



Islamic Finance *an Introduction*

„Islamic“ a word, which nowadays puts many people on alert, in particular, those who regularly watch certain media, and thus develop a kind of what is called „Islamophobia“

In this day and age, anything related to religion is usually approached with passion or aversion, which explains many misconceptions about Islamic Finance. Since the 9/11 attacks, Islamic banks and financial institutions have come under the spotlight, sadly accused by western media of funding terrorism and money laundering. After the attack it was expected that the Islamic banking sector might be crippled as investors sought to disengage from all matters Islamic.

In fact, the Islamic finance industry has emerged in the past years stronger and more visible than before. The annual asset growth of Islamic financial institutions has been an estimated 15% worldwide.

Islamic finance products are like any other finance product in a sense that it is subject to certain rules and regulations. It uses the conventional market as its pricing benchmark. All transactions are structured to comply with Islamic Law (Shariah). Shariah is not a monster or another word for punishment (again to those who watch certain media extensively). Shariah is simply a set of rules. The Shariah gives guidance as to what is and what is not acceptable behaviour in all areas of a Muslim's life. It mainly consists of the Qur'anic commands and the words and deeds of the Prophet Muhammad. Every Moslem should live his life in accordance with the Shariah, this provides a belief system. This includes economic and commercial activity. A conventional financial system primarily focuses on economic and financial aspects of a transaction. However, the Islamic system aims to place equal emphasis on ethical, moral, social and religious dimensions to enhance equality and fairness of society as a whole.

Nowadays Islamic banking is about banking, not Islam, and it is no longer the domain of the Muslim world, it is an international phenomenon that came to stay. Everyone can engage in Islamic finance, one is not obliged to wear a headscarf or grow a beard to provide or demand Islamic products.





History of Islamic Banking

The first modern experiment with Islamic banking was undertaken in Egypt undercover without projecting an Islamic image for fear of being seen as a manifestation of Islamic fundamentalism. The pioneering effort took the form of a savings bank based on profit sharing in an Egyptian town in 1963.

Subsequently in the 70s changes took place in the political climate of many Muslim countries and a number of Islamic banks came into existence in the Middle East, the first being the Dubai Islamic Bank in 1975. Islamic banking made its debut in Asia, first in Malaysia in 1983. Today there are around 300 Islamic Financial Institutions worldwide, with total assets in excess of USD 400 billion.

Islamic Finance: Philosophy and Principles

Prohibition of Interest (Riba)

A few centuries ago the Catholic Church used to burn people for charging interest, meaning this rule is no stranger to the western culture. The basic principle of Islamic banking is the prohibition of Interest (Riba). However it encourages the earning of profits because profits, determined ex post, i.e. after the venture, symbolize successful entrepreneurship and creation of additional value, whereas interest, determined ex ante, meaning before the venture, is a cost that is charged irrespective of the outcome of business operations and may not create wealth if there are business losses. This is the most important principal of Islamic Banking. Thus making money from money is islamically not acceptable. Now the question to ask here is: "How do Islamic banks make profits out of lending money?"

Like conventional banks, Islamic banks are actively involved in financing the needs of their clients. This means providing short, medium and long-term funding facilities again like any other conventional bank.

However, since the Islamic banks are prohibited from granting loans with interest to their clients, all financing operations are either based on profit/loss sharing or fixed charges and we will later see how they do that without charging interest. The lender must share in the profits or losses arising out of the venture for which the money was lent. Islamic finance is based on the belief that the provider of capital and the user of capital should equally share the risk of business ventures. This is unlike the interest based commercial banking system, where the borrower must pay back his loan with the agreed interest regardless of the success or failure of his venture.





Hence money is only a medium of exchange, a way of defining the value of something; it has no value in itself, and therefore should not be allowed to give rise to more money, via fixed interest payments. Accordingly, under Islamic rules, either people invest with risk or suffer loss through devaluation by inflation by keeping their money under the mattress. Money is considered as a potential capital rather than capital, meaning that money becomes capital only when it is invested in business.

Prohibited Products

Islamic banking stipulates that investment must be made in sectors and industries, which are in line with Shariah ethics. Meaning investment is prohibited in activities that contribute to the production of alcohol beverages, gambling, pornography, tobacco, mass destruction weaponry and all other, from an Islamic point of view, morally questionable practises.

Prohibition of Speculation

Under this prohibition any transaction entered into should be free from speculation. Therefore options and futures are considered as un-Islamic and so are forward foreign exchange transactions, because rates are determined by interest differentials.

Examples of most common Islamic Finance Products

Murabaha

Murabaha simply means selling at a profit. It has been widely used by Islamic banks to invest short term liquidity.

The concept is to buy a commodity or an asset and to sell it immediately on credit. The client will furnish a request for the goods he wants to buy; the bank would purchase the goods, on the condition that the client will, on delivery of the goods, buy them at cost plus a margin for the bank.

Under Murabaha the Islamic bank purchases the goods, in its own name and then sells them to the client at an agreed margin, on a deferred payments basis. The mark-up or sales margin will be in line with prevailing market rates. This is a popular source for short-term trade finance up to one year.





Musharaka (Partnership)

This is a partnership, normally of limited duration, formed to carry out a specific project. It is therefore similar to a conventional style joint venture. In this case, the bank enters into a partnership with a client, in which both share the equity capital of a project or deal, and both share in the profits/losses according to the equity shareholdings. This is a technique used for working capital finance as well as project finance.

Ijara Wa Iqtina (Lease / Hire-Purchase)

Under this arrangement the bank contracts to buy and lease out for a rental fee, equipment needed by its client who undertakes to purchase the asset at the end of the rental period. This is equivalent to the leasing and instalment loan similar to the conventional lease contract.

Sukuk

Sukuk or Islamic bond is one of the innovative Shariah compliant capital market products. Basically Sukuks are asset-backed bonds. Islamic bonds do not formally pay interest, the investor gets regular payments based on some other assets, such as rent on property, and thus, Sukuks are asset backed bonds being a securitization of assets. Sukuk are tradable and fairly easily liquidated.

Investors acquire the asset through a Special Purpose Vehicle (SPV). The SPV holds the right of ownership of the asset on behalf of the investors, and issues the Sukuks to them. The asset is then leased to the borrower for an agreed period. The SPV receives the lease rent from the borrower and distributes it pro rata to Sukuk holders. The borrower undertakes to purchase the asset at the end of the lease period. This method is suitable for turnkey projects requiring long term financing. For these reasons, they have drawn attention, not only among Islamic investors, but also the conventional sector. The popularity of Sukuks is now spreading at a fast pace.

Refinery upgrades, LNG terminals, airport construction, aircraft leasing, and tanker fleet purchases the spectrum of Islamic financing in the gulf projects is increasing dramatically. In the process, an acceptance of Islamic finance in Western banking circles is evident.

Several large Sukuk issues have been placed in the market recently, and were extremely successful. An interesting example of a Sukuk transaction, which was actually finalised in Germany, was the launch, by the eastern state of Saxony Anhalt, an issue of Europe's first Sukuk for EUR 100 million. The Sukuk is based on a sale and lease back scheme, under which the German state transferred the rights on certain state properties





to an SPV. The SPV will receive rent from the properties that will be distributed to the Sukuk investors. Saxony Anhalt will buy back the properties on completion of the 5 year lease term.

Challenges

There are several challenges facing Islamic Finance: first of all and maybe the most important point is the:

Lack of Uniformity / Standardization

A uniform regulatory and legal framework has not yet been developed. Existing banking regulations in Islamic countries are based on the Western banking model. Similarly, Islamic financial institutions face difficulties operating in non-Islamic countries owing to the absence of a regulatory body that operates in accordance with Islamic principles.

There is lack of uniformity in the religious principles applied in Islamic countries. Therefore there is no universally accepted central religious authority. As a result Islamic banks have formed their own religious boards for guidance, which they consult, to seek approval for each new instrument. Differences in interpretation of Islamic principles by different schools of thought may mean that identical financial instruments are rejected by one board but accepted by another.

Accounting Standards

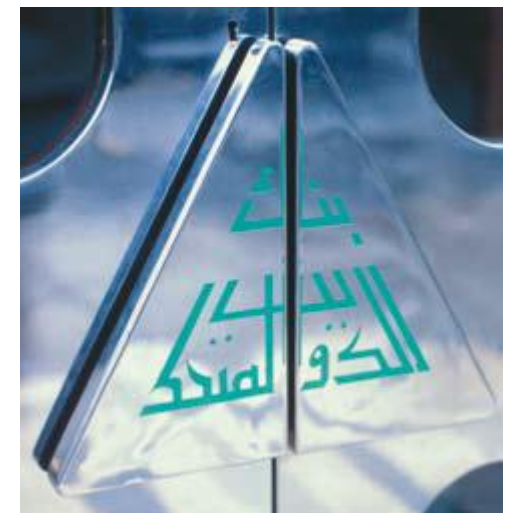
An Islamic financial system needs sound accounting procedures and standards. Western accounting procedures are not always adequate because of the different nature and treatment of financial instruments.

Personnel

Islamic institutions have a shortage of trained personnel who can analyze and manage portfolios, and develop innovative products according to Islamic financial principles.

Conclusion

It is clear that Islamic banking is not a negligible or merely a temporary phenomenon. Islamic banks are here to stay and there are signs that they will continue to grow and expand. Even if one does not share the view against the institution of interest, one may find in Islamic banking some innovative ideas, which could add more variety to the existing financial network. One of the main selling points of Islamic Finance, at least in theory, is that, unlike conventional banking, it is concerned about the viability of the project and the





profitability of the operation but not the size of the collateral. This is a similar approach to project finance of conventional banks.

Another point to be mentioned here is that currently, Islamic banks are enjoying strong liquidity, which is increasing. This could be resulting from a reaction to the islamophobia post 9/11 as well as the strong liquidity due to high oil prices.

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Private Islamic Banking in Germany – The First Steps

Interest in Islam-compliant investment products in Germany is growing. There are approximately three million Muslims living in Germany, representing the second largest religious community in the country. Thus, the question arises where these people can bank their money, if they want to do this in accordance with Islam's Shariah law.

Due to the lack of suitable financial products, many Muslims place their money in interest-free current accounts. Others transfer their wealth to Islamic accounts in their home countries, though far away but without the tantalizing thought of infringing the rules of faith.

Cominvest, a subsidiary of Commerzbank, launched its first Islamic or Sharia-compliant product in Germany in 2000, the Al Sukoor fund. Al Sukoor was planned to cater the need in Germany for an Islamic financing product, but it had to close down after five years, due to the lack of investors.

Despite the constant calls for Sharia compliant products and an Islamic financial structure, it seemed as though the need was actually not as big - but it only appeared that way. German Muslims are still calling for more chances to invest their money. There are various reasons why efforts to establish Shariah-compliant products in the German financial market have failed. The problem which exists in Germany is certainly not the absence of public interest in Sharia compliant products, but rather the way of marketing those products, which ranges from little to none at all. If clients were really interested in investing their money, they would have to take the initiative to find the information they need themselves. Sometimes consultants working for German banks cannot even answer questions about Islamic financial products.

It is understood that new and innovative products need to be provided to potential customers. For the experiment "Germany and Islamic Banking" it can be stated that the marketing efforts were not sufficient, resulting in the failure of the project.

When observing the great efforts that are being spent by German banks and insurance companies abroad, especially in the Middle East, one can get the impression that they are not aware of the great potential in their home markets (according to Wirtschaftswoche No.45).





A further problem could be the selection of the relevant financial products, which have to be suitable for Islamic investment funds. Only products or companies which do not violate the Shariah rules, e.g. gambling, alcohol or debts, can be considered. Therefore, the most number of Islamic banking products can be found in countries of the Middle and Far East.

By Sonja Erdenberger

