickly into cash in a crisis.

To remind ourselves how a Murabaha works:




**A Murabaha Transaction**

### Tawarruq

Means to "monetise" and is also called "Commodity", "Reverse" or "Two Tier" Murabaha although each has a slightly different construction in different jurisdictions.

In most cases two separate Murabaha contracts are used to create cash and a loan liability.

In simple terms, imagine you bought a car on a Murabaha for $20,000 from a bank on one year terms. The bank would complete the deal by creating a "loan" or Murabaha liability of say $22,000, if the rate of the return (profit) required by the bank is 10%).

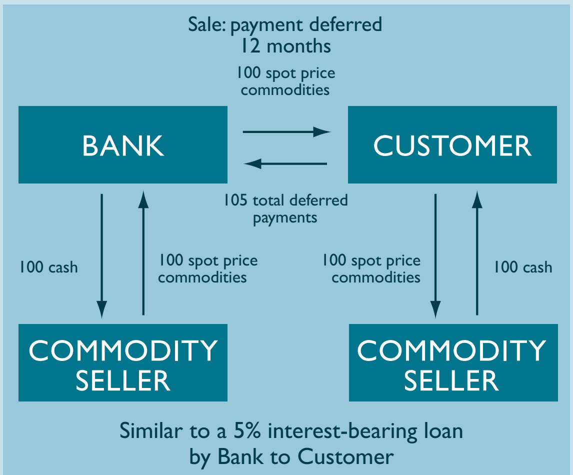
At this point you have the vehicle and a $22,000 loan. All very normal.

Imagine you simultaneously sold the car to another dealer for $20,000 or something very close as it is a still brand new and unused, using a Murabaha contract with payment on delivery.

You now have $20,000 cash and a 1 year liability of $22,000 (the loan amount). By using two separate Shariah compliant contracts you have created a cash loan.

When they were first introduced, these transactions met with strong resistance in some quarters with scholars condemning them. The grounds are it is Riba, no real trade taking place, no intention to take delivery or ownership of the goods and nothing beneficial to the community has occurred. The objections were even stronger if the buyer and seller of the goods was the same party – especially if it was the Islamic Bank.

This is how it works:




**Tawarruq example**

This form of funding has become a vital component of short term investment operations by Islamic Banks using permitted commodities (Gold and Silver forbidden as they were once "money"), to invest or acquire funds in a similar fashion to conventional inter-bank markets.

Sharia objections are beginning to fall away as the practice becomes established and many scholars approve them on the basis that some trading benefit accrues and as long as there are two separate parties on the buy and sell side. However, not all banks agree.

### Next Article

In the next article, as well as debating topical Islamic issues, we will consider Ijara and the ways banks avoid being locked in to long term fixed rentals by using a two contract system.

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