Konferenz

Islamic Finance: Perspectives from Financial Theory and Issues of Banking Regulation

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Islamic Banking and Finance at the Crossroads

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- Banking and Financial systems based on Islamic tenets exist primarily to **provide religiously acceptable services** to the Muslim community (the *umma*) through the establishment and the operations of financial institutions and organizational structures, dedicated to that purpose.

- In examining the efficacy of Islamic banking and financial markets, **two questions** should be kept in mind:
  - How well do the Islamic financial services meet the religious aims and the expectations of the Islamic community?
  - By what means and how effectively are those ends attained?

Presentation Out Line

- This presentation would explore such questions, recent issues, innovations and other developments in Islamic Finance.

- Following is the outline:
  - **Section I: Objectives of Islamic Finance**
  - **Section II: In Whose Interest?**
  - **Section III: PLS Financing Modes**
  - **Section IV: Operational Issues**
  - **Section V: Islamic Mutual Funds**
  - **Section VI: Islamic Finance: A System at the Crossroads**
  - **Section VII: Product Development and Shariah Issues in Islamic Finance**

I. The objectives of Islamic finance ..

- Islamic Finance differs from the Conventional Finance on **two major** issues:
  - **First** and foremost: an Islamic organisation must serve Allah and adopt an ethos that differentiates it from non-Islamic bodies.
  - **Second**: following on from this obligation, the bank must design and provide acceptable financial instruments and products.

- Before discussing the difference between frameworks of the Islamic and Conventional Finance, we would review some **underlying concepts** and **principles** based on which Islamic Finance and Economics is established:

I. The objectives of Islamic finance ..

a. Difference on Concept of Wealth:

- The Islamic concept of ***Amana***, or trust, signifies 'that wealth belongs to God and man is, individually and collectively, custodian of wealth' (Ali, 1999, P. 13).
- And wealth can only be employed for defined ends.
- The purpose is to create a **collective morality** and **spirituality** which, when combined with the production of goods and services, sustains the growth and advancement of the Islamic way of life.

I. The objectives of Islamic finance ..

b. Obligations of Banker & Customer:

- In Islamic Banking on both banks and customers have obligations:

'Islamic banks have a major responsibility to shoulder ... all the staff of such banks and customers dealing with them must be reformed Islamically and act within the framework of an Islamic formula, so that any person approaching an Islamic bank should be given the impression that he is entering a sacred place to perform a religious ritual, that is the use and employment of capital for what is acceptable and satisfactory to God, the Almighty'

(Janahi, 1995, p.42).

I. The objectives of Islamic finance ..

c. Obligations to Islamic Community (Umma):

- Further, these obligations extend also to the Islamic community (the ***Umma***):

> *'Muslims who truly believe in their religion have a duty to prove, through their efforts in backing and supporting Islamic banks and financial institutions, that the Islamic economic system is an integral part of Islam and is indeed suited for all times … through making legitimate and Halal profits'*
>
> *(Janahi, 1995,* p. 29).

I. The objectives of Islamic finance ..

c. Concept of Trust and Concept of Umma ….

- The Islamic concept of ***Umma*** or solidarity amongst Muslims is in turn linked to concept of ***Amana*** or trust: *that **wealth** is to be acquired, used and distributed within the framework of shari'a.*

- **No person has an absolute right to use his wealth** as he wishes but can only use it for those purposes which are consistent with Islamic values.

- The same concept of ***Amana*** also means that **Islamic banks** act as **trustees for those investors** whose funds they manage.

I. The objectives of Islamic finance ..

c. Concept of Trust and Concept of Umma ….

- In particular, when **mobilizing** deposits and making investments, the Islamic financial institution differs from a conventional bank.

- The reason is that Islamic institution has to **obey a different set of rules of Islamic *shari'a*** – and at the same time fulfil the expectations of the Muslim community by providing partnership financing through **profit-and-loss-sharing (PLS)** arrangements or **other acceptable modes** of financing.

I. The objectives of Islamic finance ..

d. Four Basic Principles of Islamic Finance:

- Based on Islamic law, **FOUR main principles** shape the activities of the Islamic bank:
- **First:** Muslims are ***banned from taking or giving interest*** (the Arabic term for which is *riba*) and otherwise benefiting from profits derived from fixed, predetermined interest payments.
- Profit earned from trade in goods and services is acceptable, but not that obtained from the exchange of money for money.

I. The objectives of Islamic finance ..

d. Four Basic Principles of Islamic Finance ….

- **Second:** for this reason, ***financial transactions need to be based on real economic activity***, not monetary exchanges.

- **Third:** Islamic financial institution (or for that matter no Muslim) ***cannot engage in financing anti-social*** activities such as alcohol, pork, armaments, and gambling that are illegal (*haram*) to an adherent to the faith.

- **Fourth:** Because of the ***prohibition on gambling***, financial products and economic transactions that carry a high level of risk or uncertainty (*gharar*, literally 'hazard') are not permitted.

I. The objectives of Islamic finance ..

e. Variations of Financial Products in Islamic Finance:

- Interest-free banking in its purest form is based on the concepts of ***shirkah*** (partnership) or ***musharaka***, and ***mudaraba*** (profit-sharing).
- An **Islamic Bank** is conceived as a **financial intermediary** mobilising savings from the public on a *mudaraba* (trustee) basis and advancing capital to entrepreneurs on a PLS partnership basis.
- A **two-tiered profit-and-loss-sharing** arrangement ideally operates.

I. The objectives of Islamic finance ..

f. Financial Products in Practice:

- However, in practice, **Islamic banks deviate** from ***the two-tiered PLS system.***

- **On the deposit side,** most funds (at least in value terms) are raised on the basis of a ***mudaraba*** **PLS contract**, although there are also deposits made on **an interest-free loans (*qard hasan*) basis** or a ***wadia*** **(safe-keeping) basis**, on which the bank may make *ex gratia* payments.

I. The objectives of Islamic finance ..

- **On the asset side,** however, ***PLS instruments*** are in reality rarely employed.
- Instead, **a variety of debt or quasi-debt financing modes** are used, designed to be based around trading activities, involving a pre-agreed profit-sharing formula.
- In order to provide security and protect itself from the risk of default, **The Bank:**
  - **enters into a purchase** and **resale contract** (***murabaha***), in which the asset is purchased by the bank from a supplier at the request of its customer and
  - then **re-sold to the customer** on a cost plus profit mark-up basis, with the bank repaid on a deferred basis or in instalments.

I. The objectives of Islamic finance ..

g. Over Dependence on Fixed Mark-up Instrument

- On over dependence on Fixed Mark-up instruments, **Hamoudi (2006)**, speaks of ***'the failures of Islamic finance'*** which have led to the creation of:

  'a bizarre and highly artificial construct that does nothing to address the social concerns that are the central reason for the creation of Islamic banking and finance' (p.8).

- The **three** articles which follow this introduction would focus on these **two issues**:
  - the **Role** of **PLS** contracts in Islamic banking and
  - the **Broader Socio-Economic** objectives of the system

II. In Whose Interest?

- The obvious ***raison d'être*** of an Islamic banking and financial system is to allow the Muslim communities to undertake financial services in ***Islamically acceptable ways***.

- **In addition** to this special function, the banking and financial institutions, like all other aspects of the Islamic society, are expected to ***'contribute richly to the achievement of the major socio-economic goals of Islam'***

(Chapra, 1985, p. 34)

II. In Whose Interest?

- The most important of these goals are:
  - economic well-being with **full employment** and **a high rate of economic growth**
  - **socio-economic justice** and **an equitable distribution** of income and wealth
  - **stability in the value of money** (in terms of inflation and foreign exchange) and
  - the **mobilisation** and **investment of savings for economic** development in such a way that a **just** (profit-sharing) return is ensured to all parties involved.

II. In Whose Interest?

- The validity of these general objectives is seldom questioned.
- However, there is **no consensus** about the appropriate structure of the overall financial system needed to achieve them.
- This omission is addressed by **Asyraf Wajdi Dusuki (2007)** in his article ***'The Ideal of Islamic Banking. A Survey of Stakeholders' Perceptions.'***

II. In Whose Interest?

Asyraf Wajdi Dusuki Study:

- **Dusuki** takes as his starting point the **two conceptions** of an ideal Islamic financial system identified by Lewis and Algaoud (2001).
  - **One vision** is the framework proposed by Chapra (1985) and Siddiqi (1983).
  - **Other vision** is that of Ismail (1986).
- They **differ in terms of the behaviour** that is expected from the **constituent institutions**.

II. In Whose Interest?

a. The Chapra Vision:

- **Chapra** suggests a system comprising the following institutions:

  central bank; commercial banks; non-bank financial institutions; specialised credit institutions; deposit insurance corporation(s); and investment audit corporations.

- Although the framework may look similar to conventional financial system, Chapra envisages that there are **differences** in the ***functions, scope and responsibilities of the institutions concerned.***

- ***Role of each institutions is crucial*** to achieve desired objectives of abolishing interest, ensuring equitable distribution of income and wealth, and promoting economic development.

II. In Whose Interest?

- **Role of Islamic Banks:** Islamic commercial banks would differ from conventional banks in **two** main ways:
  - The **First** and most **significant difference** would be the abolition of *riba*.
  - A **Second** principal difference would be that funds, which come from the public, should be used to serve the common interest and not individual gain.

- To attain these twin goals, **Islamic Banks** would thereby tend to become **universal** or **multi-purpose banks** instead of purely commercial banks: *a 'cross-breed of commercial and investment banks, investment trusts and investment-management institutions...'*

(Chapra, 1985, p. 154).

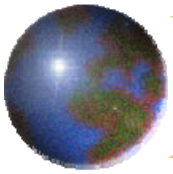
II. In Whose Interest?

- **Role of Special Credit Institutions:**

  The **Specialised Credit Institutions** would finance those projects and sectors of the economy that might not be attractive to commercial banks or other profit-motivated institutions; like: credit to farmers, artisans, and other small businesses and entrepreneurs.

- **Role of Deposit Insurance Fund and Investment Audit Corporation:**

  These would be **government-sponsored organisations** set up respectively to insure demand deposits in commercial banks and to safeguard the interests of profit-sharing investors and equity holders.



II. In Whose Interest?

- **Role of Investment Audit Corporation:** There is no equivalent to the **investment audit corporation** in Western banking because of the importance of the PLS principle in Islamic finance.

- Since Islamic finance projects and financial modes are unique, ***a different auditing process beyond conventional one*** would be required to ensure welfare and equitable division of the returns between shareholders and profit-sharing depositors.

- The main characteristic of Chapra's framework is the ***dispersal*** *of* ***social welfare responsibilities*** *and* ***religious requirements*** to all levels of the financial system.

II. In Whose Interest?

02. Abdul Halim Ismail (1986) Vision:

- Abdul Halim Ismail (1986) proposed an alternative setting for Islamic banking **based on** a more thorough **division of responsibilities.**

- He sketches an ***Islamic Economic System*** which consists of **three** sectors, namely:
  - ***Siasi:*** the government sector, which encompasses public finance and central banking;
  - ***Ijtimai:*** the welfare sector, with responsibility for the administration of taxes, and
  - ***Tijari:*** the commercial sector, which covers all private sector commercial activities.

II. In Whose Interest?

- Like ***Islamic Economic System***, the ***Islamic Financial System*** constitutes institutions from all of the three sectors.
  - Within this framework, the Islamic commercial banks belong to the ***tijar*i or the commercial sector**, and their responsibilities are limited to commercial activities.
  - The task of ensuring an equitable income distribution concerns the ***siasi*** as a task of **public finance**, not a task of the Islamic Bank
  - Collection and distribution of taxes is not a commercial bank task but rather the responsibility of different ***ijtimai*** or **Welfare Institutions**.

II. In Whose Interest?

Comparison between Chapra and Ismail Vision:

- According to **Chapra**, each of the institutions in an Islamic economic system must explicitly take responsibility for the fulfilment of the general economic and social objectives, sometimes at the cost of individual profitability.
- In **Ismail's** framework, by contrast, Islamic banks would act as commercial institutions, with responsibilities essentially to shareholders and depositors.
- And society is served by them pursuing their self-interest (***in effect Adam Smith's invisible hand***), augmenting profit and income, along with *zakat* distributions.

III. PLS Financing Modes

- Islamic financial institutions are providing financial services in Europe, United States, Australia and in UK, although the **major concentration** is in the Middle East and South and Southeast Asia (with Bahrain and Malaysia being the largest centres).

- Prohibition of Interest and Profit - Loss Sharing (**PLS**) Financing Modes are the core essences of Islamic Finance.

- **Abdul Khair Jalaluddin (2007)** in his article *"Motivations of Western Small Business Firms for Applying Profit/Loss Sharing Methods of Finance,"* surveys the attitudes of **385 small business enterprises** in Sydney, Australia to PLS methods of finance.

III. PLS Financing Modes

- **Jalaluddin** found that a large number preferred **PLS** finance to conventional finance for **two basic** reasons:
  - Risk-sharing with banks and
  - Reduction in the chances of bankruptcy due to business support in hard times

- Ironically, if these small business enterprises had actually obtained finance from an Islamic bank *(like: the Muslim Community Cooperative Australia and Balance Finance, these two are already operating in Australia)* they would find, that they face **financial conditions not dissimilar** to those on conventional loans in many operational aspects.

III. PLS Financing Modes

- In the main article in the issue on Islamic banking in the *Monash Business Review* for April 2007, **Ariff (2007)** accepts that Islamic banking is a variation of this [conventional banking] and that 'Islamic banking at this early stage' (p.9).

- The reference in this quotation to **'at this early stage'** could be considered as in its formative years, since the 30 years of Islamic banking would not equate with the hundreds of years of conventional banking.

III. PLS Financing Modes

Convergence of Islamic Banking and Conventional Banking:

- Because of innovations and operational similarities, it would seem that the two systems are coming closer together rather than drawing further apart.
- Here are such **three examples**
  - First : Transition from **Murabaha** to **Financial Murabaha**
  - Second : Use of **Tawarruq**
  - Third : Evolution of **Sukuk**

III. PLS Financing Modes

First: Transition from **Murabaha** to **Financial Murabaha**

- ***Murabaha*** simply means mark-up sale.
- Under Murabaha, the **seller** and the **buyer** do not negotiate the price, but **rather agree on a certain profit margin** added to the cost, as declared by the seller.
- In traditional way, **Murabaha** was never conceived of as a mode of finance, since it was not necessarily concluded on the basis of deferred payment, and **sale for cash** was the rule rather than the exception.

III. PLS Financing Modes

- In transforming traditional murabaha to ***credit murabaha***, or ***murabaha with deferred price***, the sale contract would be **preceded by the customer's promise** to buy the desired goods, once the financier acquires them.

- So the transformed financial *murabaha* is differentiated from the original *murabaha* sale in **two** respects:
  - **credit is an indispensable feature of the transaction**, and not just a mere possibility; and
  - **the existence of a prior promise to buy** is a precondition for the extension of credit

III. PLS Financing Modes

Response from Sharia'h Experts:

- The consequence, in the opinion of Professor **Khurshid Ahmad (1994, pp. 46-7)** is that:

'… the current practice of 'buy-back on mark-up' is not in keeping with the conditions on which murabaha or bai'mu'ajjal are permitted.

What is being done is a fictitious deal which ensures a predetermined profit to the bank without actually dealing in goods or sharing any real risk. This is against the letter and spirit of Sharia injunctions..

…as a student of economics and *Sharia* I regard this practice of 'buy-back on mark-up' is very similar *to riba* …'

III. PLS Financing Modes

- Similarly **Dr Hasanuz Zaman (1994)** writes:

"…in order to make themselves eligible to a return on their operations, the banks are compelled to ***play tricks with the letters of the law*.**

They actually do not buy, do not possess, do not actually sell and deliver the goods; but the transition is assumed to have taken place.

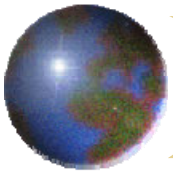
By signing a number of documents of purchase, sale and transfer they might fulfil a legal requirement but ***it is by violating the spirit of prohibition***"

(Hasanuz Zaman, 1994, p. 208).

III. PLS Financing Modes

SECOND: Use of **Tawarruq**

- ***Mahmoud A. El-Gamal (2007)*** points out that some Islamic banks have developed **Tawarruq** model that is very similar to conventional banks.
- **Tawarruq** is opposite to Murabaha and treated as source of financing.
- Under the *tawarruq* mechanism ***(the process of monetization of a commodity)***, a bank purchases and then sells its customer a commodity at a marked-up price over spot to be paid over a specified time period.
- The customer then **resells** the commodity for **cash** at the **current market spot price.**



III. PLS Financing Modes

- Interest as such is not levied, while the bank's profit comes from the difference between the **purchase** price and the **higher-price agreed** upon by its customer.

- All **three** trade transactions ***(cash sale to the bank, credit sale to the customer,*** *and* ***cash sale back to the commodity dealer)*** which justify its Islamicity can be handled by the bank, virtually instantaneously, acting as agent for both dealer and customer.

- However, the upshot is that the customer has obtained cash, in this roundabout way, in the form of an **unsecured loan**.

III. PLS Financing Modes

- **El-Gamal** sees this practice as an example of what he calls ***'shari'a arbitrage'***, when conventional lending practices are replicated in Islamically-acceptable ways in the balance sheets of Islamic financial institutions.

- To him, the Islamic finance industry is becoming dominated by **forms** or **innovations** rather than by **substance**.

- And the **major aim** is to circumvent Sharia'h principle, rather comply with the Qur'anic injunctions against ***riba*** (interest) and ***gharar*** (excessive uncertainty).

III. PLS Financing Modes

THIRD: Evolution of **Sukuk**

- Another example of transformation is the development of Islamic bonds, or ***sukuk***. Here we consider, an example of a ***sukuk al-ijara*****.**
- The originator holds assets (land, buildings, aircraft, ships, etc) that are to generate the returns to the ***sukuk*** investor.
- These assets are sold by the originator to a **Special Purpose Entity (SPE)** and then are leased back at a specified rental
- The **SPE** securitizes the assets by issuing ***sukuk*** certificates that can then be purchased by investors.

III. PLS Financing Modes

- Each ***Sukuk*** certificate represents a share in the ownership of the assets, entitling the investor to periodic distributions from the SPE funded by the originator's rental payments on the leased assets.
- The returns can be either ***fixed rate*** or ***floating rate.***
- Since the yield is predetermined and the underlying assets are tangible and secured, the certificate can be traded, enabling a secondary market to develop

  (Mirakhor and Zaidi, 2007; Obaidullah, 2007).
- **Islamic Banks** can thus **deal in, hold, buy** and **sell** these bonds.

III. PLS Financing Modes

- Now as we presented, it is evident that **with transformation** features of Islamic and Conventional products are becoming similar with some major difference.
- However some scholars hold different of opinions.
- **Mohammad Farooq (2007)** in his article ***'Partnership, Equity-financing and Islamic finance: Whither Profit-Loss-Sharing'*,** raised arguments about the impracticability of traditional PLS Financing.
- However some other scholars often **criticize** Islamic Banks for their reliance on the **cost-plus**, **fixed rate** of return instruments such as ***murabaha*** and ***ijara***.

III. PLS Financing Modes

- On resolving such disputes and contradiction different possibilities can be suggested:
  - **FIRST**: As **Hassan and Lewis (2007)** suggest , one possibility is to encourage a **four-way dialogue** between the *fiqh* academies, Islamic bankers, IFI *shari'a* scholars, and the general public.
  - **SECOND:** Neinhaus (2007) puts the blame for what is tantamount to *hiyal* on the nexus between Islamic bankers and the *shari'a* advisory boards.
  - He also recommends the establishment of independent, national *shari'a* boards less amenable to catering to the bankers' financial interests.

III. PLS Financing Modes

- **THIRD:** El-Gamal (2007) sees the share-ownership structure of Islamic banks as a culprit, and recommends mutuality as an antidote to what he calls 'rent-seeking *shari'ah* arbitrage in Islamic finance' – *(Walter, 2006).*

- That means, to resolve contradictions and confusions, Islamic banks should return to Chapra's (1985) original vision.
- Islamic banks should become more like: **merchant/investment** banks, **German universal banks** or **French *banques d'affaires*** and take equity stakes as a matter of course in complex financially-engineered capital market arrangements.

III. PLS Financing Modes

- However even such broad based debate may not resolve disputes on core values of Islamic finance as represented by **Farooq** or modernist or revisionist views of **Fazlur Rahman (1964 [2007]).**

- According to **Rahman**, the Prophetic *sunna* was never meant to remain static, but to evolve and develop.

- **Rahman's observes** while the spirit behind the prohibition of interest clearly does date back to the Holy Qur'an and the message of the Prophet, the particular definition given to *riba* as formalized by early generations of Muslims, need no longer be applied.

(Brown, 1996).

III. PLS Financing Modes

Debates on Usury in Christian Church

- **Broadly similar debates** took place in the Christian Church in the sixteenth century, beginning with **John Calvin's** denial (in a series of letters beginning in 1547) that the ***"taking of payment for the use of money was in itself sinful."***

- **Calvin** argued that:

  - Neither the **Old** nor the **New Testament** rulings on this (and other issues) were universally applicable and binding for all time.

  - Rather these rulings should be interpreted in the light of individual conscience, the equity of the **'golden rule'** and the needs of society.

III. PLS Financing Modes

- *The Consensus was:*
  - ***Usury*** *does not conflict with* ***the law of God*** *in all cases and,* provided that the interest rate is reasonable.
  - *And lending at interest is no more unjust than any other economic transaction.*
- For example: it is as reasonable as the payment of a rent charge or leasing rate on land or other assets.

As a consequence of the power of these ideas, usury was redefined as excessive interest, and 'usury laws' specifying a legal maximum rate of interest were enacted in Protestant Europe.

(Lewis, 2007)

III. PLS Financing Modes

Ways to Resolve the Disputes in Islam

- To Western eyes, it might seem that Islam is in the process of making a similar transition.
- However, the situation in Islam is very different. In Islam there are **four sources** of law making:
  - **FIRST** the Holy Qur'an (immutable and not subject to change),
  - **NEXT** in importance the *hadith* (probabilistic knowledge, subject to conformity with the Holy Qur'an and history of narration)
  - Then there are the **SECONDARY** sources, *ijma* (consensus) and
  - ***Qiyas*** (analogical reasoning), both more speculative.

III. PLS Financing Modes

- That ***the Holy Qur'an,*** the most important source, prohibits *riba* in clear and unequivocal terms cannot be disputed. The prohibition therefore must be upheld.
- However to accommodate with the reality and operational need, Islamic banks can **diversify their products or instruments portfolio** rather than focusing on PLS partnership financing alone.
- Such **innovations**, keeping the core essence of Islamic ruling intact, may be permissible.

IV. Operational Issues …

- Since initiation in 1975, Islamic Banking has spread world wide.
- After International Association of Islamic Banks has ceased publishing statistics on the number of Islamic banks, no accurate data on the same is available.
  - Benaissa, Parekh and Wiegard (2005) in the *McKinsey Quarterly* estimate there to be **270 Islamic banks**
  - El Qorchi (2005) in the IMF's *Finance and Development* puts the figure at '**over 300**'
  - Ariff (2007) in the *Monash Business Review* suggests **'about 400'** Islamic banks.

IV. Operational Issues …

- Most of the Islamic banks have been founded as **'pure-play'** Islamic institutions following the example of the Dubai bank

- However, some existing commercial banks have also **transformed** themselves, fully or partially, into Islamic banks. This **transformation** has followed the **Islamization** of the financial systems of **Iran**, **Sudan**, **Pakistan** and **Malaysia**

- Islamic financial services market now includes:
  - many conventional banks offering
  - commodity-based and other Sharia compliant investment vehicle
  - Functions as intermediaries between commodity brokers and 'pure-play' Islamic institutions.

IV. Operational Issues …

- Some banks that offer a combination of Islamic banking in '**windows**' or '**counters**' along with conventional banking operations. Such banks are described as "**hybrids**".
- Besides, some other banks have opened **special branches** that sell only Islamic banking products.
- In locations where operations of 'hybrids' are restricted, conventional banks have established **separate Islamic financial institutions** with distinctive legal identity and management.
- One such example is: HSBC has created a separate brand, **Amanah**, for its Islamic activities.

IV. Operational Issues …

- In these different ways, new banks or subsidiaries or offshoots of **conventional banks** are appearing rapidly and widening market presence in Islamic Financial Market.
- **As a result:** Islamic financial institutions are facing a '**dual**' assault from the conventional banks
  - which can not only provide tried and tested conventional banking facilities to their customers
  - but can combine the Islamic products with their existing service and reach to more customers
- According to **Farooq's** assessment:

  because of the essential similarity between many Islamic and conventional financial products, the Western conventional banks are able to adapt their products readily to this niche market and grab a sizable market share as a result.

IV. Operational Issues …

- Under this increasing level of competition, competitiveness of the **Islamic banks** *vis-à-vis* the **conventional banks** has become a crucial issue.

- **Bader, Mohamad, Ariff and Hassan (2007)** in their article examined this competitiveness issue. Besides this study, **Hassan (2006)** and **Brown, Hassan and Skully (2007)** investigated relative operating efficiency of Islamic and conventional banks.

- Bader, Mohamed, Arriff, and Hassan study compares **43** Islamic and **37 conventional banks** in **21** countries over the years **1990 to 2005.**

IV. Operational Issues …

- They come up with **results that may surprise many readers.** The study finds that:
  - Conventional banks are **not more efficient** than Islamic banks, nor are large banks uniformly more efficient than small banks.
  - In terms of **cost**, there are differences between old and new banks.
  - But in terms of **efficiency**, there is no difference among banks in the different regional groupings, including both conventional and Islamic banks.

IV. Operational Issues …

- However, Mohamed, Arriff, and Hassan study finds that **Islamic banks are more efficient** in overall profitability with conventional banks.

- This finding is also in line with Brown, Hassan and Skully (2007) analysis, although the later study spans during a shorter period and covers less countries.

V. Islamic Mutual Funds …

- **Over the recent years**, technological innovations have revolutionised stock market investment as:
  - capital markets operations have moved to on-line trading, and
  - restrictions on global movements of capital have eased globally.

- Similarly, the **demand** for **Islamically-acceptable stock** market investment has grown strongly because of current economic upswing and expansion of oil wealth.

- Between **2002** and **2005**, net oil exports of the fuel-exporting countries rose by **US$437 billion**.

V. Islamic Mutual Funds …

- Among major oil producers, three largest non-US oil producers: Saudi Arabia, Russia and Iran, produce around **a quarter of the world's oil**.
- Other large holders are, in descending order, Iraq, Kuwait, United Arab Emirates, Venezuela, Kazakhstan, Libya and Nigeria.
- Since, Islamic countries contribute to the largest portion of oil productions, with increase of oil price, oil revenues of Islamic countries also increased.

V. Islamic Mutual Funds …

- On investments of Petro-Dollar of Islamic Countries **Iley and Lewis (2007)** observes that:

  In the 1970s, the oil exporting countries held their petrodollars in short-term, liquid deposits with international banks. Now the oil revenues are being invested in long-term bonds and other more risky assets, such as hedge funds and a variety of capital market investments

- This **excess** of **Investable Fund** created demand for innovations in Islamic financial markets.

- As a result: Issues of ***sukuks*** (Islamic bonds) and other ***shari'a*-acceptable** capital market instruments based on real investments (construction, aircraft leasing) flourished.

V. Islamic Mutual Funds …

- However, much of the demand for Islamic stock market investments has been met by the major **Western stock markets**, due to their size and liquidity.

  These investments in non-Islamic companies have been reconciled with Islamic investment precepts by means of 'screening' and 'purification' procedures (Hassan, 2001).

- **Screening** and **purification** procedure engages the following principle:

  - The process engages **removing the companies** that engage in supply, manufacture or service of things prohibited by Islam (*haram*), such as *riba*, pork meat, alcohol, gambling, etc.

V. Islamic Mutual Funds …

- After removing companies with unacceptable core business activities, **the remaining list** is tested by a financial-ratio 'filter' with objective to remove companies with an unacceptable debt ratio.

- **Common benchmarks** are:
  - **Debt/Asset Ratio** must be less than one-third
  - **Accounts Receivable/Total Assets** must be less than one-half
  - **Interest Income/Operating Income** must be less than 10%.

- **A dividend Cleansing/Impure Income** figure is then calculated. If say, 5% of the whole income of a company has come out of interest-bearing returns, 5% of the dividend must be given in charity.

VI. Islamic Finance: A System at the Crossroads

- Islamic finance seems to be at the crossroads.
- This suggestion may seem a strange one when we consider that in the space of thirty years, the industry has become both robust and profitable.
- **Lewis and Algaoud (2001)** points out that by 2001, 270 Islamic banks are holding assets of around $265 billion, compared to 176 banks with assets of $148 billion in 1997.
- Market sources indicate that Islamic financial institutions are growing much faster than conventional banks *(Benaissa, Parekh and Wiegand, 2005).*

VI. Islamic Finance: A System at the Crossroads

- Moreover, in spite of innovations of Islamic Bonds and other products in line with Shari'a, a large portion of **Islamic Petro-Dollar remains untapped.**

- To make the best use of market potentials of Islamic financial market, apart from the **'pure-play' Islamic Institutions**, a diversified range of commercial banks have started providing Islamic financial products along with conventional ones.

VI. Islamic Finance: A System at the Crossroads

- At the retail level, an expanding array of conventional banks compete head on with the purely Islamic banks by providing Islamic financial services in a variety of ways.
- Some are best described as '**hybrids**', offering Islamic '**windows**' or '**counters**' hand-in-hand with conventional banking operations.
- In locations that restrict the operations of 'hybrids', conventional banks have established separate Islamic financial institutions with distinctive legal identity and management, such as **Amanah** (**HSBC**) and **Noriba** (**UBS**).

VI. Islamic Finance: A System at the Crossroads

- In changing business paradigm, **two key challenges** of Islamic banking can be identified as:
  - Threat from conventional banks entering the Islamic financial market and encroaching the exclusive domain of dedicated 'pure-play' Islamic financial institutions
  - Increasing similarity of Islamic and Conventional products and services that makes them less differentiated
- To explore these challenges; two questions are asked in this presentation:
- **First Question:**

  Whether the Islamic institutions can survive this 'dual' assault from the conventional banks?

VI. Islamic Finance: A System at the Crossroads

- Since, conventional banks provide **a well-diversified** financial service and product line to cater different needs of clients, most common perception is that Islamic institutions must match in financial innovation.

- This desire has led to development of Islamic financial instruments, **replicating the characteristics** of conventional products within the purview of acceptability in terms of *shari'a* oversight.

- For example:
  - the adaptation of conventional hire purchase and leasing contracts to *ijara* (Islamic leasing) structures, and
  - the development of *sukuks* by modifying and utilizing techniques developed in conventional structured finance arrangements

VI. Islamic Finance: A System at the Crossroads

- **Second Question** stems from this search for innovation:

  If Islamic banking merely modifies conventional financing in such a way as to satisfy the shari'a scholars, what is there that remains distinctive about the Islamic system?

- The obvious risk is: If the adaptive devices were to dominate the system and come to be regarded as tantamount to legal fictions (*hiyal*), Islamic banking would look like **an issue of mere branding**, like Mecca Cola instead of Coca Cola.

- Then there is the issue of the **social charter** that inspired many who help found the system.

VI. Islamic Finance: A System at the Crossroads

- Although the term 'halal banking' is often used as a description for Islamic banking operations, distinctiveness of the Islamic banking system needs to be viewed against the wider agenda of: ***social welfare, equitable development and poverty alleviation.***

- This broad **social ethos** is a differentiating factor in the market that runs alongside strict legal compliance with Islamic jurisprudence.

VI. Islamic Finance: A System at the Crossroads

- **M. Umer Chapra (2007)** in his article "The Case Against Interest: Is it Compelling?" argues that there is still an important distinction between the Islamic financial system and the interest-based conventional banking system, because the former is not based on interest.
- This distinction is clearest in the case of the equity-based, profit-and-loss sharing (**PLS**) financing modes, such as *mudaraba* and *musharaka*.
- Dr **Chapra** advocates that Islamic banks ought to do more of such equity participation.
- He also accepts **sale-based** financing as obvious since not all financing requirements are amendable to PLS methods.

VI. Islamic Finance: A System at the Crossroads

- **Sales-based financing modes** (*murabaha, ijara, bai' salam* and *istisnaa)* are less risky than PLS financing because the rate of return is fixed in advance and built into the deferred payment price on a cost plus (or 'mark-up') basis.

- **Charging mark-up may seem just another term for interest as** charged by conventional banks where interest is admitted through the back door as commodity financing.

- **But there are some major differences**: Let us consider a case of *Murabaha*

VI. Islamic Finance: A System at the Crossroads

- Under ***murabaha*** an Islamic bank finances purchase of a good or asset:
  - *by buying the item on behalf of its client, and then*
  - *adding a mark-up before reselling the item to the client on a cost plus basis profit contract.*

- What makes the traditional *murabaha* transaction **Islamically** legitimate is that:
  - *the bank first acquires the asset for resale at profit, so that a commodity is sold for money and*
  - *the operation is not a mere exchange of money for money (or Riba)*

VI. Islamic Finance: A System at the Crossroads

- In the process the **bank assumes certain risks** between purchase and resale; for example: a sudden fall in price could see the client refusing to accept the goods or there may be a delay in payment due to unexpected circumstances.

- That is, the **bank takes responsibility for the good** before it is safely delivered to the client.

- The **services rendered by the Islamic bank are therefore regarded as quite different** from those of a conventional bank which simply lends money to the client to buy the good.

VI. Islamic Finance: A System at the Crossroads

- **CHAPRA** considers that these differences are important in two respects:
  - **FIRST**, because the seller of goods (the financier) must own and possess the goods being sold, speculative short-selling is ruled out, helping to curb the type of excessive speculation.
  - **SECOND**, the sales-based financing methods do not involve direct lending and borrowing but comprise purchase or lease transactions based on real goods and services.
- Thereby **financing in the Islamic system** tends to expand pari passu with the growth of the real economy and **constraining excessive credit creation.**

VI. Islamic Finance: A System at the Crossroads

- **Mahmoud A. El-Gamal** in his article ***"Mutuality as an Antidote to Rent-Seeking Shari'a-Arbitrage in Islamic Finance,"*** is much less enamoured than is Chapra of present trends in Islamic banking.

- He observes:
  - Islamic finance industry has degenerated into one that is dominated by form not substance.
  - The chief aim is to circumvent, rather than comply in any meaningful way, with the Qur'anic injunctions against *riba* (interest) and *gharar* (excessive uncertainty).

- This aim is realized when conventional lending practices are replicated in Islamically-acceptable ways in the balance sheets of Islamic financial institutions – a process that he calls **'*shari'a*-arbitrage'.**

VI. Islamic Finance: A System at the Crossroads

- He provides the example of *Tawarruq* (the process of monetization of a commodity)
- Under the *tawarruq* mechanism, a bank purchases and then sells its customer a commodity at a marked-up price over spot to be paid over a predetermined time period.
- The customer then resells the commodity for cash at the current market spot price.
- Interest as such is not levied, with the bank's profit coming from the difference between the purchase price and the higher price agreed upon by its customer.

VI. Islamic Finance: A System at the Crossroads

- ***Sharia*-arbitrage,** it must be said, is not a new problem.
- According to Schacht (1964), many of the issues go back to the early days of Islam [in Medina during Malik (d.796)] when attempts to circumvent the prohibitions on *riba* by legal devices (*hiyal*) began.
- One such tool was ***Bay 'Atan fi Bay'a*** that consisted of the double sale.
- **For example:** the (prospective) debtor sells to the (prospective) creditor an item for cash, and immediately buys it back from him for a greater amount payable at a future date.
- Here difference between two prices represents the interest.

VI. Islamic Finance: A System at the Crossroads

What is the solution to the practice of *shari'a*-arbitrage?

- **Solution One:** To Western eyes an obvious answer would be to admit the substance and abandon the form, by Islam following Christianity:
  - effectively bowing to what may seem the inevitable, and
  - relinquishing the religious prohibitions upon *riba* financing – except, that is, for excessive (usurious) interest charges.
- **Islamic finance would then** resemble the ethical investment movement in the West, by excluding *haram* activities (finance of alcohol, pork production, gambling, etc) but allowing loans to be made at reasonable commercial rates.

VI. Islamic Finance: A System at the Crossroads

- Such a resolution was argued **over 40 years** ago by **Fazlur Rahman (1964)** and other **revisionists** on the issue of *riba*. However, this prospect is unpalatable both:
  - to critics of the current trends in the industry (who wish to preserve the specialness of Islamic financing) and
  - to practitioners (who benefit from *shari'a*-arbitrage) alike.

- **Solution Two**: Another solution would be for the ***fiqh*** academies to engage more with Islamic bankers and ***shari'a*** scholars to develop products that would rather be based on voluntary codes of Islamic 'purity'.

VI. Islamic Finance: A System at the Crossroads

- One such example is the development of ***sukuk*** that comprises **three** steps:
  - ***Pooling of Assets*** *(either cash-based or synthetically created);*
  - ***De-Linking of the Credit Risk*** *of the collateral asset pool from the credit risk of the originator, usually through the transfer of the underlying assets to a finite-lived, standalone special purpose vehicle (SPV); and*
  - ***Trenching of Liabilities*** *that are backed by the asset pool'*

(Fender and Mitchell 2005: 69).

VII. Product Development and Shariah Issues in Islamic Finance ……

- **Islamic banks**, like other banks operating in a much more competitive environment, seek to boost their performance and profitability, but unlike their competitors they must do so in a way that **complies with *shari'a***.

- New products and service innovations by an Islamic financial institution must be approved by its ***shari'a*** committee, comprising a panel of scholars versed in ***fiqh***, that is, Islamic jurisprudence or the science of interpreting religious law.

VII. Product Development and Shariah Issues in Islamic Finance ……

- **On the role of Shari'a** in product development **two school of thoughts** exist:

- **Some argue** that this need to obtain *shari'a* approval is a hurdle in the path of Islamic product innovation (Benaissa, Parekh and Wiegand, 2005).

- **Others have argued,** perhaps on the basis of controversial developments such as *tawarruq* and *sukuks,* that *shari'a* boards have become rather too permissive, and accommodating to, the bankers in recent years (Nienhaus, 2007).

VII. Product Development and Shariah Issues in Islamic Finance ……

- **M. Fahim Khan (2007)** in his article "The Growth of Islamic Financial Industry: Need for Setting Standards for Shariah Application," examines why this diversity in *shari'a* opinion exists and what can be done about it.

- **After considering** the reasons for diversity in *fiqh* rulings, he argues that any attempt to harmonize or codify *fiqh* opinions is not the answer.

- **Rather**, there needs to be a standardization of the processes involved in advising, supervising and monitoring *shari'a* compatibility, including how a ruling should be determined.

VII. Product Development and Shariah Issues in Islamic Finance ……

- **These initiatives might occur:**
  - **at a national level** (and Khan cites the Sudanese model, the Bahraini model, and the Malaysian model as examples), or
  - **at the international level** through bodies such as
    - Islamic Development Bank
    - International Islamic Ratings Agency
    - Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI)
    - International Islamic Centre for Reconciliation for Commercial Arbitration for Islamic Finance.

VII. Product Development and Shariah Issues in Islamic Finance ……

- **Mohammad Hashim Kamali (2007)** in the article "Commodity Futures: An Islamic Legal Analysis," presents a study of *shari'a* opinion in the particular case of commodity futures

- The legitimacy of futures under Islamic law has been questioned on **five grounds**:

  - *the goods do not exist at the time of contract;*
  - *the goods are not owned at the contract date;*
  - *there is no physical delivery (in most cases) with open positions invariably closed out;*
  - *deferment in the transaction is tantamount to the sale of one debt for another; futures involve speculation.*

VII. Product Development and Shariah Issues in Islamic Finance ……

- **Kamali** examines each of these contentions, especially the *hadith* 'sell not what is not with you' which is oft-cited in the case of *fiqh* rulings on the subject.
- He finds each argument to be wanting or, at least, contestable.
- After considering the potential benefits of futures trading for hedging and other licit purposes, he advocates that commodities **futures transactions should be ruled as valid**, on the grounds that
  - they are not in violation of any decisive *fiqh* principle and are,
  - free of *riba,*
  - gambling (*maysir*) and
  - excessive *gharar*, all of which are prohibited activities.

VII. Product Development and Shariah Issues in Islamic Finance ……

- Important ***fiqh*** issues are involved in the validity of combining two or more contracts to structure Islamic financial products.

- Strict juristic rules govern the extent to which product development in Islamic markets can proceed by combining Islamic financial contracts.

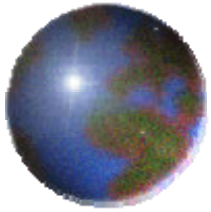
- These rules are outlined and assessed by **Mohammed Burhan Arbouna** in his article " The combination of contracts in Shairah: A Possible Mechanism for Product Development in Islamic Banking and Finance".

VII. Product Development and Shariah Issues in Islamic Finance ……

- **Arbouna** observes that the validity of combining contracts is not an issue under Islamic law because of the general principle of freedom of contracting in *shari'a*.
- Rather, **what is at issue is the nature of the contracts involved.**
- This means that parties can conclude whatever contracts, or deals consisting of a number of contracts, they deem desirable, so long as there is not an explicit source of law prohibiting their actions, and the combination serves a valid purpose.

VII. Product Development and Shariah Issues in Islamic Finance ……

- In case of a **hybrid structure**, each component of has to be examined to identify the possibility of a prohibited feature existing, while the overall combination needs to be assessed on the basis of terminology, objectives and the degree of uncertainty and ambiguity.



Thank You

Philipps Universität Marburg

What Information is Needed to Judge the Risk of Structured Financial Instruments?

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1 Introduction to the problem

- Motivation
  - Increasing important of Islamic Finance

    (Source: GLOBAL ISLAMiC FiNANCE & COMMERCE)
    - Global market of Islamic financial products: 56 billion €
    - Expected growth over the next years to 350 billion €

– Structured financial products and the recent subprime crises

  • Citibank: 11 billion USD loss
  • Merrill Lynch: 8.4 billion USD loss
  • Industriekreditbank and SachsenLB had to be bailed out by their owners

– Banking supervision could not prevent this crisis.

- Questions
  - First, measurement of the risk of structured financial instruments
  - Second, information requirements of banking supervision

Objective of presentation: to provide an answer to both questions

- Contribution of the presentation compared to the literature
  - New approach to measure risk: asset pricing theory as opposed to explicit risk measures
  - New insights on risk drivers: cash flow and context

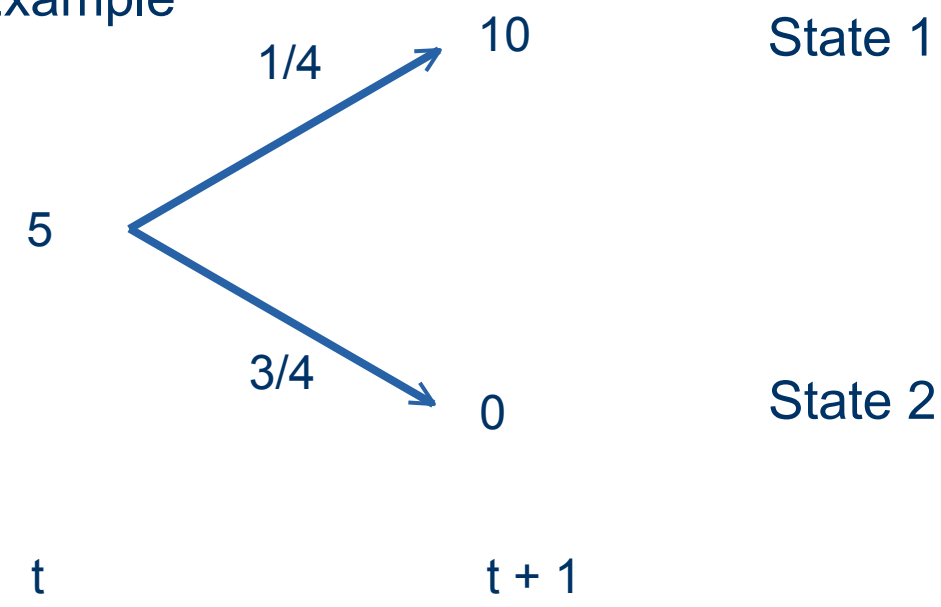
2 Theory

2.1 Definitions

- Structured financial instrument
  - Consists of several basis products
  - One of these products is a derivative

- Derivative
  - Financial instrument
  - whose cash flow depends on the value of its underlying

- Risk
  - Future cash flows are not known today
  - Example



2.2 Methodology

- Asset pricing theory

  Translates future risky cash flow into prices

- Test criterion
  - Price of asset 1 in context 1< price of asset 1 in context 2
  - Context 1 ***must*** involve ***more risk***
  - Since lower price is associated with higher risk

- Description of the context of an investor
  - Definition
    - Context describes the environment in which the investment is embedded
    - Cash flow of the investment does not belong to its context

– Example

- Financial market

	price	cash flow in state 1 (probability: ¼)	cash flow in state 2 (probability: ¾)
Asset 1	5	10	0
Asset 2	90	100	100

- Portfolio of “old” loans of a bank

Loans	?	120	80

Context

- Structured financial instrument

Structured financial instrument	?	0	20

Invest-ment

2.3 Measuring Risk

- Two scenarios
  - Structured financial products ***can be duplicated***
  - Structured financial products ***cannot be duplicated***

2.3.1 Duplication possible

- What does duplication mean?

	price	cash flow in state 1 (probability: ¼)	cash flow in state 2 (probability: ¾)
Asset 1	5	10	0
Asset 2	90	100	100
Structured financial instrument	?	0	20

	price	cash flow in state 1 (probability: ¼)	cash flow in state 2 (probability: ¾)
Asset 1	5	10	0
Asset 2	90	100	100
Structured financial instrument	?	0	20

$-2 \cdot 10 + 0.2 \cdot 100 = 0$

$-2 \cdot 0 + 0.2 \cdot 100 = 20$

- Duplication means

The financial market offers the ***same cash flow*** as the structured financial instrument.

- Duplication means

  The financial market offers the ***same cash flow*** as the structured financial instrument.

- Duplication portfolio (= financial market) and structured financial instrument are identical from an economic point of view.

Duplication possible

	price	cash flow in state 1 (probability: ¼)	cash flow in state 2 (probability: ¾)
Asset 1	5	10	0
Asset 2	90	100	100
Structured financial instrument	?	0	20

$-2 \cdot 10 + 0.2 \cdot 100 = 0$

$-2 \cdot 0 + 0.2 \cdot 100 = 20$

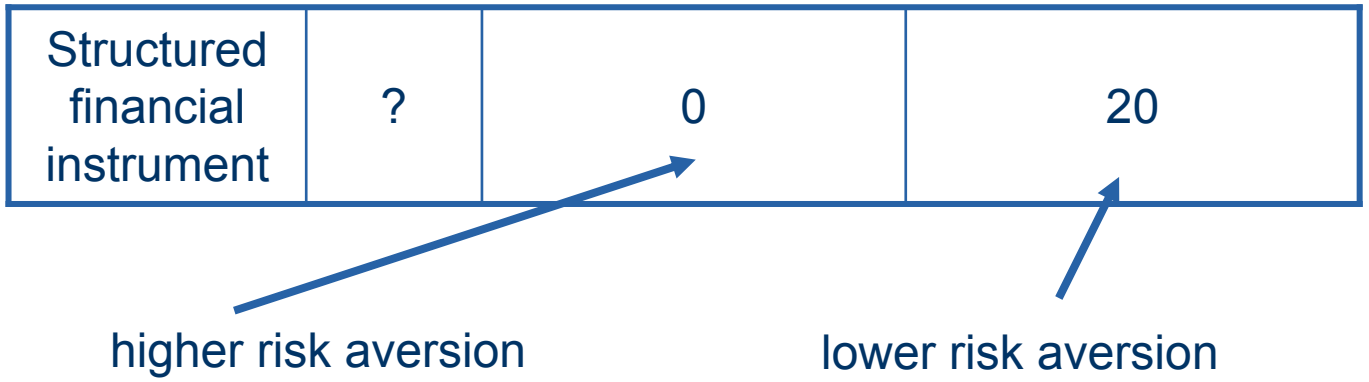
- Consequences
  - 1st consequence
    - Price of structured financial product = price of duplication portfolio (Black/Scholes methodology):

      $-2 \cdot 5 + 0.2 \cdot 90 = 8$

    - Identical price => structured financial instrument has the same risk as the duplication portfolio

– 2nd consequence

- Risk preferences do ***not*** matter



- State probabilities (1/4 or 3/4) do ***not*** matter

– 3rd consequence

The portfolio of “old” loans of the bank does ***not*** matter.

2.3.2 Duplication impossible

- What does impossible duplication mean?

modified financial market

	price	cash flow in state 1 (probability: ¼)	cash flow in state 2 (probability: ¾)
Asset 2	90	100	100
Structured financial instrument	?	0	20

	price	cash flow in state 1 (probability: ¼)	cash flow in state 2 (probability: ¾)
Asset 2	90	100	100
Structured financial instrument	?	0	20

$0.2 \cdot 100 = 20 > 0$ $0.2 \cdot 100 = 20$

	price	cash flow in state 1 (probability: ¼)	cash flow in state 2 (probability: ¾)
Asset 2	90	100	100
Structured financial instrument	?	0	20

$0.1 \cdot 100 = 10 > 0$ $0.1 \cdot 100 = 10 < 20$

- Duplication impossible means

  The financial market offers a ***different cash flow*** than the structured financial instrument.

- Financial market and the structured financial instrument are ***no longer*** identical from an economic point of view.

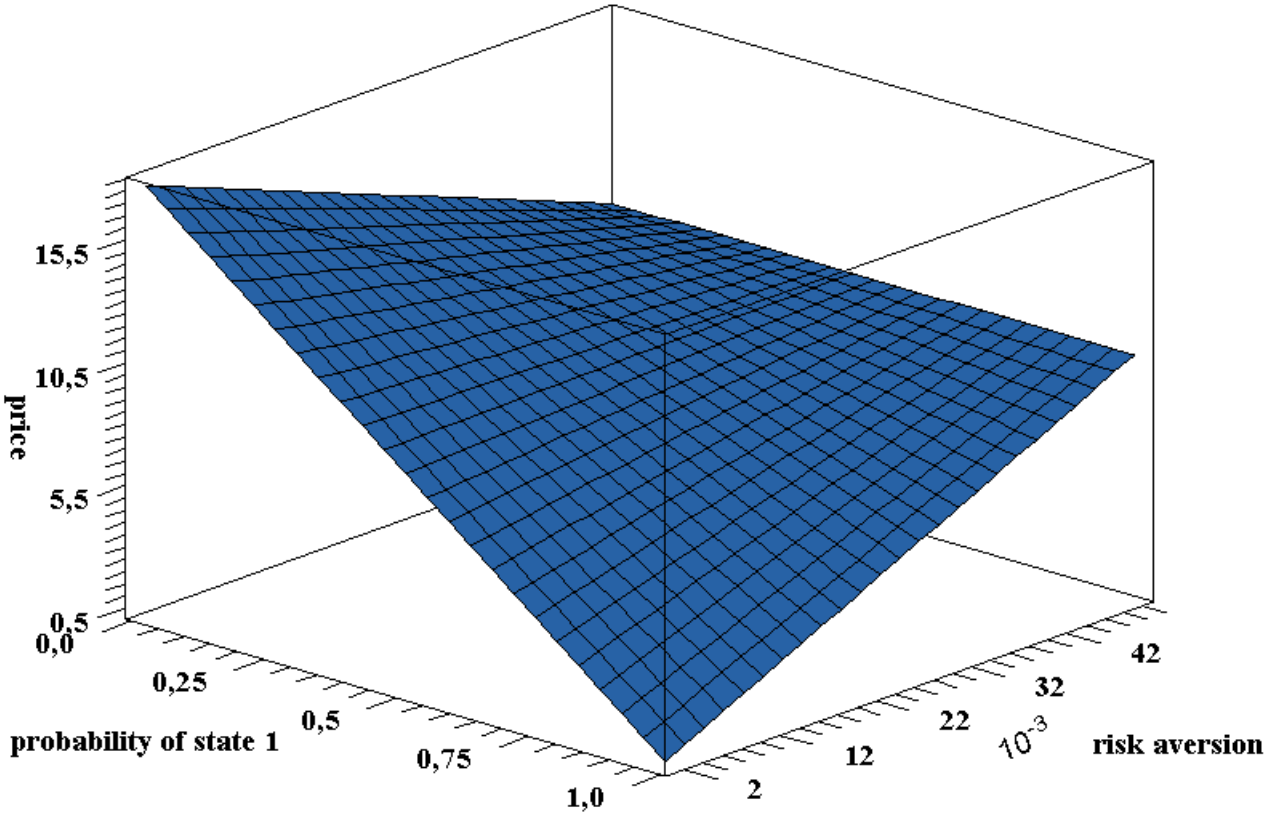
Duplication impossible

- Consequences
  - 1st consequence
    - The price of the structured financial instrument ***cannot*** be derived from the financial market ***alone***.
    - Investors must value the cash flow discrepancy (Cox/Ingersoll/Ross methodology)

– 2nd consequence

  - Risk preferences ***do*** matter
  - State probabilities (1/4 or 3/4) ***do*** matter

- Graphical illustration



– 3rd consequence

• The portfolio of “old” loans of the bank ***does*** matter.

– Intuition

- Portfolio of “old” loans of a bank

Loans	?	120	80

- Structured financial instrument

Structured financial instrument	?	0	20

- Sum of both positions

Loans + structured financial instrument	?	120	100

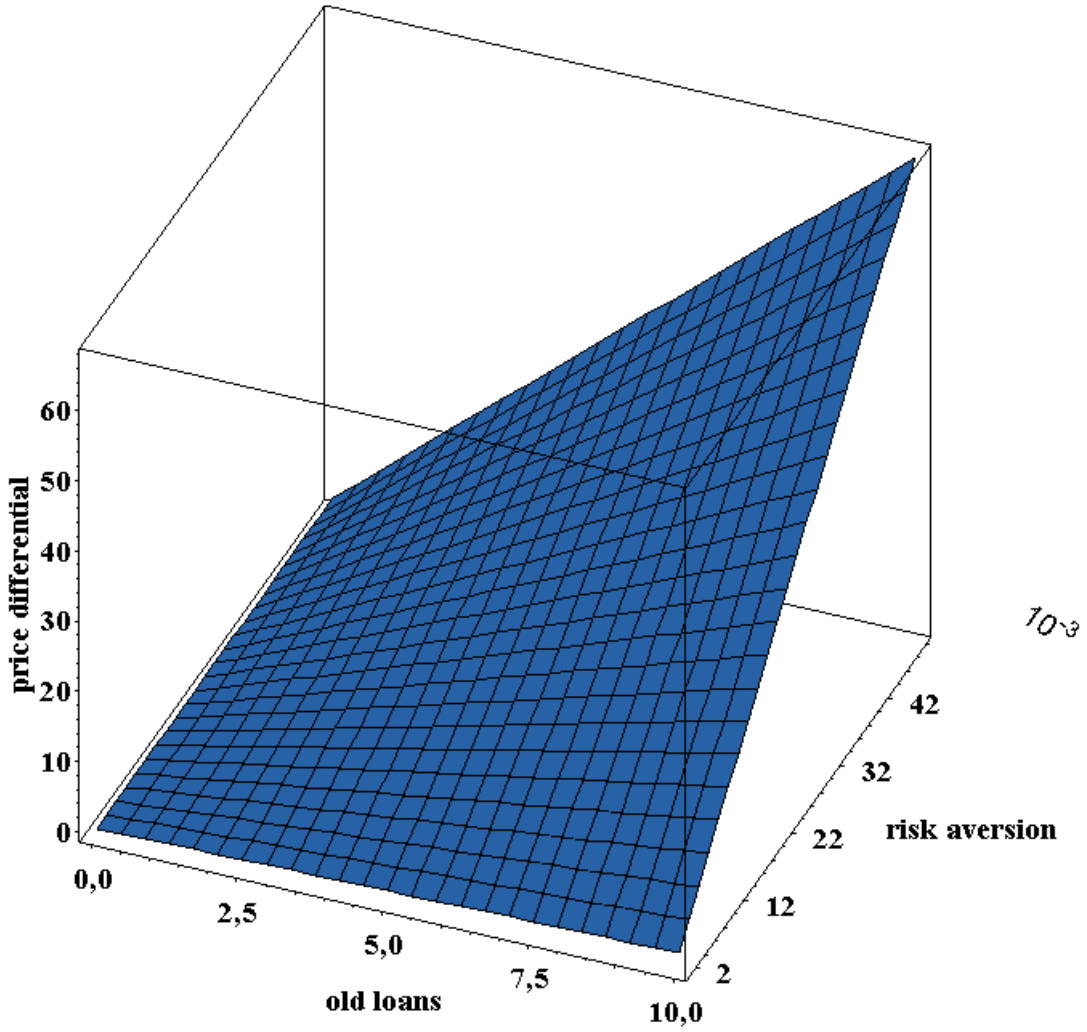
– Graphical illustration

price of the structured financial product ***with*** consideration of the portfolio of "old" loans

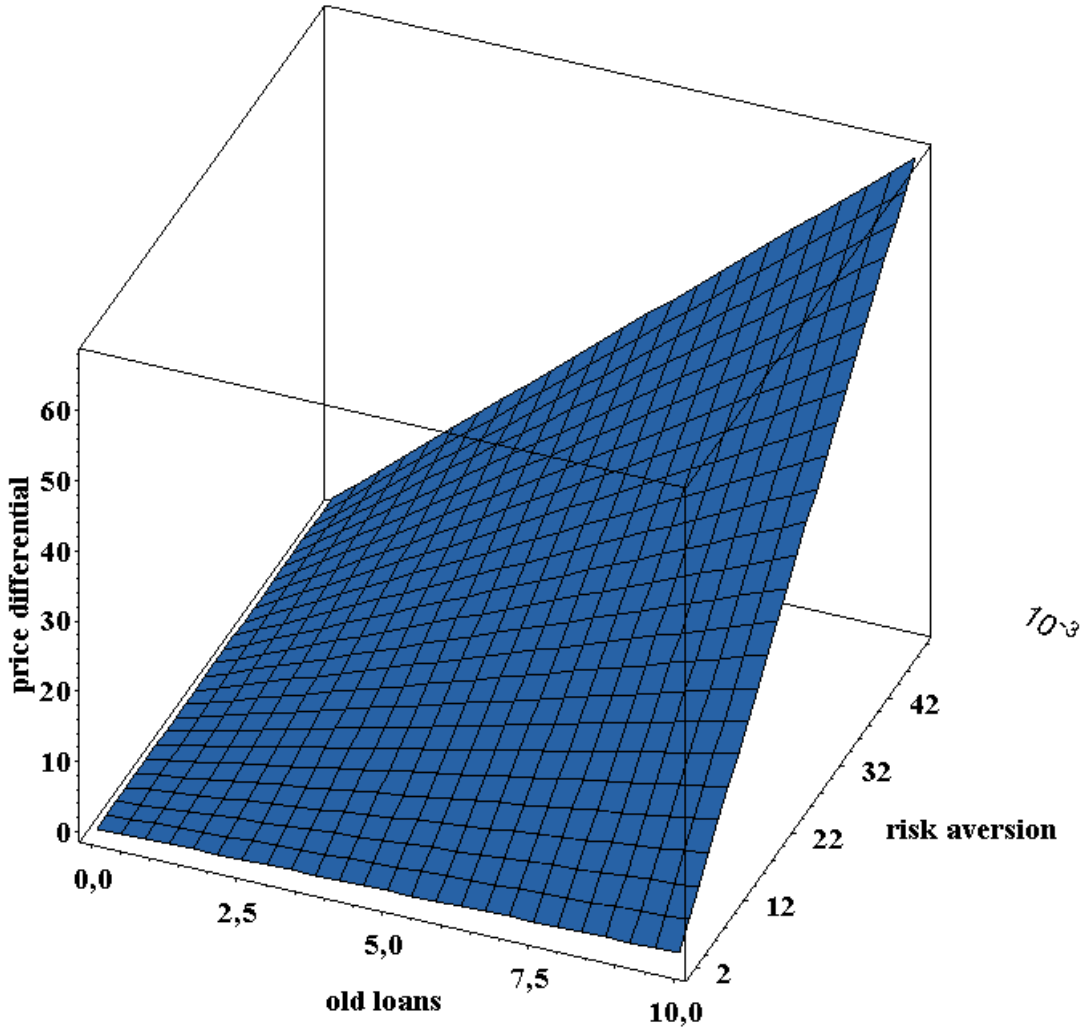
–

price of the structured financial product ***without*** consideration of the portfolio of "old" loans

(***stand alone price***)



"*good*" risk


price differential
60
50
40
30
20
10
0
0,0
2,5
5,0
7,5
10,0
old loans
2
12
22
32
42
risk aversion
10^-3

– Counter-example

- Portfolio of “old” loans of a bank

Loans	?	80	120

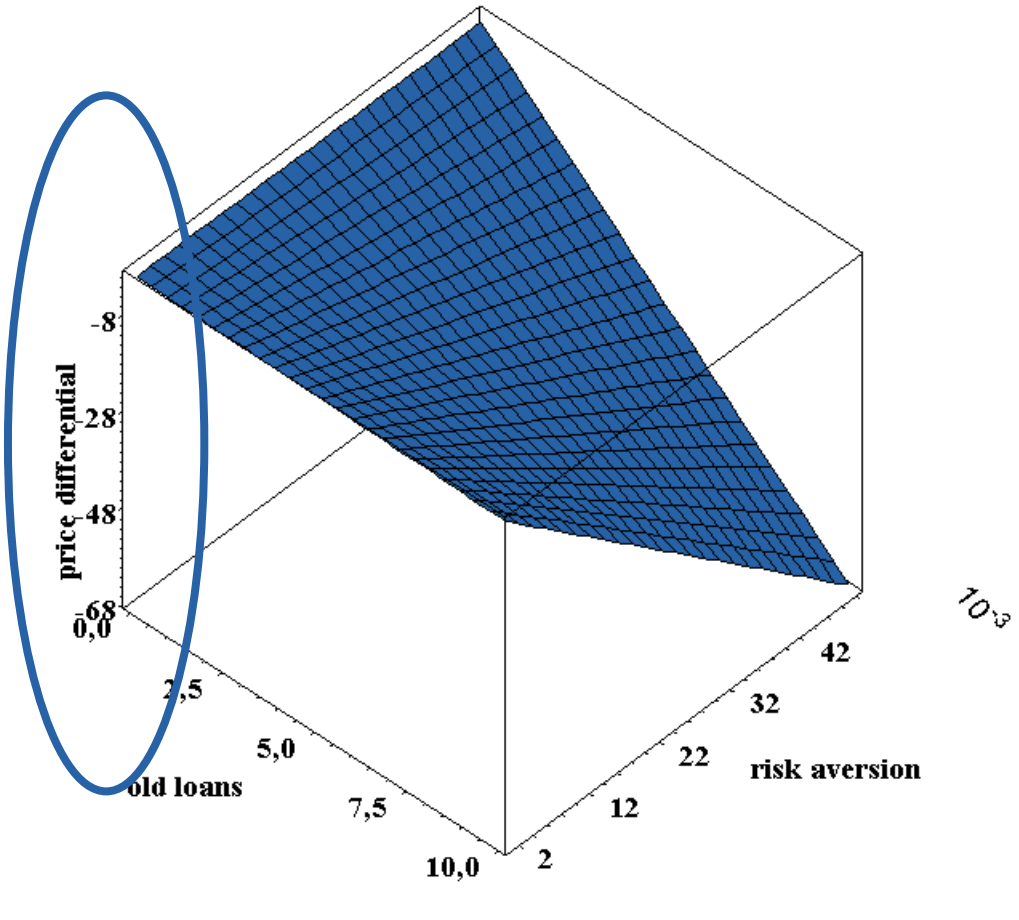
- Structured financial instrument

Structured financial instrument	?	0	20

- Sum of both positions

Loans + structured financial instrument	?	80	140

"*bad*" risk


price differential
-8
-28
-48
-68
0,0
2,5
5,0
7,5
10,0
old loans
2
12
22
32
42
risk aversion
10^-3

3 Application

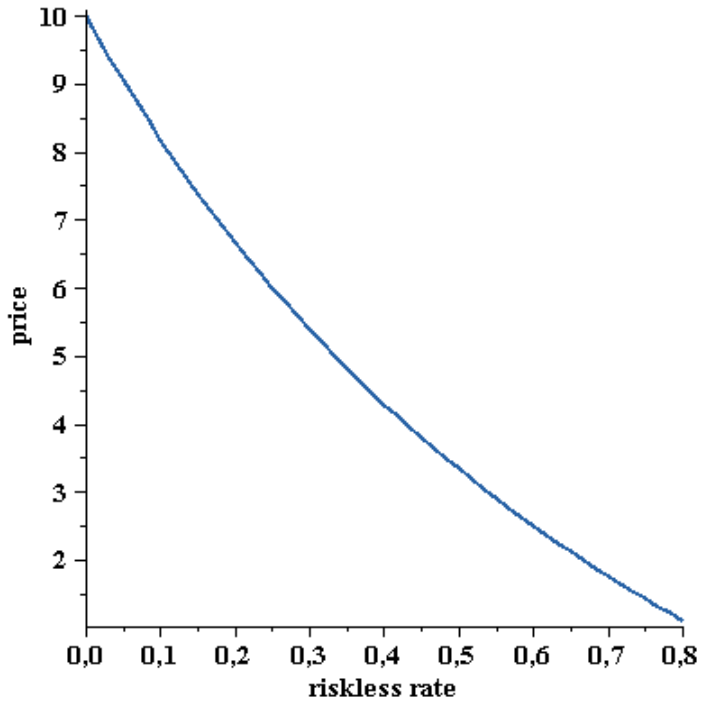
3.1 Islamic financial products and interest rate risk

- Introductory example

Structured financial instrument	?	0	20

- Definition
  - If the price of a financial instrument changes when interest rates change,
  - this product is subject to interest rate risk.

- Dependence of the price of the structured financial instrument on interest rates
  - Duplication possible



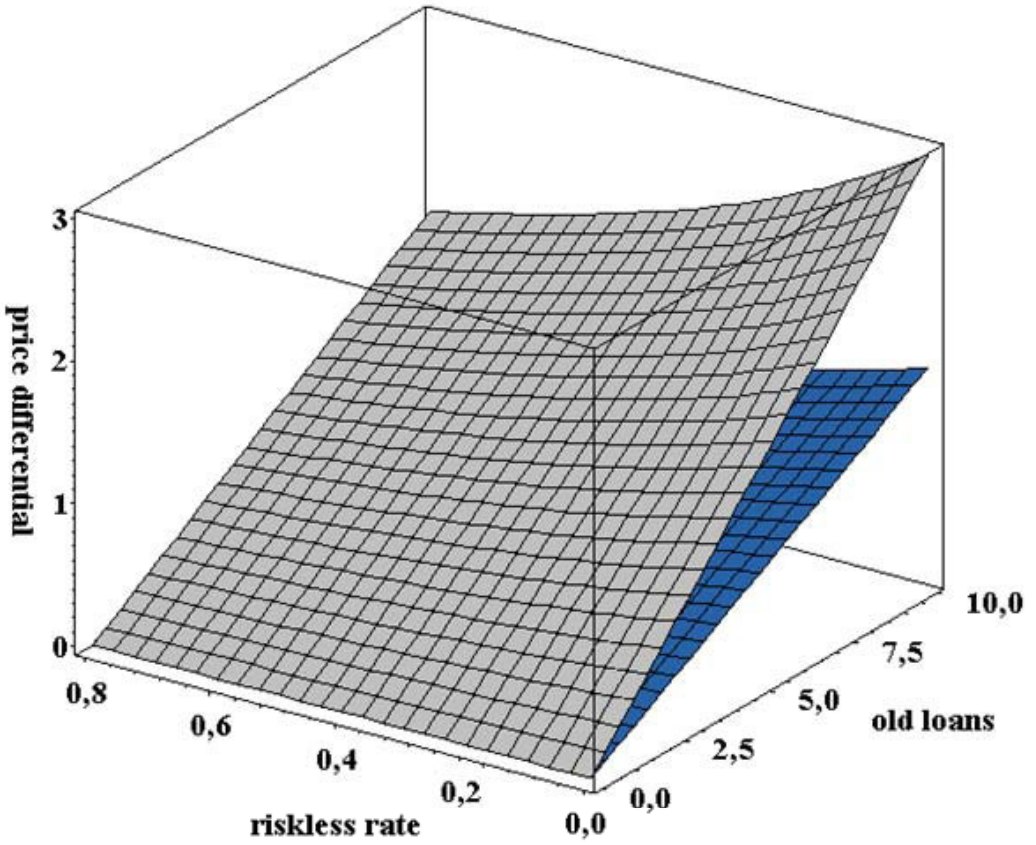
– Duplication impossible

price of the structured financial product ***with*** consideration of the portfolio of "old" loans

–

price of the structured financial product ***without*** consideration of the portfolio of "old" loans

(***stand alone price***)



High risk aversion

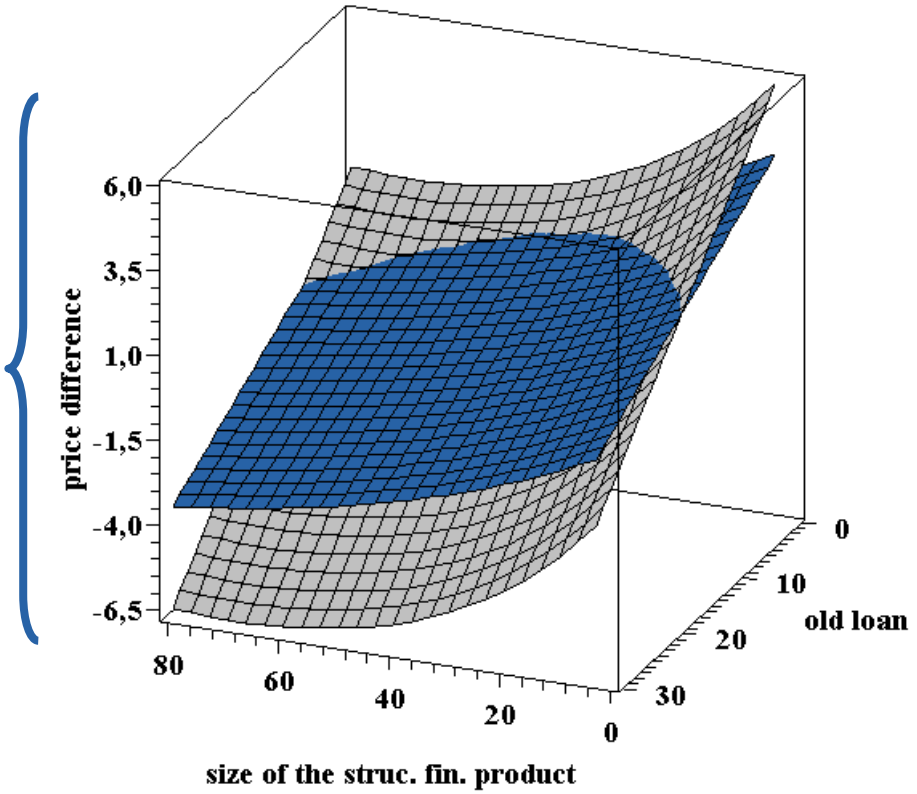
Low risk aversion

- Risk on markets without a riskless asset

Price without

—

Price with riskless asset



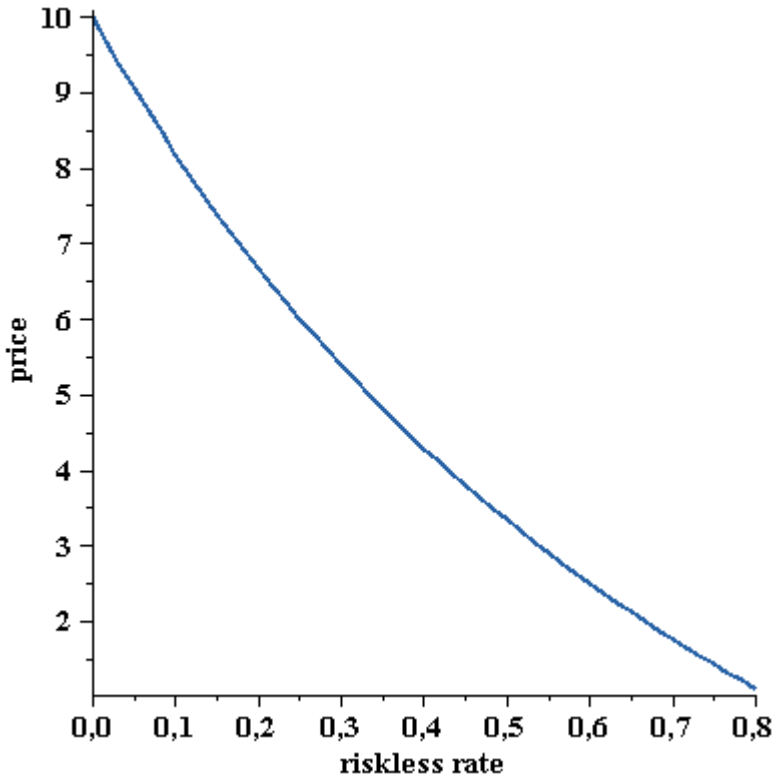
High risk aversion

Low risk aversion

3.2 Consequences to banking supervision

- Information
  - Duplication ***possible***: information just ***on the cash flow*** of the structures financial product is required
  - Duplication ***impossible***: information on the cash flow of the structured financial product ***as well as*** the bank's "old" loan portfolio is required

– Information on interest sensitivity is needed in both valuation scenarios (duplication possible or impossible).



- Incentive Compatibility
  - Duplication possible: cash flows are obvious
  - Duplication impossible: there is no incentive that will result in true revelation (stand alone price is a bad proxy)

4 Conclusion

- Huge losses with structured financial instruments
- Information required to judge the risk of these structured financial instruments
  - Duplication possible: cash flow
  - Duplication impossible: cash flow and bank's "old" loans
  - Interest rate sensitivity

- Banking supervision must actively gather this information.

Thank you for your attention!

Capital Structure, Agency Theory and Corporate Governance Issues in Islamic Banks

PRESENTATION AT PHILIPPS UNIVERSITY OF MARBURG
Germany
7 December 2007

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Secretary-General, Islamic Financial Services Board (IFSB)

Contents

- Capital structure of an Islamic Bank
- Modern capital structure theories with regard to conventional banks
- Are modern capital structure theories with regard to conventional banks relevant for Islamic banks?
- Analysis of PSIA in Islamic Banks in Terms of Agency Theory
- IFSB's Guiding Principles on Corporate Governance for Islamic Banks
- IFSB's Standard on Transparency and Market Discipline
- PSIA and IFSB's Capital Adequacy Standard (CAS)

Capital structure of an Islamic bank

- Islamic banks operate in accordance with the principles of *Shari'ah,* which prohibits, among other things, payment and receipt of *riba* (interest).

- This means that Islamic banks cannot incur or earn interest in their financial transactions.

- Hence, unlike conventional banks, Islamic banks can neither enter into interest-bearing loan contracts nor accept interest-bearing deposits.

- Islamic banks mobilise and utilize funds using Shariah compliant contracts that are not (normally) used by their conventional counterparts.

Table 1: Capital Structure of an Islamic Bank

ASSETS	LIABILITIES
Cash & cash equivalents	Current Accounts (CA)
Sales receivables	
Investment in securities	
Investment in leased assets	**Equity of Profit Sharing Investment Accounts (PSIA)**
Investment in real estate	
Equity investment in joint ventures	Profit Sharing Investment Accounts (PSIA)
Equity investment in capital ventures	Profit Equalization Reserve (PER)
Inventories	Investment Risk Reserve (IRR)
Other assets	**Shareholders' Equity (SE)**
Fixed assets	

Total capital = CA + PSIA + SE

Components of capital structure of an Islamic bank

Shareholders' funds

- Only source of equity funds raised by the bank through sale of common shares to the public.
- No preference shares issued as it would violate the *Shari'ah* to pay fixed percentage dividends to holders of these shares.
- Include reserves accumulated over the years.
- Shareholders have sole control over the bank through the Board of Directors.

Current accounts

- Akin to cheque accounts of conventional banks.
- Customers have the right to withdraw their funds on demand.
- Customers not entitled to receive any returns on their deposits.

Components of capital structure of an Islamic bank

Profit-Sharing Investment accounts (PSIA)

- Mobilised under the Mudaraba contract, PSIA are a profit-sharing financial instrument that is neither a financial liability nor an equity instrument in the conventional senses of these terms. (According to IAS 32, they are a form of capital that is a type of liability, as is the case with some 'puttable stock')

- PSIA supply funds to an entrepreneurial party (Islamic bank or *mudarib*) for trading and investment purposes while the Islamic bank contributes its expertise.

- Profits from operations funded by investment accounts are divided between the bank and PSIA holders according to ratios agreed in advance in the contract.

- As owners of the bank, shareholders receive a proportion of this profit (Mudarib share) as a reward for the work which their agent (the management of the bank) performs in managing PSIA funds.

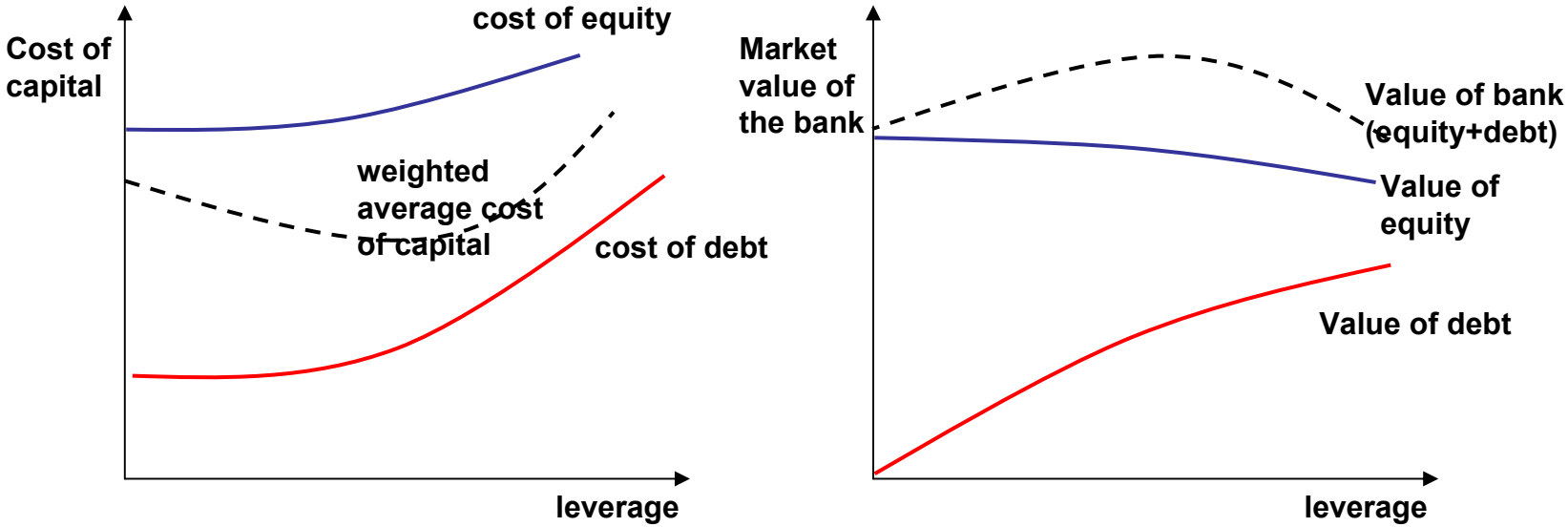
Components of capital structure of an Islamic bank

Profit-Sharing Investment accounts (PSIA)

- In case the aggregate portfolio investment results in a loss from normal business causes or natural causes, PSIA holders bear all the loss pertaining to their investments to the extent of their deposits.
- In that case, shareholders receive no reward for work performed by the management of the bank in managing these funds.
- If the loss is due to misconduct or negligence of the bank, it has to make good the loss, i.e. this turns the loss into a liability of the bank.
- Unrestricted PSIA
  - The contract signed by PSIA holders authorises the bank to invest their funds at its discretion, including commingling their funds with those of shareholders.
- Restricted PSIA
  - The contract signed by PSIA holders specifies, among other conditions, the type of investment in which their funds are to be invested (e.g. real estate, leasing, etc), but it does not give them the right to interfere in the management of the funds.

Modern capital structure theories with regard to conventional banks

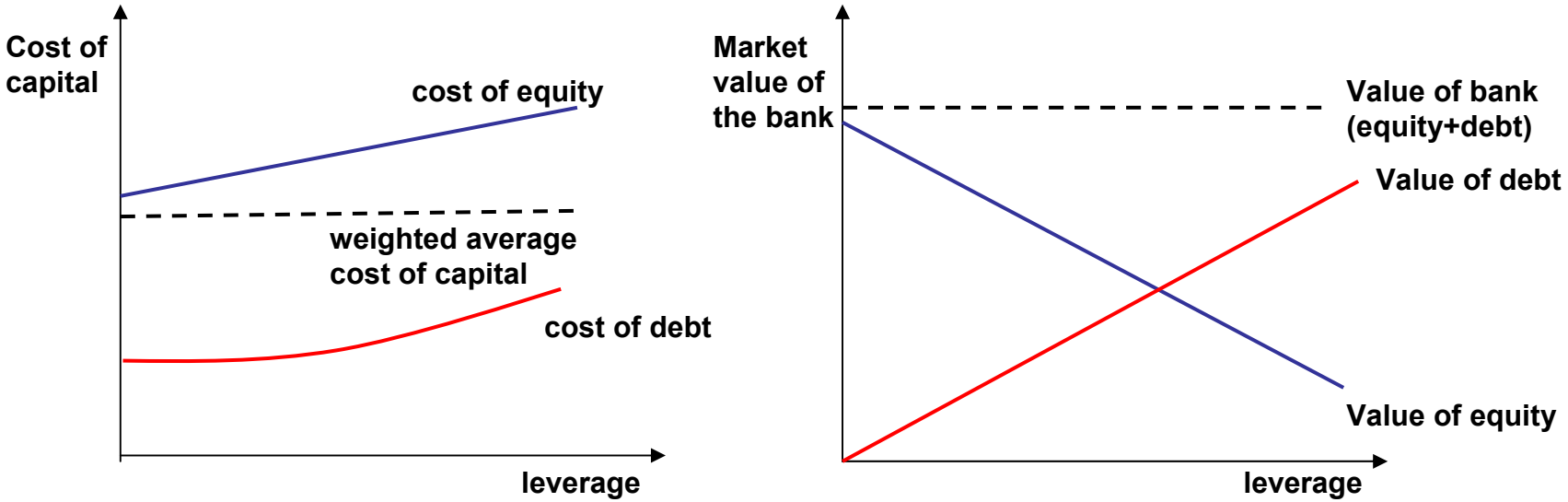
Traditional school



- For conventional banks, the "traditional view" suggests that as debt is increased from a low level, financial risk is first perceived to be insignificant and causes modest change in the cost of equity or debt. This reduces the bank's weighted average cost of capital and simultaneously the market value of the bank rises.
- As a bank increases its use of debt financing, the financial risk perceived by shareholders will increase leading to an increase in the expected cost of equity. The weighted average cost of capital levels off and the bank's market value is maximised.
- Further increases in debt financing lead to an increase in weighted average cost of capital and a decrease in the value of the bank.

Modern capital structure theories with regard to conventional banks

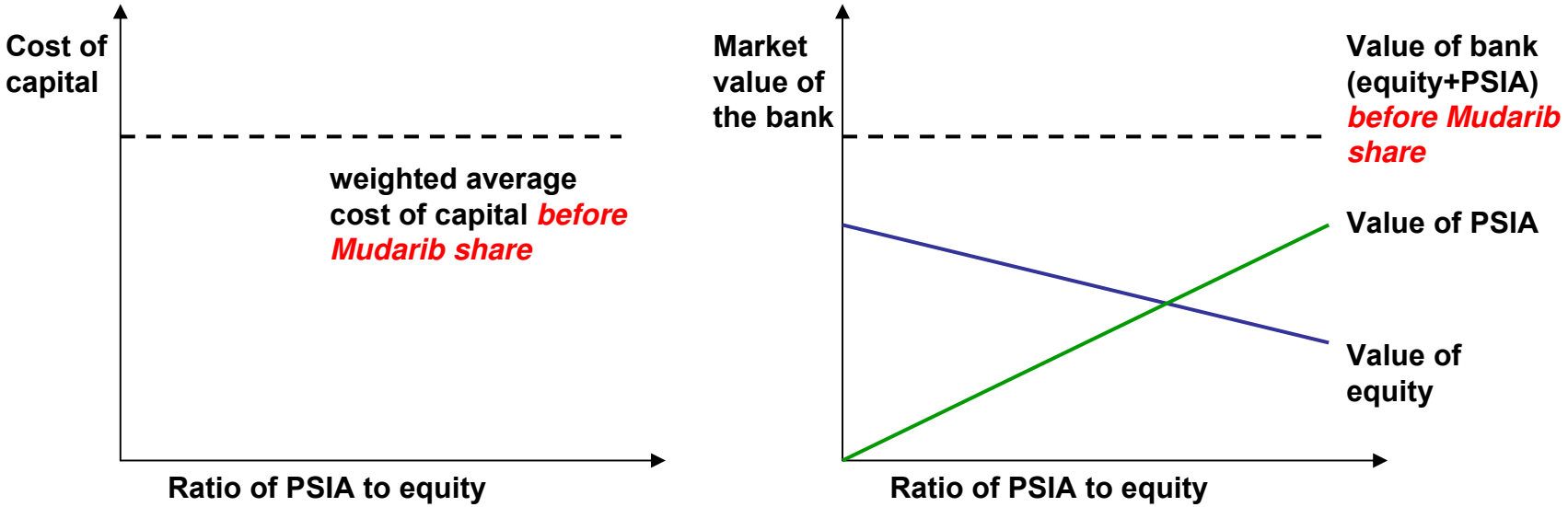
Modigliani-Miller (MM)



- For conventional banks, the "MM model" suggests that as debt financing increases in a bank's capital structure, the cost of equity will always rise so as just to offset any benefits which can be reaped from the lower cost of debt funds relative to equity. This assumes that there are no taxes or transactions costs.
- Hence, under these assumptions the market value of the bank and its cost of capital are independent of the degree of debt financing.
- If MM assumptions of no taxes and no transactions costs are relaxed, the effects of debt tax shields and bankruptcy costs may produce an outcome similar to the 'traditional' model with an optimal level of debt (trade-off theory).

Are modern capital structure theories with regard to conventional banks relevant for Islamic banks?

Islamic Banks' WACC and Value before effect of Mudarib share

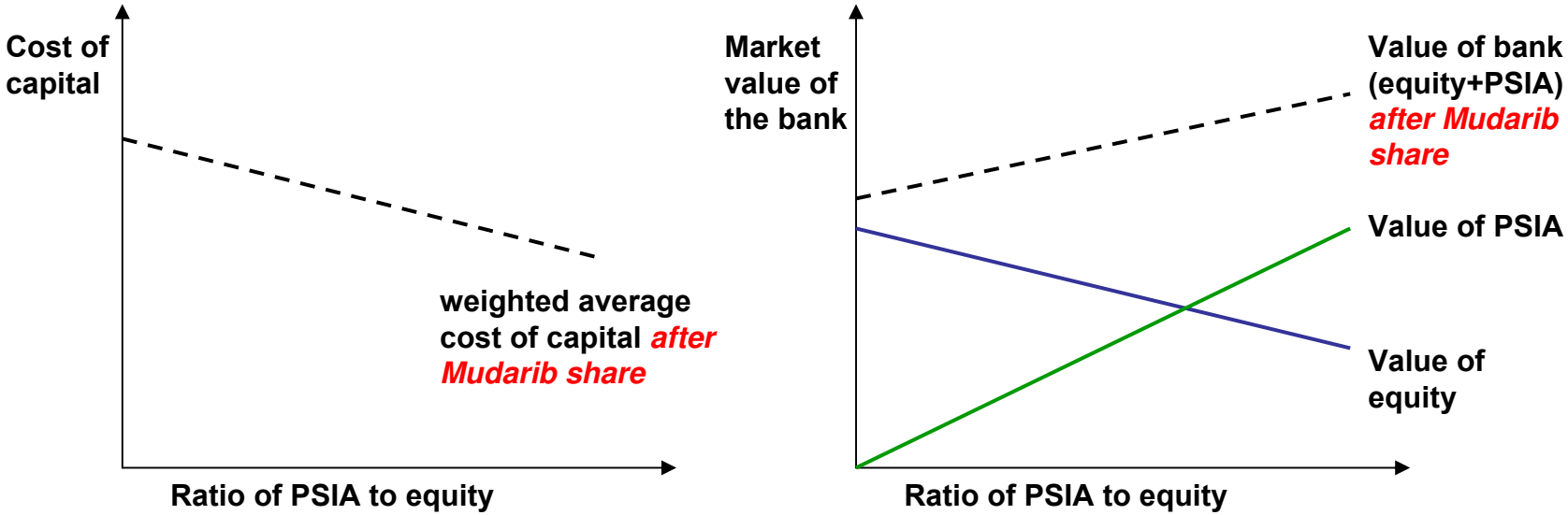


- As the terms of the contract that governs the relationship between PSIA and shareholders do not give the former a first claim on Islamic bank's earnings or assets, and as PSIA holders face the same portfolio investment risk as shareholders, thereby expecting an *ex ante* (but not a predetermined) similar return, an increase in PSIA financing will not increase the financial risk to the shareholders but will provide them with additional income from the bank's Mudarib share deducted from the PSIA share of profit.
- *Before deduction of the bank's Mudarib share of profit*, increasing PSIA financing and keeping equity financing constant will neither increase nor decrease the WACC and the Islamic bank's market value.

Reference: Al-Deehani, T., R.A.A.Karim and V.Murinde (1999), "The Capital Structure of Islamic Banks under the Contractual Obligation of Profit Sharing". *International Journal of Theoretical and Applied Finance*, Vol.2, No.3, page 253.

Are modern capital structure theories with regard to conventional banks relevant for Islamic banks?

Islamic Banks' WACC and Value after effect of Mudarib share



- *After deduction of the bank's Mudarib share of profit*, increasing PSIA financing and keeping equity financing constant will lower the WACC and the Islamic bank's market value will increase. The cost of equity will not increase because the risk of the assets financed by PSIA is borne by the PSIA holders. This constitutes what may be termed 'Islamic financial leverage'.

Reference: Al-Deehani, T., R.A.A.Karim and V.Murinde (1999), "The Capital Structure of Islamic Banks under the Contractual Obligation of Profit Sharing". *International Journal of Theoretical and Applied Finance*, Vol.2, No.3, page 253.

Illustrative example of leverage effect of PSIA

Shareholders' funds	10
PSIA funds	90
Total	100
Mudarib share	40%
Return on assets	3%
Shareholders' profit (3% x 10) + (40% x 3% x 90) =	1.38
Rate of return on shareholders' funds 1.38⁄10	13.8%
PSIA profit 3% x 60% x 90 =	1.62
Rate of return on PSIA funds 1.62/90	1.9%

- The M*udarib* share of profits on PSIA are a major source of revenue for Islamic banks. As the *Mudarib* share is calculated on a profit (but not loss) sharing basis, the use of PSIA by Islamic banks constitutes an interesting form of Islamic financial leverage.
- Thus, with relatively small invested capital, shareholders receive proportionately a large portion of the profits and earn a much higher rate of return on their capital.
- Shareholders of Islamic banks generally earn a higher rate of return compared to IAH due to the leverage ratio of PIA funds to shareholders' funds and the *Mudarib* rate.

Analysis of PSIA in Islamic Banks in Terms of Agency Theory

- The *Mudaraba* contract used by Islamic banks for mobilising and managing investors' funds may be seen as involving a complex agency problem.
- The bank's management acts as agent for the shareholders, while the bank as *mudarib* acts as an agent for the PSIA.
- This gives rise to the possibility of conflicts of interest facing the bank's management between the interests of the two categories of investors (shareholder and PSIA). For example, risk profile of both investors may not be the same, especially for unrestricted PSIA holders.
- One of the basic conditions of *Mudaraba* contract (restricted or unrestricted) is the separation of ownership from management of funds. Like shareholders, therefore, PSIA have no right to interfere in the management of their funds which is the sole prerogative of the Islamic bank.
- However, unlike shareholders, the corporate governance of Islamic banks does not give PSIA any power to appoint (or dismiss) the members of the Board of Directors, the *Shari'ah* Supervisory Board or the external auditors.
- While the capital of both shareholders and PSIA is at risk, unlike shareholders, PSIA neither have control over management nor are they in a position to enforce monitoring measures on the management. In the last resort, they can withdraw their funds.

Analysis of PSIA in Islamic Banks in Terms of Agency Theory

- Hence, PSIA holders have no option but to trust the shareholders to monitor the management (vicarious monitoring).

- Through the *mudarib* share of profit mechanism, shareholders stand to gain from any profit earned from investing PSIA funds. As this *mudarib* share of profit constitutes a valuable source of earnings to shareholders, they have vested interest in employing a performance measure whereby the management of the bank would be expected to achieve a satisfactory rate of return on PSIA, i.e. a rate commensurate with the market rate of return earned by similar financial instruments.

- This would tend to motivate present PSIA to continue their investments with the bank as well as to attract other potential PSIA.

- However, the proposition that PSIA can safeguard their own interests by relying on shareholders' monitoring to operate on their behalf assumes (a) no conflict of interest between PSIA and shareholders; and (b) the existence of a readily available benchmark rate of return in the market for a given level of risk, which is not the case.

Analysis of PSIA in Islamic Banks in Terms of Agency Theory

- The management of an Islamic bank has the incentive to discriminate against PSIA by:

  - ✓ Favouring shareholders to whom they are accountable via the Board of Directors at the expense of PSIA who have no governance rights.

  - ✓ Taking excessive risks through leverage using PSIA funds since the Islamic bank, as a *mudarib*, is exposed only to zero profit, hence very limited downside while PSIA are exposed to the risk of loss.

  - ✓ "Cherry picking" the more attractive projects for investment purposes of shareholders' funds.

  - ✓ "Smoothing" PSIA's profit payouts via transfers of profits into and out of a Profit Equalization Reserve (PER), giving a misleading impression of stable returns.

  - ✓ Masking losses on investments of PSIA funds by use of an Investment Risk Reserve (IRR) formed out of prior period PSIA profits, which acts as an internal buffer to absorb losses on investments of PSIA funds.

IFSB's Guiding Principles on Corporate Governance for Islamic Banks

- The standard recommends best practices on how organs of governance of Islamic banks should deal with issues of potential conflicts of interest between shareholders and PSIA.

- To protect the rights of PSIA, the standard recommends establishing a Governance Committee at Islamic banks to

  - ✓ oversee and monitor the implementation of governance policies through close collaboration with the management, Audit Committee and *Shari'ah* Supervisory Board;
  - ✓ provide the BoD with reports and recommendations based on its findings in the exercise of its functions ; and
  - ✓ ensure adequate and relevant disclosures of investment policies and practices to PSIA in a timely and effective manner and proper implementation of PSIA contracts

IFSB's Standard on Transparency and Market Discipline

- The standard on Transparency and Market Discipline aims to encourage Islamic banks and regulators to disseminate information that is vital to assist PSIA in their decision making. Transparency or public disclosure of reliable and timely information should enable PSIA's assessment of financial conditions and performance, business activities, risk profile and risk management practices of an Islamic bank.
- Market discipline should enable PSIA holders to transmit signals that could exert influence on Islamic bank's behaviour hence forcing Islamic banks to conform to market forces.
- While greater disclosure could lead to more effective market discipline, both transparency and market discipline are indeed necessary to control risk-taking practices of Islamic banks, matching stakeholders' risk appetites (especially of PSIA) as well as to assess whether risks are properly priced.
- However, given that PSIA holders (a) do not execute their investments with the bank through capital markets, and (b) are usually naïve investors, it is unlikely that they play an active role in disciplining Islamic banks.
- A possible alternative means to enhance market discipline could be to develop the information environment, e.g. rating of Islamic banks, financial analyses published by the media etc.

PSIA and IFSB's Capital Adequacy Standard (CAS)

- Under the capital structure theory for Islamic banks, shareholders can in principle increase their rate of return at no extra risk to their equity by increasing their return from the *mudarib* share. It would therefore be in the shareholders' best interests to maintain their equity at a minimum and increase PSIA financing to the highest level possible.

- This capital structure theory holds *in so far as unrestricted PSIA holders bear their own commercial risks and therefore can be treated for capital adequacy purposes purely as investors in a collective investment scheme* (as on Slide 10 above). In this case, α, which refers to the proportion of assets funded by unrestricted PSIA, would take the minimum value of **zero.** In this case, an Islamic bank is not required to allocate capital for the risky assets financed by PSIA (except for operational risk).

ELIGIBLE CAPITAL

TOTAL: RWA (CR + MR) + ORW	**LESS**	**(1-α)**	**FUNDED BY PSIA: RWA (CR + MR)**	**LESS**	**α**	**FUNDED BY PER/IRR: RWA (CR + MR)**

PSIA and IFSB's Capital Adequacy Standard (CAS)

- However, if unrestricted PSIA holders are treated more like depositors because of regulatory requirements or market pressures, the capital structure theory for Islamic banks no longer holds as unrestricted PSIA would be treated in the same way as liabilities for capital adequacy purposes.
- In this case, α would take the maximum value of **one** and an Islamic bank would be obliged to allocate capital to protect PSIA holders as part of the mechanism to maintain the benefits of PSIA financing and minimise withdrawal risk that may jeopardise the commercial position of the Islamic bank and systemic stability of the financial system. The bank's capital structure would thus behave much like that of a conventional bank (WACC would remain constant under MM assumptions).
- α may of course take a value between zero and one (0< α <1), as in Bahrain. WACC would then decrease as the PSIA increase but by less than shown on Slide 11.

			ELIGIBLE CAPITAL			
TOTAL: RWA (CR + MR) + ORW	**LESS**	**(1-α)**	**FUNDED BY PSIA: RWA (CR + MR)**	**LESS**	**α**	**FUNDED BY PER/IRR: RWA (CR + MR)**

PSIA and IFSB's Capital Adequacy Standard (CAS)

- Note that α is a measure of the extent of displaced commercial risk (DCR), i.e. volatility of returns on PSIA-funded assets 'displaced' onto shareholders in order to smooth the profit payouts to PSIA.
- Note also that the PER mentioned earlier is used specifically to mitigate this DCR, i.e. PSIA holders are made (they have no choice in the matter) to smooth their own payouts instead of the shareholders doing this for them.

ELIGIBLE CAPITAL

TOTAL: RWA (CR + MR) + ORW	**LESS**	**(1-α)**	**FUNDED BY PSIA: RWA (CR + MR)**	**LESS**	**α**	**FUNDED BY PER/IRR: RWA (CR + MR)**

Thank you for your attention

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