

ISLAMIC BANKING

A GUIDE FOR SMALL AND MEDIUM-SIZED ENTERPRISES



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A GUIDE FOR SMALL AND MEDIUM-SIZED ENTERPRISES

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Guide dealing with methods to access Islamic finance, and examining the role of Islamic banking in assisting export activities of small firms – highlights the evolution of the Islamic banking industry, and describes the instruments used to finance clients; outlines key principles and perspectives of Islamic banking relevant to small firms; provides an overview of the Islamic microfinance sector and identifies possible challenges to its growth; explains how to use Islamic banking instruments for specific transactions; includes a case study on Islamic banking for women in Malaysia.

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Introduction

The 2008 financial crisis and subsequent drying up of credit had a particularly severe impact on small and medium-sized enterprises, especially in developing economies.

Vastly diminished export opportunities and a weakened banking system added to the difficulties that small and medium-sized companies traditionally face in accessing finance. Banks have been even more reluctant to take on risk linked to small enterprises. Such companies have also been shaken by the uncertainties unleashed by the crisis, including questions about the soundness of existing financial institutions.

Even as confidence returns and credit begins to flow again, the crisis underlined the need for small firms to know as much as possible about their financing options. Among the alternatives are systems such as microfinance and Islamic banking, which are growing in size and reach.

Islamic banking is not recent. Emerging as early as the 8th century, Islamic banking developed financial instruments that influenced the banking system in Europe in medieval times, such as bills of exchange, the first forms of partnership, limited partnerships, cheques and promissory notes.

A complement to conventional banking

The past few years have seen Islamic banking grow to unprecedented levels, with over US\$ 580 billion in assets and US\$ 300 billion invested in Islamic mutual funds, an annual expansion of at least 20% in 2007 and 2008, with trends set to be the same for 2009.

This shows that for many, Islamic banking represents an interesting complement or alternative to conventional banking. For some, using Islamic finance is closely linked to the desire to follow the laws of sharia in business activities. But there are other aspects of Islamic banking that can make it attractive to a wider group, including micro, small and medium-sized companies. Islamic banking emphasizes the partnership relationship, where success is rewarded and failures shared.

Significantly, conventional financial institutions (UBS, Paribas, HSBC and Citibank, to name but a few) have opened dedicated Islamic banking windows. While these primarily serve customers from the Middle East, the Gulf region and South Asia, they also have clients in Europe, Canada and the United States. Islamic banking has started to cater to the specific banking needs of women entrepreneurs, and women are also involved in managing successful Islamic banks.

Using this guide

This guide on Islamic banking is part of ITC's Trade Finance programme, which provides assistance to help small firms in developing countries develop their capacities to link to global markets through exports.

This guide is intended primarily for trade support institutions of developing countries, and owners or finance managers of small firms. The aim is to help these firms decide whether Islamic banking options are feasible for them, and how to use them.

Many existing books on Islamic banking outline the theoretical underpinnings or provide explanations of its financial instruments for specialists. This guide intends to help the non-specialist reader understand and use Islamic finance. Part I – Understanding Islamic Finance – covers the key principles and perspectives of Islamic banking relevant to small firms. Part II – Using Islamic Finance – consists of a “how to” guide to use Islamic banking instruments for specific transactions.

The intention is to describe, explore and demystify methods to access Islamic finance. The book also looks at the role Islamic banking can play in assisting export activities of small firms. ITC hopes this book will enhance understanding of a banking system that can offer new perspectives and ways to conduct financial transactions that will lead to access to new export markets.

Part One

UNDERSTANDING ISLAMIC FINANCE

Chapter 1

Basic principles of Islamic banking

Islamic banking can be simply defined as a banking operation that abides by sharia (Islamic law), under which a key tenet is the prohibition of interest or *riba*. Generally, Islamic banking is understood to mean interest-free banking.

Loans are a central element of conventional banking, with banks borrowing from depositors and lending to people in need of finance. Conventional banks thus make money from the difference between the lower interest rate they pay on deposits and the higher interest rate they charge their customers. Islamic banks, on the other hand, are prohibited from paying or receiving interest. Sharia-compliant banks do not give out loans; instead, they use other modes – sale-, lease- and partnership-based instruments – to make profit.

Besides being prohibited from earning *riba*, Islamic banks cannot engage in *haram* activities prohibited under sharia, such as those involving pork, alcohol, pornography and gambling. They cannot buy stocks of wine and sell them to a client. Nor can they lease a gambling slot machine to a gaming company, for example. In addition, these banks must also minimize *gharar* (ambiguity) in their contracts. To achieve this, Islamic banks must clearly state four elements in a sale and lease transaction: price, quantity, quality and time of delivery.

This chapter briefly highlights the evolution of the Islamic banking industry and then sheds light on the instruments used to finance clients.

Evolution of Islamic banking

Islamic economists and jurists initiated critique on the interest-based operation of conventional banks in Muslim countries in the 1900s and a number of savings institutions were established in the 1960s. However, the first Islamic commercial bank only emerged in 1975, when Dubai Islamic Bank commenced operations. The 1980s then saw a proliferation of Islamic banks around the globe. As of 2008, there were more than 300 Islamic financial institutions across over 50 countries.

The Middle East and Asia are two main markets where Islamic banks have flourished. Bahrain, Kuwait, Qatar, Saudi Arabia and the United Arab Emirates are active players in the Middle East. Egypt, Lebanon, Oman and the Syrian Arab Republic are catching up.

In Asia, Malaysia has a fully developed Islamic financial system (consisting of banking, *Takaful*, or insurance, capital market and money market components). Other developing players include Brunei Darussalam, Indonesia, Pakistan, the Philippines and Thailand.

The growth in these markets is fuelled in part by natural demand from the Muslim population within those countries. As awareness increases and Islamic banks extend their service, even non-Muslim customers have opted for Islamic banking facilities. This is normal in Malaysia, for example, where sometimes half of an Islamic bank's customer base is non-Muslim. In the West, banks are also competing for a piece of the lucrative Islamic banking business pie.

The first Islamic Finance House was established in Luxembourg in the late 1970s, followed by Islamic Bank International of Denmark, Islamic Investment Company in Melbourne, Australia and American Finance House LARIBA in the United States of America. The Islamic Bank of Britain was founded in the United Kingdom in 2004, and by 2008, five Islamic banks had been established in the country. Citibank, HSBC, Standard Chartered, ABN Amro and Deutsche Bank are among conventional banks that have entered the Islamic space.

The industry initially focused on retail and commercial banking activities while capital market activities such as Islamic fund management and Islamic bonds (*Sukuk*) began to boom after the 1990s. With the development of capital market activities, more and more countries are jumping on the bandwagon. Singapore established its first Islamic bank, The Islamic Bank of Asia, in 2007 and aspires to become the Islamic financial hub in Asia. Hong Kong (China) and Japan have also expressed similar aims. Capital market development would allow these non-Muslim countries to tap cash-rich Gulf Cooperation Council (GCC) investors and to continue playing a major role in international capital markets.

Foundation of Islamic banking

Prohibition of interest means money cannot be simply traded for money. However, money can be used to buy goods that can subsequently be sold or leased. Money can also be pooled into a business venture, with the partners sharing the profit generated from the effort. The financing instruments available from Islamic banks are described below.

Sale-based instruments

Murabahah

This is a sale contract where the cost and the profit margin are disclosed to the buyer. *Murabahah* is usually called **cost plus** because the bank tells the client exactly that – the cost and how much they are adding to it. “I bought this machine at US\$ 10,000 and I’m going to sell it to you at US\$ 15,000. You can pay me within a year.”

This is unlike a normal sale, where the vendor's profit is not disclosed. The normal sale where only the end selling price is stated is known as *Musawamah*. In this type of sale, the bank discloses to the client only the sale price. “I’ll sell this machine for US\$ 20,000 and you can pay in 15 months. Would you like to buy this?” The buyer can agree to the price or negotiate until the parties reach an agreement.

Murabahah is the instrument used most commonly by Islamic banks, although some use Musawamah. In Murabahah, the bank buys an underlying asset and then sells it. Thus, there is an exchange of asset and money, unlike a loan, in which money is exchanged for money.

Islamic banks use Murabahah in two ways. First, Murabahah is utilized in asset acquisitions where the client wants to own a tangible asset, such as a piece of machinery, a building or inventory. This can be called **true-trade Murabahah**, where the client is interested in owning the item acquired by the bank. True-trade Murabahah cannot be used to finance business expenses such as salary and overhead expenses, as the bank cannot buy and sell those.

Under **commodity Murabahah** (also known as *Tawarruq* or reverse *Murabahah*), Islamic banks buy certain commodities (for example, metals and crude palm oil) from a commodity broker, then sell them at cost plus profit on a deferred basis. Since this is a credit sale, the client does not have to pay immediately.

The client, however, does not want this commodity. He or she wants cash. The client thus sells the commodity (either on his own or more commonly via the bank on his behalf) to another commodity broker and receives cash. The client then uses this and pays the bank the deferred payment owed.

In commodity Murabahah, the client is not interested in owning the item that the bank acquired, but rather wants only cash. Commodity Murabahah is popular in the Middle East because it facilitates cash financing. The client can use the cash for working capital purposes.

Although commodity Murabahah is allowed by sharia scholars, they frown upon it because the intention of the parties is solely to get cash. They are not interested in the underlying commodities in the transaction. This same reason (intention of the parties) is the basis for prohibiting *Bai al Inah* (sale and buyback). *Bai al Inah* is, however, allowed in Malaysia on the basis of *Maslahah* (public benefit).

In commodity Murabahah, the bank buys from one broker and the client sells to another broker (i.e., more than two parties are involved). In *Bai al Inah*, the exchange is between two parties only (the bank and the client). The bank sells its asset (building, land lots, shares and so on) to the client on a deferred basis (say, at US\$ 10,000 to be paid in six months). As the client has bought the asset and now owns it, he or she sells back the same asset to the bank on spot basis and gets cash (say, US\$ 8,000). Just as commodity Murabahah is popular in the Middle East, *Bai al Inah* holds wide appeal in Malaysia because both instruments give the client cash.

Simply put, Murabahah is a sales transaction. It is currently implemented in three forms:

- ❑ *True-trade Murabahah: The bank buys a tangible asset and sells it to the client, who wants to own this asset.*
- ❑ *Commodity Murabahah: The bank buys a commodity from a broker and sells it to the client, who does not want to own the commodity, so the client sells it to another broker to get cash.*
- ❑ *Bai al Inah: The bank sells its asset to the client (on credit), who immediately sells back the same to the bank (on cash basis) and obtains the sought sum. Bai al Inah involves only two parties, while commodity Murabahah involves more than two.*

Murabahah could be used to fund the purchase of an asset already in existence – a car, a completed building, machinery and so on. To fund an asset that is not yet in existence (agricultural produce that needs to be cultivated or properties under construction, for example), *Salam* or *Istisna* are used.

Salam

This is a forward sale contract used for generic goods (i.e., commodities). *Salam* is an exemption to the general rule of sale because the vendor is allowed to sell on a forward basis, meaning the subject matter has yet to exist on the day of sale. The Prophet allowed farmers to sell their uncultivated agricultural produce on a forward basis, with the buyer paying the full price on day one and the parties agreeing on the quantity and time of delivery. This way, farmers could use the money paid as capital to start cultivation. Upon maturity, the farmer delivered the agreed quantity of the produce to the buyer.

In the current banking scene, Islamic banks can use this instrument to fund small farmers. A wheat farmer can sell one ton (1 000 kg) of wheat to an Islamic bank, to be delivered in six months. The bank pays the total purchase price (say, US\$ 10,000). After six months, the farmer delivers the wheat to the bank, which can sell this on the open market or to any interested third party to gain profit. *Salam*, however, is not popular with Islamic banks. It is widely used in Sudan but not elsewhere.

Istisna

Istisna is an extension of the *Salam* concept. *Salam* is limited to generic goods and requires full payment up front. *Istisna*, on the other hand, is used for the construction or manufacturing of unique goods (which require certain specifications). It is similar to *Salam* because it is used to finance goods not yet in existence; however, it does not require full payment up front (the payment is flexible).

For example, a small and medium-sized enterprise (SME) wants to start a shipping business and wishes to purchase a ship. The SME could approach an Islamic bank for help with the acquisition, asking the bank to construct the ship. In effect, the SME is buying the ship to be constructed from the Islamic bank (an *Istisna* transaction).

The SME thus would be paying the Islamic bank the purchase price (the cost to the bank to buy the ship and the profit margin it is charging). The bank, of course, does not have the capacity to build the ship and thus would file an order with the shipbuilder. This is another *Istisna* contract, under which the Islamic bank buys the ship to be constructed from the shipbuilder.

The second leg of the transaction is the cost of the ship that the bank is paying to the shipbuilder. Simply put, in this parallel *Istisna*, the bank buys the ship under construction from a shipbuilder (cost to the bank) and sells it to the SME (selling price, i.e., cost plus profit). The SME then makes a deferred payment to settle what it owes the bank.

Lease-based instruments

Islamic banks can also use leasing as an alternative to sale-based instruments. Both sale and lease transactions involve an exchange. In a sale transaction,

ownership is transferred to the client, with money exchanged at time of sale. In a lease transaction, ownership does not transfer to the client; money is exchanged with the right to use an asset.

Ijarah simply refers to a lease transaction. In an operation similar to Murabahah, the Islamic bank first buys the asset from a supplier then leases it to the client. However, in contrast to the Murabahah undertaking, the bank continues to own the asset. Upon the expiry of the lease, the client returns the asset to the bank.

In the Islamic space, all leases are treated as operating leases. If the client wishes to own the asset at the end of the lease, then the parties need to enter into an additional contract. Usually, there will be either a sale or gift at maturity, with the end of the lease followed by ownership transfer. This is known as *Ijarah Muntahiyah Bi Tamleek* (lease ending with ownership). Some markets refer to it as *Ijarah Thumma Bai* (lease then sale) or *Ijarah wa Iqtina* (lease and acquisition).

Partnership-based instruments

Unlike sale and lease transactions that involve exchange, the third category of instruments calls for the pooling assets. These are partnership-based contracts in which the Islamic bank invests capital to become partners with the client. The return to the bank depends on the actual business performance of the client. There are two basic instruments in this category.

Musharakah

Under this mode of financing, both bank and client contribute capital and agree to a profit-sharing ratio. “Capital” does not necessarily refer to cash; it can also be capital in kind. Thus, an Islamic bank could provide cash capital while the client could use its tangible asset as capital in the partnership. The bank as one of the partners has the right to make strategic decisions and manage the business. The bank could also choose to be a sleeping partner. Based on the performance of the business, both partners would share the profit and losses.

Mudarabah

In a *Mudarabah* financing, only the bank (*Rab al maal* or capital provider) provides capital while the client (*Mudarib* or entrepreneur) manages the business. The bank cannot interfere in the day-to-day running of the business. Any profit is shared, with the bank (as the sole *Rab al maal*) having to absorb losses (i.e., monetary losses). The client is not paid a salary, and if he or she does not make a profit, the client loses all the time and effort expended on the venture.

Concluding observations

The exchange-based instruments (sale and lease) result in predetermined returns to Islamic banks, which are not exposed to the business risk of the client. On the other hand, these banks are exposed to such risk via the

partnership-based instruments (Musharakah and Mudarabah). Therefore, in practice, Islamic banks prefer to finance their client using sale and lease instruments. This way, they can limit their risks to the default risk of the client. Partnership-based instruments are usually reserved for clients that have demonstrated good business performance and repayment ability.

Table 1 summarizes the features of benevolent loan, exchange contracts and mixture contracts that are used to finance clients. A benevolent loan is not used for financing purposes as it is not a profit-making vehicle. Exchange contracts are the most popular form of financing as they limit the risk exposure of Islamic banks, while mixture contracts are provided on a selective basis as they would expose the banks to the client's business risk.

Benevolent loan	Exchange contracts	Mixture contracts
<ul style="list-style-type: none"> • Exchange money with money • Guarantee of principal • No extra charges allowed • Not-for-profit transaction (<i>Tabarru</i>) 	<ul style="list-style-type: none"> • Sale and lease contracts (Murabahah, Salam, Istisna, Ijarah) • Exchange money with asset • Must determine price for exchange to take place • Once price is determined, return to bank is certain • Result in debt arising from sale and lease 	<ul style="list-style-type: none"> • Pool money (i.e., capital) and agree to a profit-sharing ratio • Partnership contracts (Musharakah, Mudarabah) • Capital needs to be invested • No guarantee on principal and return • Return is uncertain; it depends on actual business performance

Chapter 2

Islamic banking for SMEs

Within Islamic finance there is a wide range of financial instruments, each with a specific purpose. When considering Islamic finance, it is important to ensure that the instrument used is suitable for the economic purpose that a company seeks to achieve.

There are two main categories of transaction types:

- ❑ Profit- and loss-sharing partnership methods which can be compared with equity investments; and
- ❑ Transactions with a predictable or fixed return structure.

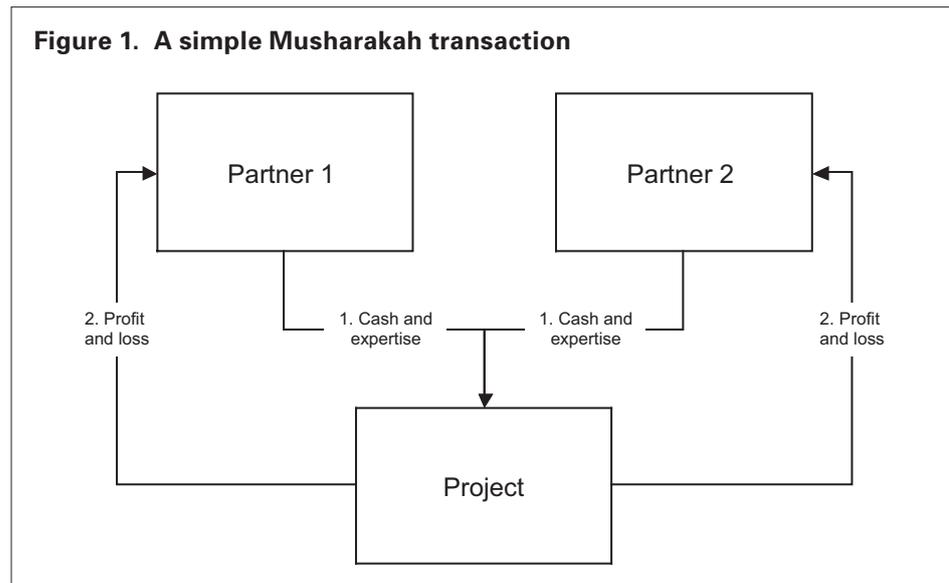
Other financial instruments such as foreign exchange, letters of credit, agency contracts and guarantees are also available. This chapter takes up four categories of instruments: partnership contracts, structures with predictable returns, other contract types and *Sukuk*.

Partnership contracts

There are two types of partnership transactions: joint venture (Musharakah) and passive partnership (Mudarabah). The main difference between the two structures relates to what the partners contribute to the partnership.

Joint venture

The Arabic term “Musharakah” means sharing and is used in financial transactions to identify joint ventures or partnerships. More than two parties can be involved, and generally each provides knowledge and skill as well as a share of the capital. Knowledge and skill can take the form of management or advisory services or even doing the actual work itself. It is possible for one of the partners only to provide capital, in which case he or she becomes a sleeping partner. The profit ratio is pre-agreed in the contract and reflects the level of capital provided, effort, skill and expertise the partners bring to the joint venture. Losses are borne by the partners in proportion to the capital they have provided. The liability of the partners is technically unlimited.



Once the contract has been agreed between the partners, the process can be broken down into the following two main components:

❑ **Cash and expertise**

All partners contribute to the capital and expertise of the business or project. They do not have to provide equal amounts of capital or equal amounts of expertise.

❑ **Profits and losses**

Any profit earned from the joint venture is to be shared between the partners according to the ratios agreed in the original contract. Any losses borne by the partners are strictly in proportion to the amount of capital they have contributed. It is not permissible to fix a lump-sum profit for any single partner.

Diminishing Musharakah

Diminishing Musharakah is a variation of partnership in which it is agreed between the parties at the start that one partner will, over time, purchase units in the joint venture from the others at a pre-agreed unit price. At the start of the agreement, the project is divided into a number of equal units (shares) that are bought by one of the partners over the life of the transaction. In a diminishing Musharakah, the repurchasing agreement is part of the contract.

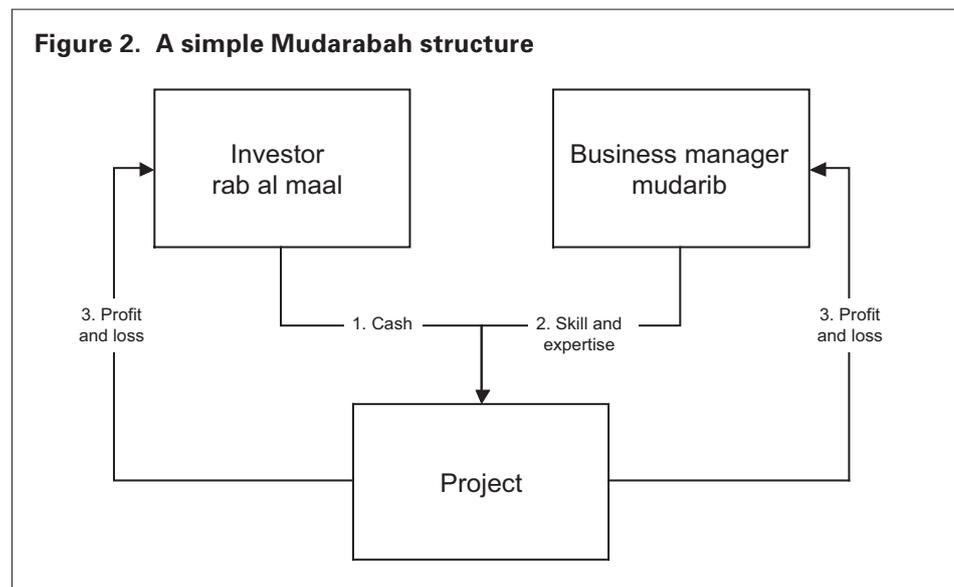
The purchasing party will gradually own a larger share of the joint venture and, as a result, his or her share of the capital increases. With this increase in capital, the purchasing party will be liable for a larger proportion of any loss. Profit ratios will be revised either with each purchase or on a periodic basis as agreed between the partners.

Passive partnership

The Mudarabah transaction is a partnership transaction in which only one partner contributes capital (the capital providing investor or Rab al maal), and the other (the business manager or Mudarib) contributes skill and expertise.

The investor has no right to interfere in the day-to-day operations of the business, although the contract between the partners can contain mutually agreed conditions the business manager has to abide by. The relationship between the partners is founded upon trust, with the investor having to rely heavily on the business manager, his or her ability to manage the business and honesty when it comes to profit share payments.

The passive partnership transaction can be used for private equity investments, but is also often used when clients deposit money with a bank. When used for deposits, the bank contributes its skill and expertise in identifying appropriate investment opportunities.



Once the contract has been agreed between the partners, the process can be broken down into the following main components:

❑ **Capital injection.**

The investor provides capital to the project or company. Generally, an investor will not provide any capital unless a clearly defined business plan is presented. In this structure, the investor pays 100% of the capital.

❑ **Skill and expertise.**

The business manager's contribution to the partnership is his or her skill and expertise in the industry or area.

❑ **Profit and loss.**

As in the joint venture, profits are shared according to a pre-agreed ratio; losses are distributed in proportion to the capital provided. Since only one party provides all the capital, this party bears all the loss.

In the event of a loss, the business manager does not receive any compensation for his or her efforts. The only exception to this is if the business manager has been negligent, in which case he or she will be liable for the total loss.

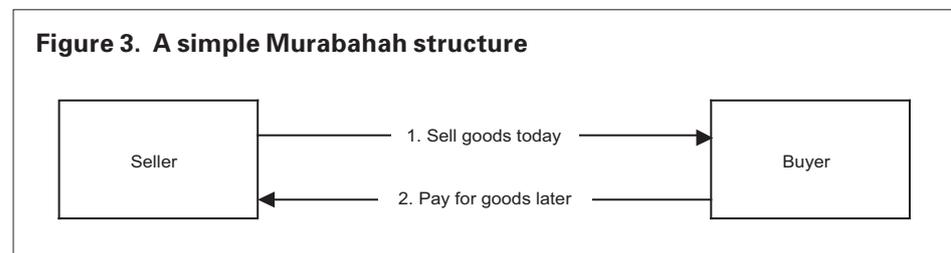
The investor is liable only for the amount of capital provided, which means that the Mudarib cannot commit the business to any sum that is over and above the capital provided.

Instruments with predictable returns

These are favoured by banks and their regulators as reliance on third party profit calculations is eliminated. There are four main instruments in this category: Murabahah, Ijarah, Istisna and Salam.

Deferred payment sale

Deferred payment sale or instalment credit sale transactions are known as Murabahah. They are mainly used for the purchase of goods for immediate delivery with payment to be settled at a later date. In its most basic form, this transaction involves the seller and buyer of the merchandise as illustrated below:



As part of the contract between the buyer and the seller, the price of the goods, markup, delivery date and payment date are agreed. The seller takes immediate possession of the goods, against future payment. The buyer has full knowledge of the price and quality of the goods purchased. In addition, the buyer is aware of the exact amount of markup paid for the convenience of paying later. In the context of trading, the advantage to the buyer is that he or she can use the goods to generate a profit and use this profit to pay the original seller.

Example of a deferred payment sale

Asian ExIm imports linen from Italy on a wholesale basis and sells it to local shops in the region. One of its clients, newly incorporated Beds Inc., has purchased 500 sets of bed linen at a price of US\$ 25 each. Beds Inc., having just started operating, needs to generate a profit from selling the linen to clients and has requested that payment to Asian ExIm be made in three months' time. Asian ExIm agrees, and charges Beds Inc. a fixed markup of US\$ 160.

Asian ExIm delivers the linen today and, three months later, receives US\$ 12,500 for the bed linen supplied, plus a markup of US\$ 160. The payment from Beds Inc. totals US\$ 12,660.

The underlying asset can vary, and can include raw materials and goods for resale.

In Islamic finance, the Murabahah transaction can, for instance, be applied to trade finance and working capital financing.

Leasing

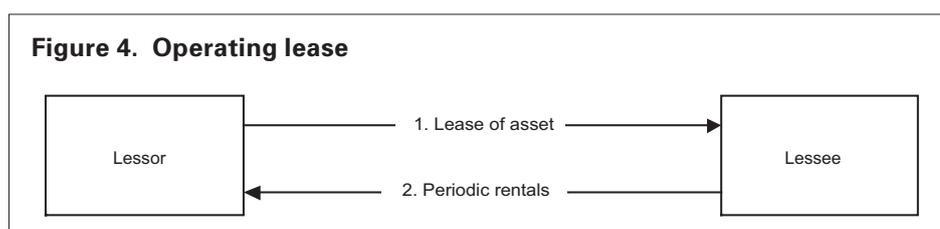
An Ijarah transaction is a lease in which one party (lessor) allows another party (lessee) to use an asset against the payment of a rental fee. As with conventional finance, two types of leasing transactions exist: financial and operating.

In a financial lease (*Ijarah wa Iqtina* or *Ijarah Muntahiya bi Tamleek*), the lessee provides a purchase undertaking at the start of the transaction, stating that he or she will buy the asset at the end of the lease period.

In an operating lease, such a purchase undertaking is not included and the lease cannot be conditional on a purchase undertaking.

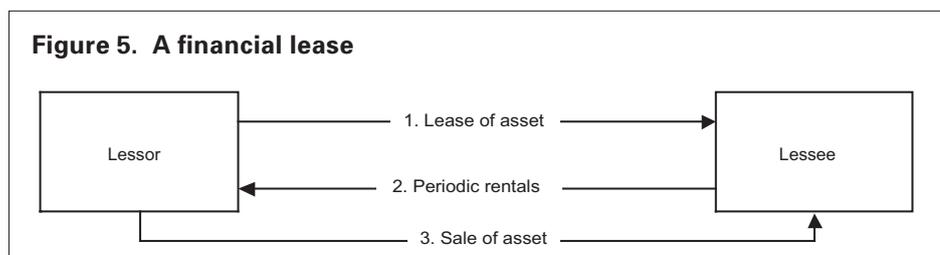
Not every asset is suitable for leasing. The asset needs to be tangible, non-perishable, valuable, identifiable and quantifiable.

In an operational lease, depicted in the figure 4 below, the lessor leases the asset to the lessee, for a pre-agreed period and the lessee pays pre-agreed periodic rentals. The rental or lease payments can either be fixed for the period or floating with periodical re-fixing. The latter is usually done by linking it to a conventional index such as the London Interbank Offered Rate (LIBOR), which represents the cost of capital.



At the end of the period, the lessee can either request to extend the lease or hand the asset back to the lessor. The lessor takes a view of the residual asset value at the end of the lease term, and takes ownership risk. When the asset is returned to the lessor at the end of the period, he or she can either lease it to another party, or sell the asset on the open market. In the case of a sale, the lessor may offer the asset to the lessee.

A financial lease, as depicted in figure 5, has an additional step, which is the sale of the asset to the lessee at the end of the period.



As with an operating lease, rentals can be fixed for the period or floating based on a benchmark. As part of the lease agreement, the lessee provides the lessor with a unilateral purchase undertaking which specifies the amount at which the lessee will purchase the asset upon expiry of the lease.

Three options are possible:

- ❑ *Gift.* In this case, the lessor has gradually paid for ownership of the asset during the lease period, as part of the rental fee. Once all rentals are paid, there is no further payment required from the lessee to obtain the asset.
- ❑ *Against fixed payment.* At the end of the lease, the lessee becomes the owner of the asset once he or she has paid the purchase amount agreed in the contract.
- ❑ *Against market value.* At the end of the lease, the lessee becomes the owner of the asset once he or she has paid the market value to the lessor.

In practice, options 1 and 2 are the most common.

In both cases, the lessor owns the asset and runs all risks associated with ownership. He or she is also responsible for major maintenance and insurance.

Because the lessee is using the asset on a daily basis, he or she is often better positioned to determine maintenance requirements, and is generally appointed by the lessor as an agent to ensure all maintenance is carried out. In addition, the lessee is, in some cases, similarly appointed as an agent for the lessor to insure the asset.

In the event of a total loss of the asset, the lessee is no longer obliged to pay any rentals. The lessor, however, has full recourse to any insurance payments.

Example of a lease

Early Bird Transport is looking to extend its distribution network and wants to invest in new delivery trucks. Instead of tying up a significant amount of money in new trucks, it decides to lease them instead from Lease-A-Truck on an operational lease basis.

Lease-A-Truck provides Early Bird with two trucks against a monthly rental fee, which covers maintenance, depreciation and insurance. Lease-A-Truck retains ownership throughout the duration of the transaction, and informs Early Bird which garage to take the trucks to for maintenance and repairs. Lease-A-Truck settles any bills directly with the garage.

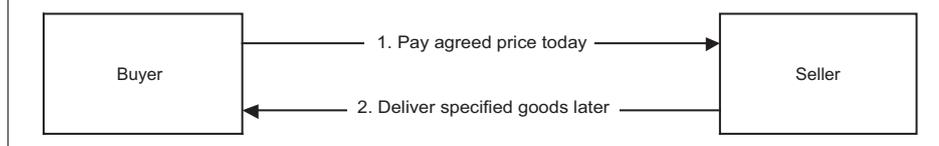
At the end of the lease period, Early Bird has one of the following choices:

- ❑ *Extend the lease for a further period;*
- ❑ *Purchase the trucks at current market value from Lease-A-Truck; or*
- ❑ *Hand the trucks back to Lease-A-Truck.*

Short-term production finance

Short-term production, construction and agriculture contracts can be financed using a Salam contract.

In this type of contract, a payment is made today against future delivery of the asset. As the purpose of the funding is to construct or produce the asset, the asset itself does not have to be in existence, and the seller does not need to have ownership. In its simplest form, Salam is a contract between a buyer and a seller as shown below:

Figure 6. A simple Salam structure

The contract is typically short term (one to three months in duration), but could be entered into for longer periods. The type, quality and quantity of the asset need to be clearly specified in the contract. Any asset that cannot be specified in this way, such as precious stones, cannot be made the subject of a Salam transaction.

The seller has a contractual obligation to deliver the specified quantity and quality at the agreed delivery date. If the seller cannot deliver from his or her own production, he or she will have to buy the remaining quantity to fulfil the contractual obligation. The goods involved must be commodities that are freely available.

The seller receives the funds to enable production of the underlying asset, while the buyer obtains an asset in the future with the expectation that the eventual price will be higher than the original payment.

Because the buyer takes a business risk, the transaction is not subject to any of the prohibitions on uncertainty and gambling.

Example of short-term production finance

Farmer Malik has noticed a substantial demand for pumpkin seeds and wants to enter this market. In order to be able to harvest the pumpkins in November of the following year, extract the seeds and package them, he requires an up front investment of US\$ 2,500.

Malik comes to an agreement with Super Duper Supermarkets, which wants to buy 100 kg of quality A pumpkin seeds, packaged in 100 g bags for US\$ 2,500, for delivery in November. Malik receives the US\$ 2,500 and starts the process of making the soil ready and planting the seeds.

Come November, Malik harvests the pumpkins, extracts 150 kg of seeds and packages 100 kg of quality A seeds, which he delivers to Super Duper. The seeds are sold for US\$ 3 a packet, generating revenue of US\$ 500 (US\$ 3,000 – US\$ 2,500) for Super Duper.

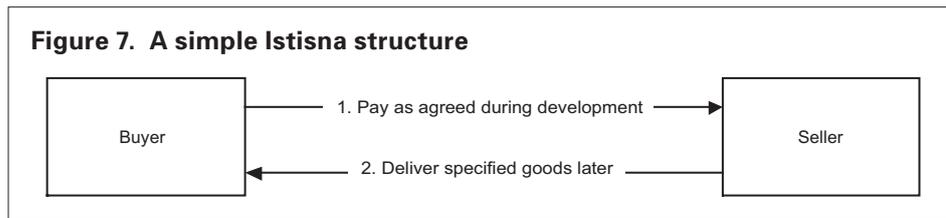
The remaining 50 kg varies in quality from A to C, which Malik then sells for a total amount of US\$ 1,000.

Long-term production finance

Like a Salam contract, Istisna is a purchase contract for future delivery of an asset. It is exempt from the same two conditions regarding the asset, ownership and existence.

The contract is typically for a longer term, and payment to the producer or contractor of the asset does not have to be in full in advance. Payment is likely to be in various instalments in line with the progress made on the development of the asset and is, therefore, well suited to project finance and construction.

The asset typically needs to be manufactured, constructed or processed, and is of a significant size and capital outlay.



Under the simple structure shown in figure 7, it is assumed that the buyer will have the money to pay for the asset during its construction. However, this is not necessarily the case and a financier could be involved. The financier will finance the construction and consequently sell or lease the asset to the buyer for a pre-agreed period.

As in a Salam transaction, the buyer takes a business risk in this transaction. It is therefore not subject to any of the prohibitions on uncertainty and gambling.

Example of long-term production finance

Build A Doll is expanding and in need of a new manufacturing plant with a total cost of US\$ 500,000 which will be built by Considerate Builders Inc. Build A Doll negotiates the following payment schedule and pays Considerate Builders upon completion of each phase:

	US\$
10% of the amount to be paid up front to prepare the site	50,000.00
10% once the foundation is laid	50,000.00
25% once the walls are built.	125,000.00
20% once the roof is finished and the windows are put in.	100,000.00
15% once the plumbing and electricity are finished.	75,000.00
15% when the interior decorating is completed.	75,000.00
5% when the final issues are resolved.	25,000.00
Total paid at end of construction	500,000.00

Other instruments

Besides the profit- and loss-sharing instruments and the financing options with a predictable return outlined above, there are other financial structures that do not necessarily fall into either of these categories.

Foreign exchange

Foreign exchange, or *Sarf*, is a transaction in which one person buys an amount of a specific currency against an equivalent amount in another currency. This is similar to foreign exchange contracts offered by conventional banks and money changers. Within Islamic finance, only spot transactions are currently permissible and forwards, options and futures are deemed to be speculative.

Letters of credit

Islamic letters of credit are similar to conventional letters of credit and are an undertaking by a bank to make a payment to a named party against the presentation of the stipulated documents.

Letters of credit are often used in combination with trade-type transactions such as Murabahah and Salam. Depending on which party requests them, the letters of credit provide certainty that the goods will be delivered prior to payment being made, or transfer the risk of non-payment to the financial institution issuing or confirming the letters.

Letters of credit are highly standardized and typically subject to international regulations. These regulations are described in detail in the Uniform Customs and Practice for Documentary Credits issued by the International Chamber of Commerce.

Different types of letters of credit exist, such as irrevocable, confirmed and stand-by.

Guarantee

A financial guarantee is a guarantee provided by one party (the guarantor) to cover any payment default by another party. An example of a guarantee is when parents provide a guarantee to the bank for their child's payments under a home purchase plan. In the event the child misses a payment, the parents will automatically be liable.

In Islamic finance, unlike in conventional finance, guarantees cannot be used to assure profits or to guarantee business performance. They can only guarantee payment in the event of a shortfall or default by a named counterparty.

In Islamic finance, the guarantor cannot charge a fee for providing the guarantee.

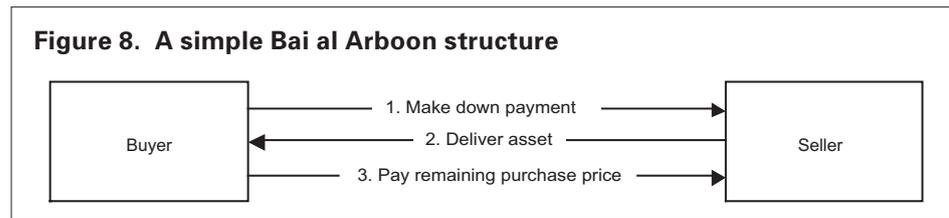
Unilateral promise

A *Wa'd* is a unilateral promise from one party to another, and can, for example, be structured along the lines of "I promise to pay you £ 15 next week if you help me organize my brother's birthday party."

Acceptance by the other party is not required, since this is not a bilateral contract. The conditionality in this phrase is also acceptable for the same reason. However, in order for this to turn into a contract, the second party needs to accept.

Down payment

A *Bai al Arboon* represents a non-refundable down payment on a purchase which signifies the buyer's intent to buy the asset and is typically made toward goods that will be delivered at a later date. It is depicted in its most simplistic form in figure 8 below.



The down payment forms part of the overall price agreed between the buyer and the seller, but is non-refundable in the event the buyer later does not take delivery of the asset.

Simplified, the steps are as follows:

- ❑ Buyer and seller agree on a price and the buyer makes a down payment (e.g., 20% of the purchase price). The asset is specified and the delivery date is agreed;
- ❑ On the agreed delivery date, the seller delivers the asset to the buyer, or the buyer collects it from the seller;
- ❑ On the agreed delivery date, after inspecting the asset, the buyer pays the balance of the purchase price (e.g., 80% of the original purchase price).

Example of Bai al Arboon

My brother agrees to buy a motorbike from Biker's Best, a specialist motorbike garage, for €4,995. The motorbike is not new, and has been in the showroom for a few weeks. The seller needs to check the motorbike before it is collected and service it to ensure that it is roadworthy.

Although the deal is done, the seller would like some sort of guarantee, and does not want to be in a position where he has done all the work only to find the buyer has changed his mind. The seller requests a down payment and they agree on €995. When my brother goes to collect the motorbike, he pays the remaining €4,000.

If he had pulled out of the purchase, the €995 would have been forfeited by the seller to cover the cost of work he had done in getting the motorbike ready for sale.

Agency agreement

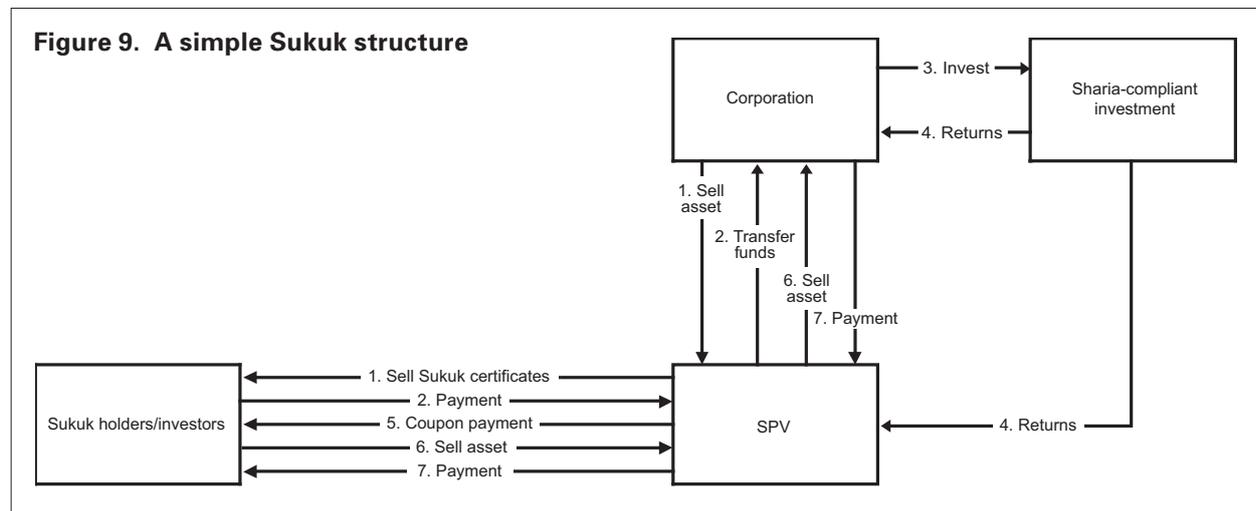
Wakalah is the agreement that governs the principal-agent relationship between two parties, where one party is requesting another to act on its behalf. The application of the *Wakalah* is varied and can range from appointing an agent (*wakeel*) to purchase or sell an asset, to the investment of funds. The agent is entitled to a fee for services provided.

In addition, he can keep any profit he makes over and above a pre-agreed anticipated profit rate as an incentive. In Islamic finance, the agency agreement is often used to govern restricted and unrestricted investment accounts.

Investment certificate

Sukuk is probably the most well-known instrument in Islamic finance and is most correctly identified as an investment certificate. It is often called a bond-type instrument because it has some similar characteristics.

Unlike the holder of a conventional bond, however, a Sukuk holder also owns a proportional part of the underlying asset. Sukuk is not a separate instrument in itself, but more like a structure facilitating the funding of large projects that would be beyond the capabilities of an individual or a small group of investors. Sukuk can be listed on recognized exchanges and is, with a few exceptions, generally tradable. In its simplest, generic form, Sukuk can be depicted as follows:



The special purpose vehicle (SPV) purchases the asset from the original owner on behalf of the Sukuk holders. The SPV is often set up as part of the group of companies selling the asset and hence raising the funds.

In the interest of the Sukuk holders, it needs to be ensured that the SPV is bankruptcy-remote, which means that insolvency of the original seller of the asset will not affect the SPV. In addition, the SPV should not be subject to any negative tax implications and will need to be established in what is known as a tax-friendly jurisdiction.

Like conventional bonds, Sukuk can be bought from the issuer or on the secondary market. Unlike in the conventional bond market, however, Sukuk tends to be held to maturity and the secondary market is not very active. Although quotes are provided by some market makers, the spreads between bid and asking price are particularly wide and availability of issues is still thin.

The Sukuk holder owns a proportional share of the underlying asset and has a financial right to the revenues generated by the asset.

However, as mentioned before, the holder is also subject to ownership risk, which means that he or she is exposed to any risk associated with the share of the underlying asset. Conventional bonds, on the other hand, remain part of the issuer's financial liability.

Sukuk always has one of the following underlying transaction types as a basis:

- Mudarabah
- Musharakah
- Ijarah
- Salam
- Istisna

The Murabahah transaction is generally not deemed feasible for securitization since it would be akin to debt trading.

Arguably the most well-known Islamic investment tool, Sukuk might not be suitable for smaller businesses. The cost of setting up and managing the SPV, the legal documentation and issuance process can be prohibitive for relatively small amounts of funding.

Which transaction type?

With the exception of Sukuk, the examples provided in the previous section are based on two organizations or individuals dealing directly. As companies grow, their financial requirements go beyond what can be arranged between parties, and financial institutions become involved to provide the funding.

Each of the transactions mentioned can also have a bank or financial institution involved, which will then act as an intermediary to mobilize funds and apply them to investments in businesses.

When considering Islamic finance as an alternative funding source, a company needs to take the business requirement into account. The following are examples of the different ways Islamic financial structures can be applied to SMEs:

- **Partnership contracts.** Joint ventures or passive partnerships can be applied for private equity participations. The bank takes a share of the ownership of the organization and shares in the profits and losses. Partnership transactions are favoured by scholars because they are designed to share risk and reward, which is in line with Islamic economic thought. From the bank's perspective, the disadvantage lies in the effort required to ensure that all partners are comfortable with the way the project or company is run and its profitability. Regulators in some countries prefer banks not to take equity positions in companies because of the potential additional risk associated with non-arm's length trading.
- **Deferred payment transactions.** When including a financial institution in a deferred payment transaction, the bank purchases the asset against a cash payment from the seller and subsequently sells the asset to the buyer against future payment of the principal, plus a pre-agreed markup to be paid on a pre-agreed date. Typically, the bank instructs the seller to deliver the asset direct to the buyer although ownership is transferred to the bank before the asset is passed on to the buyer. This transaction type is particularly suited for working capital and export finance.
- **Leasing.** Leasing transactions are suitable when there is a need for a particular asset such as vehicles or equipment, but the company prefers to rent or lease the equipment rather than owning it outright with all the associated ownership risk. The bank purchases the asset and acts as the lessor. The client is the lessee and pays for the use of the asset.
- **Production finance.** Production finance transactions are suitable for financing assets that need to be manufactured or built. The bank in this case acts as an intermediary between the contractor and the ultimate buyer and facilitates the payments. Long-term production finance is usually applied to

construction and project finance transactions of a huge scale and is often combined with a lease.

The last three of the above can also be classified as predictable return structures and are preferred by banks and regulators because they do not require significant monitoring to ensure they receive the correct profit share.

Which mode is most suitable is, in addition, guided by taxation and legal issues in the jurisdiction where a company is operating.

When Islamic finance may or may not be the best choice

Parallels are often drawn between Islamic finance and socially responsible investing, which is also referred to as sustainable or ethical investing. Socially responsible investing encompasses an investment strategy that seeks to maximize both financial returns and socially responsible or ethical behaviour. Generally, people who make such ethical investment decisions rely on their faith and conscience.

Socially responsible investors also favour investments that promote environmental stewardship, consumer protection, human rights and diversity.

In addition, some investors actively avoid investing in businesses that involve alcohol, tobacco, gambling, and weaponry and defence. Sharia acknowledges the right of an individual to create wealth, but discourages hoarding, monopolistic activities and excessive materialism. Generally, sharia encourages social justice without hampering entrepreneurship.

Investors do not always have to be Muslim. The principles of sharia tend to fit in very well with non-Muslim investors seeking socially responsible investment opportunities and offer a viable alternative to other means available in the market. SMEs seeking funding do not have to be owned by Muslims either. However, the principles regarding the strength of the business plan and the value of the underlying assets do apply.

This section will review what SMEs need to be aware of if they are considering using Islamic financial services.

Prohibited industries

Within the framework of sharia, a number of industries are prohibited, and any SME which is involved in these industries will not be able to attract Islamic finance. Islamic finance is not available for the following industries:

- ❑ **Conventional banking and insurance.** Conventional banking and insurance are associated with interest and are therefore not permissible.
- ❑ **Alcohol and alcohol production.** This includes any distilling, marketing and sales activities.
- ❑ **Pork-related products and non-compliant food production.** Non-compliant food production covers everything which is not prepared in a halal way and includes meat which is not slaughtered in a fashion acceptable under halal.

- ❑ **Gambling.** This covers casinos and betting shops, but also bingo halls and online betting.
- ❑ **Tobacco.** As with alcohol, this includes the production, marketing and sales of tobacco and associated products.
- ❑ **Adult entertainment.** Any activity associated with adult entertainment, including escort services, brothels and movies with explicit sexual content, is prohibited.
- ❑ **Weapons, arms and defence manufacturing.**

In addition, Islamic financial institutions typically do not invest in the equity of companies that are highly leveraged using conventional financial instruments because of the interest component associated with the debt.

Transaction-type considerations

Given the size of an SME, its requirement for financing is typically not very high, and the issuance of corporate bonds or its Islamic finance alternative Sukuk would generally not be recommended.

The types of Islamic financial transactions that would be most suitable for an SME are detailed above in the section “Which transaction type?” An SME would benefit most from a standard financial solution, occasionally coupled with minor amendments to cater for specific company requirements.

Although it is the bank’s responsibility to ensure that the client is provided with all the required information to enable him to make the right decision regarding the transaction type, the level of funding, cost and other elements, the SME has also to take its own responsibility for ensuring the recommended financial solution is the right one.

As long as the company is not satisfied with the solution offered, the level of information provided or any element of the transaction or relationship, it will need to address the problem before entering into any contractual arrangement.

Other general considerations

Many of the reasons why Islamic finance might not be the right opportunity for an SME, or any other company, are very similar to the reasons for rejecting a conventional product offering.

Cost

The financing arrangement offered by any financial institution should not be prohibitive in cost. Whether it is a conventional or an Islamic bank offering, the cost should be competitive given the investment opportunity, size of the transaction, the bank’s cost of funds and the level of perceived risk. While SMEs typically require smaller financial solutions that are generally more expensive than larger transactions, bank charges should be competitive for the service the bank provides.

Purpose

The financial institution has a duty to ensure that the instrument offered is suitable for the purpose and meets the business requirements of the SME.

However, if the SME feels that the product offering does not meet its purpose, it has the responsibility for questioning the financial institution and ensuring that it becomes comfortable that its purpose will be met.

For example, a suggestion from a bank for an SME to issue a Sukuk as an instrument for raising US\$ 500,000 in financing would not be suitable. Sukuk are generally highly individual and geared to larger transaction sizes of US\$ 10 million and over. Not only would this transaction type not be fit for purpose, but it would also lead to an unacceptable increase in cost.

Information

The relationship between bank and client is two-way. Just as the bank requires the client to provide information about its business, so should the bank provide clear and sufficient information on charges, structures and the most appropriate transaction type. If the bank declines to provide this information, the client should consider changing to a financial institution it will be more comfortable with. The fact that an SME is small is not a valid reason for the bank to withhold information.

Legal and tax requirements

Legal and tax requirements that unnecessarily increase the cost of funding should in any case be avoided. Because Islamic finance is still a relatively young industry, the legal and tax frameworks do not always cater for Islamic transaction types. If the legal and tax framework do not facilitate such transactions, the SME is better guided to apply a conventional financial structure.

Chapter 3

Islamic microfinance: an emerging market niche¹

An estimated 72% of people living in Muslim-majority countries do not use formal financial services. Even when financial services are available, some people view conventional products as incompatible with the financial principles set forth in Islamic law. In recent years, some microfinance institutions (MFIs) have stepped in to service low-income Muslims who demand products consistent with Islamic financial principles – leading to the emergence of Islamic microfinance as a new market niche.

Islamic microfinance represents the confluence of two rapidly growing industries: microfinance and Islamic finance. It has the potential to not only respond to unmet demand but also to combine the Islamic social principle of caring for the less fortunate with microfinance's power to provide access to finance to the poor. Islamic microfinance is still in its infancy, and business models are just emerging.

The supply of Islamic microfinance is concentrated in a few countries, with the top three countries – Indonesia, Bangladesh and Afghanistan – accounting for 80% of global outreach. Nevertheless, demand for Islamic microfinance products is strong. Surveys in Jordan, Algeria and the Syrian Arab Republic, for example, revealed that 20% to 40% of respondents cite religious reasons for not accessing conventional microloans.

This chapter provides an overview of the Islamic microfinance sector and identifies possible challenges to its growth.

Box 1. Basic Islamic microfinance contracts

There is only one type of permissible “loan” according to sharia: the Qard-Hassan (or benevolent) loan, which is interest-free and often considered a form of charity because it is typically forgiven in the event of default. All other mechanisms are better termed financing agreements, or contracts. However, for the purposes of this chapter, the term “loan” may be used to denote financing arrangements within the sharia context.



¹ This material is an edited excerpt of “Islamic Microfinance: An Emerging Market Niche,” by Nimrah Karim, Michael Tarazi and Xavier Reille. Chapter 49. Washington, D.C.: CGAP, August 2008. Printed with the permission of the publisher.



The following are the most widely available types of Islamic microfinance contracts. Each can either operate individually or be combined with other contracts to create hybrid instruments.

- *Murabahah sale (cost plus financing contract).* The most widely offered sharia-compliant contract is *Murahahah*, an asset-based sale transaction used to finance goods needed as working capital. Typically, the client requests a specific commodity for purchase, which the financier procures directly from the market and subsequently resells to the client, after adding a fixed “markup” for the service provided.

It is permissible for the financial institution to appoint the client as an “agent” on its behalf (by means of a contract) to directly procure the commodity from the market. However, ownership of the commodity (and the risk inherent thereto) strictly lies with the financier until the client has fully paid the financier. In most cases, clients repay in equal instalments.

The markup is distinct from interest because it remains fixed at the initial amount, even if the client repays past the due date. Among the primary conditions for a *Murahahah* sale to remain sharia-compliant are: (i) the financier must own the commodity before selling it, (ii) the commodity must be tangible, and (iii) the client must agree to the purchase and resale prices.

- *Ijarah (leasing contract).* *Ijarah* is a leasing contract typically used for financing equipment, such as small machinery. Duration of the lease and related payments must be determined in advance to avoid speculation. For the transaction to be considered Islamic (and not a sale with camouflaged interest), the *Ijarah* must specify that ownership of the asset, and responsibility for its maintenance, remains with the financier. It contract may be followed by a sale contract, in which event ownership of the commodity is transferred to the lessee.
- *Musharakah and Mudarabah (profit and loss sharing).* The profit and loss sharing (PLS) schemes are the Islamic financial contracts most encouraged by sharia scholars.

Musharakah is equity participation in a business venture, in which the parties share the profits or losses according to a predetermined ratio. It can be used for assets or for working capital.

Mudarabah denotes trustee financing, in which one party acts as financier by providing the funds, while the other party provides the managerial expertise in executing the project. Profits are shared according to a predetermined ratio; any losses are borne entirely by the financier.

If the *Mudarabah* joint venture results in a loss, the financier loses the contributed capital and the manager loses time and effort. Both PLS schemes require particularly vigilant reporting and a high level of transparency for profits and losses to be distributed justly. Consequently, though promoted strongly by sharia, they result in substantial operating costs particularly for micro and small enterprises that are not accustomed to formal accounting.

- *Takaful (mutual insurance).* The equivalent of Islamic insurance, *Takaful* is a mutual insurance scheme. The word originates from the Arabic word “*kafalah*,” which means guaranteeing each other or joint guarantee. Each participant contributes to a fund that is used to support the group in times of need, such as death, crop loss or accidents. Paid premiums are invested in a Sharia-compliant manner to avoid interest.

Box 2. How do savings work?

Islamic savings products are deposits that are invested pursuant to the principles set forth in this chapter. A typical savings product is a form of Mudarabah, in which the saver “invests” a deposit in the business of a financial institution. The financial institution invests its managerial expertise and intermediates the deposits/investments in a sharia-compliant manner. Profits (or losses) are shared pursuant to prior agreement.

Such a savings arrangement could be considered a form of Musharakah because other depositors are also depositing funds for investment in the same financial institution. Even Takaful can operate as a savings product because premiums are invested in a sharia-compliant manner and are often disbursed at the end of an agreed term, regardless of any insurance claim.

Development of the Islamic finance industry

Global expansion

Despite its origins in the Gulf, sharia-compliant banking has proved popular with Muslims in other countries as well, leading to the development of new Islamic banks across North Africa and Asia. Of the total US\$ 500.5 billion global Islamic finance market, 36% is located in Gulf Cooperation Council (GCC) countries (Bahrain, Kuwait, Oman, Qatar, Saudi Arabia and the United Arab Emirates), 35% in non-GCC Southwest Asia and North Africa, and 23% in Asia (primarily Malaysia, Brunei Darussalam and Pakistan).

Over time, Islamic financial services also have expanded well beyond the Muslim world and are offered not only by Islamic banks, but also by Islamic subsidiaries of international financial institutions. Islamic financial services are currently available in India, China, Japan, Germany, Switzerland, Luxembourg, the United Kingdom, the United States and Canada.

The United Kingdom, which was ranked tenth on The Banker’s list of “Top 15 Countries by Sharia-compliant Assets” in 2007, has recently announced its aim to make London a global centre for financial markets in the Muslim world.

Government regulation

Islamic financial services originally operated in an unclear regulatory landscape. However, as they expanded, they presented several regulatory challenges that governments have attempted to address to various degrees. One approach has been to ... encourage, even mandate, Islamic financial services by law.

Northern Sudan, for example, adopted sharia-compliant regulatory frameworks for the entire banking sector in 1984. Indonesia broke new ground in the realm of Islamic finance by creating in 1992 a formal, regulated sharia banking sector alongside, and not instead of, its conventional banking sector. New

regulations in Malaysia, Brunei Darussalam and Pakistan have also supported the expansion of an Islamic finance industry alongside conventional financial services.

Another regulatory approach addressed growth by separately regulating unique aspects of Islamic banking via sharia supervisory boards (SSBs). For example, several countries such as Kuwait, Jordan, Lebanon and Thailand have regulated the competence and composition of SSBs, as well as related rules governing the appointment, dismissal and qualifications of SSB members.

However, no country is known to regulate the sharia jurisprudence to be used by SSBs in judging sharia compliance (though Jordan and Kuwait do impose SSB member unanimity or majority vote requirements).

International organizations

In parallel with increased attention by regulatory authorities, international organizations have been set up to create Islamic finance accounting and other standards:

❑ Islamic Financial Services Board (IFSB)

Based in Malaysia, it issues prudential standards and guiding principles for Islamic finance. IFSB has issued guidelines on risk management and capital adequacy for Islamic banks.

❑ Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI)

Based in Bahrain, it promotes financial reporting standards for Islamic financial institutions.

❑ Islamic Development Bank (IDB).

A multilateral body headquartered in Saudi Arabia, it fights poverty and promotes economic development in Islamic country members. It promotes microfinance and poverty alleviation programmes through its Islamic Solidarity Fund for Development (ISFD), which recently committed US\$ 500 million to microfinance development through its microfinance support programme.

Despite a shared core of Islamic values, these institutions often diverge from national regulators – and each other – over sharia standards. For example, AAOIFI standards are mandatory in only a handful of countries and are selectively implemented elsewhere.

Islamic microfinance

Demand

Conventional microfinance products have been successful in Muslim-majority countries. One of the earliest microfinance programs originated in Bangladesh with the setting up of Grameen Bank, initiated by Nobel Prize winner Muhammad Yunus. Islamic countries such as Indonesia and Pakistan

have a vibrant microfinance industry; approximately 44% of conventional microfinance clients worldwide reside in Muslim countries. Yet, conventional microfinance products do not fill the needs of many Muslim clients.

Just as there are mainstream banking clients who demand Islamic financial products, there are also many poor people who insist on these products. Indeed, sharia compliance in some societies may be less a religious principle than a cultural one – and even the less religiously observant may prefer sharia-compliant products.

A number of market studies commissioned by the International Finance Corporation (IFC) suggest strong demand for Islamic microfinance products. In addition Bank Indonesia report in 2000 indicated that 49% of the rural population of East Java considered interest prohibited and would prefer to bank with sharia-compliant financial institutions.

Although there is a market of poor clients who strictly engage in Islamic transactions, there is also a category of Muslim clients who use conventional products but prefer Islamic ones. Microfinance practitioners in Muslim-majority countries indicate that in Afghanistan, Indonesia, the Syrian Arab Republic and Yemen, some conventional microborrowers tend to switch over once Islamic products become available.

Government promotion of Islamic microfinance

As in the case of the larger Islamic banking industry, government regulation can play a significant role in the expansion of sharia-compliant microfinance.

Indonesia

The Government has actively promoted Islamic microfinance. In 2002, Bank Indonesia prepared a “Blueprint of Islamic Banking Development in Indonesia”, in which it outlined a nine-year plan for the development of the Islamic finance sector, including support for the 105 sharia rural banks.

Indonesia now provides a supportive regulatory framework and has licensed 35 new Islamic rural banks in the past five years. Bank Indonesia is also spearheading efforts in capacity building by establishing a centre in Medan to offer training in and certification on Islamic financial operations to sharia rural bank staff, managers and directors.

Pakistan

The State Bank of Pakistan, which already has a legal and regulatory framework in place for conventional MFIs, also developed guidelines in 2007 for the rapid expansion of Islamic microfinance. The guidelines stipulated four types of institutional arrangements for offering Islamic microfinance, i.e., via: (i) the creation of Islamic microfinance banks, (ii) Islamic banks, (iii) conventional banks and (iv) conventional microfinance banks.

The guidelines set forth requirements regarding licensing, appointment of sharia advisers to rule on sharia compliance, and segregation of Islamic product funds (and related documentation) by banks and MFIs that offer both conventional and sharia-compliant products.

Banks downscaling and expanding product line

An encouraging development in the growth of Islamic microfinance is that Islamic commercial banks have started to offer Islamic microfinance services. Yemen's Tadhamon International Islamic Bank, for example, set up a micro-and small enterprises division in late 2006. In addition, some Islamic banks are planning to offer Islamic microfinance products beyond just microcredit.

On 20 January 2008, Noor Islamic Bank and Emirates Post Holding Group announced plans to establish a company offering sharia-compliant banking services to the low-income segment of the population of the United Arab Emirates. The proposed company would provide a wide array of Islamic microfinance products, including microcredit, insurance, debit and credit cards, remittance and currency exchange, and salary payments.

Also in January 2008, Allianz Life Indonesia announced that, after an 18-month pilot project, the sharia-compliant microinsurance "Family Umbrella" product would become an established line.

Islamic microfinance: CGAP survey results

The Consultative Group to Assist the Poor (CGAP) conducted a global survey on Islamic microfinance in 2007, collecting information on over 125 institutions and contacting experts from 19 Muslim countries. This section presents the principal findings of this first global survey on the performance and outreach of Islamic microfinance.

Limited outreach

The outreach of Islamic finance is limited. According to the CGAP survey, Islamic MFIs reach 300,000 clients through 126 institutions operating in 14 countries and an estimated 80,000 clients through a network of Indonesian cooperatives. According to the survey, Bangladesh has the largest Islamic microcredit outreach, with over 100,000 clients and two active institutions. However, it is also the country where conventional microfinance products have the largest outreach – nearly eight million borrowers – and Islamic microfinance represents only 1% of its microfinance market.

In Muslim countries, Islamic microfinance still accounts for a tiny portion of the total microfinance outreach. For example, in the Syrian Arab Republic and Indonesia, Islamic financing instruments comprised only 3% and 2%, respectively, of outstanding microfinance loans in 2006.

The supply of Islamic microfinance is concentrated in a few countries. Indonesia, Bangladesh and Afghanistan account for 80% of the global outreach of Islamic microfinance. In all other countries, microfinance is still in its infancy, with no scalable institutions reaching clients on a regional and national level. For most countries, the average Islamic microloan amount (with respect to primarily the Murabahah product) is similar to conventional microloans.

Like conventional microfinance, Islamic microfinance tends to focus on female clients – a majority of Islamic MFI clients according to the CGAP survey were women (59% on average, but up to 90% in Bangladesh). Overall, the percentage

of female clients using Islamic microfinance products (59%) is comparable to those using conventional microfinance products (65.7% globally, and 65.4% in the Arab world).

Box 3. A look at the Islamic Republic of Iran

The Iranian Government requires all of its commercial banks to provide sharia-compliant non-interest-bearing loans to the low-income population. Typically, these loans are disbursed to cover personal expenses such as wedding costs, repayment of outstanding debts, home rental and repair costs, medical expenses, tuition fees and the purchase of consumer goods.

Outreach is significant and, as at March 2008, the Central Bank of Iran estimated that three million families benefited from approximately 6 000 Qard Hasan institutions (“benevolent loan funds” known in the country as Qarzul-Hassaneh funds), with a total outstanding loan amount of Rls 50 trillion (US\$ 5.5 billion).

However, Qarzul-Hassaneh Funds are most often considered charities, and not MFIs, because loans are typically: (i) made for large one-time expenditures; and (ii) forgiven in the event of default. They are not generally considered to provide access to finance in a sustainable manner.

Outside the Qarzul-Hassaneh Funds, microfinance in the Islamic Republic of Iran is informal, though a number of originally charitable organizations have reportedly started microfinance operations.

Table 2. Outreach of Islamic microfinance, by country

Region	No. of institutions included	% female (average)	Total no. of clients	Total outstanding loan portfolio (US\$)	Average loan balance (US\$)
Afghanistan	4	22	53 011	10 347.290	162
Bahrain	1	n.a.	323	96.565	299
Bangladesh	2	90	111 837	34 490.490	280
Indonesia*	105	60	74 698	122 480.000	1.640
Jordan	1	80	1 481	1 619.909	1.094
Lebanon	1	50	26 000	22 500.000	865
Mali	1	12	2 812	273.298	97
Pakistan	1	40	6 060	746.904	123
West Bank and Gaza**	1	100	132	145.485	1.102
Saudi Arabia	1	86	7 000	586.667	84
Somalia	1	n.a.	50	35.200	704
Sudan	3	65	9 561	1 891.819	171
Syria(n Arab Republic)	1	45	2 298	1 838.047	800
Yemen	3	58	7 031	840 240	46
TOTAL	126	59	302 303	197 891.882	541

* Micro and rural banks only.

** There were seven MFIs in the West Bank and Gaza that offered, with the help of training and funding facilities offered by the Islamic Development Bank, a total of 578 Islamic loans between 2005 and 2006. Data on only one of these seven are displayed in the table because the remaining six MFIs were disbursing Islamic loans with average loan sizes higher than 250% of the region’s gross domestic product per capita.

Finally, the CGAP survey identified that over 70% of the products offered are Murabahah. Islamic MFIs generally offer only one or two sharia-compliant products. Concentrating primarily on asset financing, the industry still lacks product diversification to serve the various financial needs of the poor.

Table 2 includes outreach on only the institutions that CGAP was able to contact during its survey, except those in Indonesia (where information was obtained from Bank Indonesia's 2007 statistics) and in the West Bank and Gaza (where information was provided by the Deprived families Economic Empowerment Program or DEEP. The table excludes the outreach of Indonesia's 4 500 Islamic cooperatives. However, according to experts in Indonesia, only 60% of these Islamic cooperatives are still active, and their total outreach is estimated at 80 000 clients.

As in the rest of this chapter, an MFI is defined as an institution targeting the poor and whose average loan size is less than 250% of the country's gross domestic product per capita.

Islamic microfinance by institution type

Among the institutions that offer Islamic microfinance products, non-governmental organizations (NGOs) are the dominant players in terms of reaching the largest number of clients, with just 14 institutions reaching 42% of clients. Commercial banks (represented by only two institutions, Yemen's TIIB and Bangladesh's Islami Bank Bangladesh) have the second-largest outreach with over 87,000 clients.

Interestingly, the 105 sharia-compliant rural banks in Indonesia account for 25% of total clients, but 62% of the outstanding loan portfolio because of their significantly higher average loan size and focus on small and micro-enterprise financing.

Institution type	No. of institutions	Total no. of clients		Total outstanding loan portfolio (Islamic)		Average loan size (Islamic) US\$
		No.	% of total	US\$	% of total	
Cooperative	1	6 671	2	926 251.00	<1	132
Village bank (Syrian Arab Rep.)	1	2 298	1	1 838 047.00	<1	800
NGO	14	125 793	42	41 421.58	21	303
Rural bank (Indonesia)	105	74 698	25	122 475.158	62	1 640
NBFI	3	4 293	1	1 893.207	<1	595
Commercial bank	2	87 569	29	29 030.997	15	305
TOTAL	126	305 237	100	198 090.268	100	629

Notes: This table reflects the data of only those institutions (mixed and fully Islamic) that provided reliable outreach information to CGAP during its 2007 global survey of Islamic microfinance. Data regarding the 105 rural banks in Indonesia were obtained from the Indonesian Central Bank's 2007 Statistics. This table excludes data on the outreach of Indonesia's 4,500 cooperatives. As in the rest of this chapter, an MFI is defined as an institution targeting the poor and whose average loan size is less than 250% of the country's gross domestic product per capita.

Focus on Indonesia

Indonesia gives an insight into the development of Islamic microfinance because of its dual conventional/Islamic microbanking system, which includes both conventional rural banks (Bank Perkreditan Rakyat or BPRs) and sharia-compliant rural banks (Bank Perkreditan Rakyat Syariah or BPRSs). The latter are privately owned and regulated and supervised by Bank Indonesia. They are licensed to offer banking services (loans and savings facilities, but no payment services) in a district area only. As of December 2006, there were 1 880 BPRs and 105 BPRSs.

BPRSs are more socially oriented than BPRs. Their mission statement calls for supporting the community, in particular micro-entrepreneurs. They also have strong links with Indonesian Muslim mass movements such as Nahdlatul Ulama or Mohammedia. Each BPRS has a sharia board to monitor the conformity of products to Islamic principles. However, board rulings are not consistent, and consequently, Islamic microfinance products can vary widely depending on the specific BPRS. BPRSs primarily offer Murabahah products and savings services based on a revenue-sharing model. They have been quite successful at mobilizing savings for the community, and their loan-to-deposit ratio is higher than 110%.

BPRSs are still young institutions without a proven track record. It is too early to draw conclusions on BPRS profitability; however, several factors might explain a lower return on assets (ROA), including the social mission of BPRSs.

BPRSs are meeting a growing demand for sharia-compliant microfinance products. Their rate of growth has been impressive: from March to December 2007, Murabahah receivables increased by 26%, Musharakah financing rose by 27% and Mudarabah financing climbed up by almost 50% (Bank of Indonesia data). BPRSs can be profitable but nevertheless, like many microfinance providers, they face several challenges in reaching sustainable scale.

Possible challenges to the growth of Islamic microfinance

Islamic microfinance has the potential to expand access to finance to unprecedented levels throughout the Muslim world. However, the industry has yet to demonstrate it can provide financial services that meet the needs of poor people on a large scale. A deeper base of market research and proven business models are much needed. Nevertheless, several possible challenges to scale up Islamic microfinance can be identified.

Islamic microfinance business models are still being developed and no performance benchmarks have been established. However, two areas are of particular importance: operational efficiency and risk management.

□ **Operational efficiency.** This is key to providing affordable financial services to the poor. Managing small transactions is expensive, and MFIs must innovate to reduce transaction costs.

In Murabahah or Ijarah transactions, the provider of funds purchases a commodity (such as equipment or inventory) and resells or leases it to the user with a markup. Islamic MFIs may benefit from cheaper prices on the wholesale market, but the costs associated with purchasing, maintaining, selling or leasing a commodity (such as a sewing machine) are expensive, and

the added costs are often passed on to clients. However, some institutions have cut their costs in Murabahah transactions by requiring the end user to search for and identify the desired commodity. Islamic institutions should consider developing similarly novel techniques and practices to minimize costs and offer more attractive pricing to their clients.

- ❑ **Risk management.** Risk management is another important factor in building sustainable institutions. The conventional microfinance industry has developed a set of good practices to manage credit risk, and MFIs boast excellent portfolio quality.

Conventional MFIs generally do not secure loans through collateral but instead rely on peer pressure and strict discipline for collection. Such techniques should be adapted to comply with the risk-sharing and no-interest principles embedded in Islamic finance.

The question of authenticity

Although there is ample evidence of demand for Islamic microfinance products, meeting such demand requires that low-income clients are comfortable that the products offered are authentically Islamic. Critics of Islamic finance products suggest that the pricing of some products offered as sharia-compliant too closely parallels the pricing of conventional products.

For example, some institutions offer Murabahah where interest appears to be disguised as a cost markup or administration fee. Islamic finance sometimes suffers from the perception that it is simply a “rebranding” of conventional finance and not truly reflective of Islamic principles.

For low-income segments of society religious leaders often serve also as advisers on Islamic finance and therefore are able to provide guidance on the authenticity of Islamic financial product.

Greater efforts should be explored to: (i) increase collaboration between financial experts and sharia experts on product authenticity; (ii) encourage exchange of experiences among religious leaders (particularly those serving poor populations at the local level) relating to sharia compliance of microfinance products; and (iii) educate low-income populations, in collaboration with local religious leaders, on how financial products comply with Islamic law.

Building capacity

Capacity building is needed at all levels to realize the full potential of Islamic microfinance. At the macro level, the Islamic Development Bank and Islamic financial standard setters (such as IFSB or AAOIFI) should consider developing global financial reporting standards adapted to microfinance to build the infrastructure for transparency in the global Islamic microfinance sector. This infrastructure would entail comprehensive disclosure guidelines on Islamic microfinance accounting principles, pricing methodologies, financial audits and, eventually, rating services.

At the micro- and institutional levels, international donor agencies can play a major role in expanding access to finance in Muslim countries by helping existing institutions reach scale and funding pilot projects testing various

business models. In addition, more efforts should be made to train Islamic MFI managers and staff through, for example, the development of operational tools and manuals (such as those developed by Deutsche Gesellschaft für Technische Zusammenarbeit, or the German Agency for Technical Cooperation, for use in Indonesia).

Product diversity

Islamic MFIs rely heavily on the Murabahah product. However, poor people have diverse financial requirements and, for many, savings or housing products may be more urgent needs. The innovative design of a range of sharia-compliant products and services would provide greater financial access to a broader segment of Islamic microfinance customers.

Leveraging Zakat and Islamic funds

Throughout the Muslim world, microfinance (Islamic or otherwise) is still seen as a philanthropic activity rather than a business enterprise. Consequently, in the context of Islamic microfinance, there is a growing tendency to view *zakat* (funds donated pursuant to the Muslim obligation to pay alms) as a source of funding.

Indeed, given the underlying principle of Islamic finance to promote the welfare of the community, *zakat* funds appear ideally suited to support Islamic microfinance. However, a heavy reliance on charity is not necessarily the best model for the development of a large and sustainable sector, and more reliable, commercially motivated streams of funding should be explored.

Chapter 4

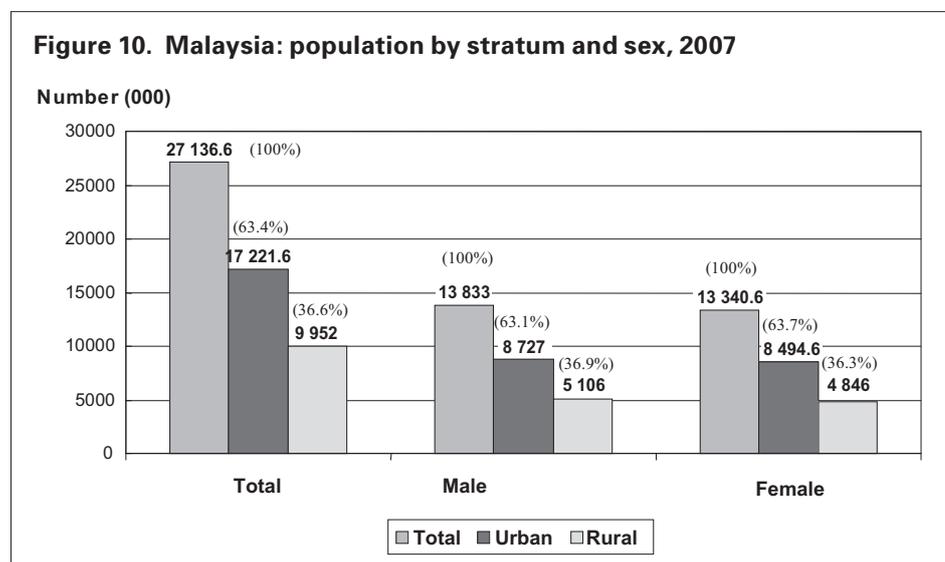
Islamic banking for women: a case study

More than half of the Malaysian population is made up of women and statistics show that female university graduates outnumber males in various sectors. Women are also increasingly found in professional and managerial jobs, particularly in the public sector. Government policies, programmes and strategies for gender mainstreaming make it likely that these trends will continue.

At the same time, not much has been done to cater to the financial needs of women. This market offers considerable possibilities.

This chapter looks first at the gender breakdown of population and occupations in Malaysia and then at developments in banking for women.

As can be seen in figure 10, the proportions of men and women residing in urban and rural areas are similar. High population in urban areas probably reflects employment opportunities.



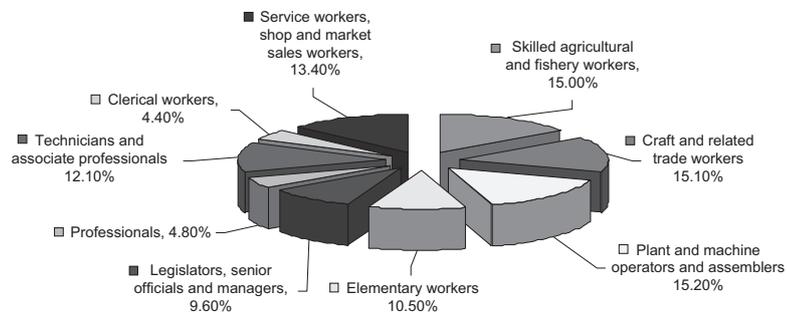
Source: Ministry of Women, Family and Community Development, Malaysia.

Occupational structure

In the employment market, more women have been moving into managerial and professional positions. Figures 11 and 12 illustrate the distribution of male and female employment in Malaysia in 2006, categorized by occupation.

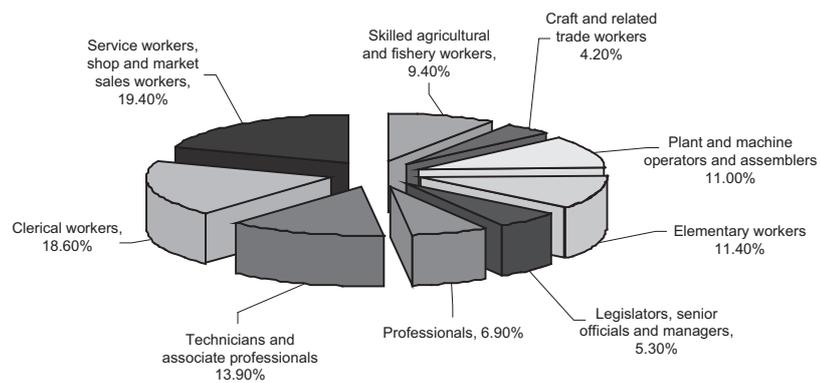
Both figures show that the proportions of male and female employment in managerial and professional jobs are similar. In terms of gender proportion, it is 26.5% and 26.1% for males and females respectively.

Figure 11. Malaysia: distribution of male employment by occupation, 2006



Source: Ministry of Women, Family and Community Development, Malaysia.

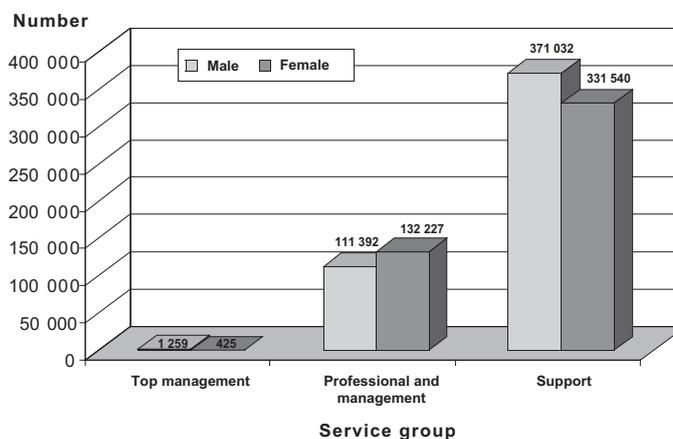
Figure 12. Malaysia, distribution of female employment by occupation, 2006



Source: Ministry of Women, Family and Community Development, Malaysia.

In the public sector, women hold 54.3% of professional and management positions, compared with 45.7% for men (see figure 13).

Figure 13. Malaysia, public-sector personnel by service group and sex, 2006



Source: Ministry of Women, Family and Community Development, Malaysia.

Note: Data exclude armed forces and police force.

Tables 4 and 5 show that women have increased their representation in senior positions in the private sector, although there remains scope for progress.

With more women joining the ranks of managers and professionals, there is potential for developing women's banking.

Table 4. Malaysia, women at decision-making level in the public sector, 2007

Position	2007			
	Total	Male	Female	% Female
Secretary-General	27	23	4	14.8
Director General (federal)	68	60	8	11.8
Chief Executive (federal statutory bodies)	64	55	9	14.1

Source: Ministry of Women, Family and Community Development, Malaysia.

Notes: As at 25 July 2007. Bursa Malaysia.

Table 5. Malaysia, women at decision-making level in the corporate sector, 2007

Position	2001	2002	2003	2004	2005	2006	2007
	% Female						
Members of Board of Directors	10.1	10.5	10.1	9.9	10.2	7.6	5.3
President, Vice-President, Managing Director, Chief Executive Officer, Chief Operation Officer, Senior General Manager, General Manager	12	12.1	12.3	13.5	13.9	14.3	24

Source: Ministry of Women, Family and Community Development, Malaysia.

Notes:

1. As at 25 July 2007.

2. Based on survey by Ministry of Women, Family and Community Development (MWFC) on 50 companies listed under Bursa Malaysia.

Investment habits of women

Research by the Ministry of Women, Family and Community Development in 2005 on female investment habits showed that about 38.7% of investments were made through the employment provident fund. About 69% kept their money in savings accounts while 39.9% continued to invest in gold, silver or jewellery.

Women were also more inclined to keep their income in savings accounts as a form of investment, which act as a buffer against unexpected incidents. This type of saving provides low returns compared with investment in real estate and ownership of stocks or businesses. The research also indicated that women's tendency to spend now and save later stood at 66.1%. For big ticket items, about 27.3% saved to buy real estate and 26.8% for cars.

It has also been demonstrated that women's top priority in savings and insurance, or Takaful, are their children's health and education – less priority is given to themselves. Women are also generally vague about coping strategies in times of hardship or calamity.

The findings show that women routinely handle financial responsibilities, including daily budgeting, credit financing and managing debt for themselves and the family. However, they are less likely to engage in investment activities, despite the potential returns.

Need for Islamic banking for women

Women's economic role

Women are increasingly playing leading roles in business, including fields traditionally viewed as male bastions. Moreover, women are a major driving force in the economy. According to some studies, they make a majority of the choices relating to purchases on credit and investments.

Multitasking

As more and more women have careers and hold well-paid jobs, the tradition of women being looked after financially by their father, husband or brother has changed dramatically. With this financial independence, however, also come new challenges in financial decision-making.

Generally, women are more concerned with their money cash flow than men. For banks, there are opportunities to be had in catering to women's specific needs, particularly as the number of women with a high net worth is growing. This can involve providing dedicated financial consultants to manage women's financial matters, not only personal wealth management but also credit, investment and potential business requirements.

Financial planning

Although there is confusion surrounding the concept of financial planning, essentially it is about the management of one's finances and planning of investments, with the goal of sustaining and growing long-term wealth. Financial planning, therefore, should start as early as possible. At each stage, there are new challenges. For a young woman who has just landed her first job, the priority might be purchasing something for herself. Others might be helping out with the household bills or their siblings with their education.

When a woman enters marriage, her needs and priorities might change. A new addition to the family will also see the need for the couple to make adjustments to meet increasing current and future financial requirements, including education, medical outlays, insurance and setting aside for rainy days.

Financial and investment plans need to be flexible enough to anticipate and adapt to change.

Women as entrepreneurs

In Malaysia, as in other developing countries, women have been the backbone of small and medium-sized enterprises.

The Malaysian Government has taken measures to facilitate the involvement of women in business through the provision of access to capital. The Women Entrepreneurs Fund, for example, was established in 1998 with an allocation of RM 10 million (US\$ 2.76 million). A bank for SMEs with a special window for women entrepreneurs has also been set up.

Moreover, there are training and development courses to assist women in becoming successful entrepreneurs. These include courses in business management, marketing, sales, packaging and labelling, as well as manufacturing practices and business networking.

Az Zahra privilege ladies banking

Acknowledging the growing needs of today's women, RHB Islamic Bank launched Az Zahra Privilege Ladies Banking in April 2008. Comprising a set of privilege banking services for women with a high net worth, it is the first such service in Malaysia. Adapted from the name of Prophet Muhammad's daughter, Saidatina Fatima Az Zahra RA, Az Zahra means "the shining one".

Concept and strategy

Given that women are becoming more visible in the market, the concept allows RHB Islamic Bank to serve their growing financial and banking needs. Another key aspect is that in many areas, women and men are segregated. Services provided to women can be tailored, with their banking needs seen to by an all-female staff.

RHB Islamic conducted research on banks in the United Arab Emirates, particularly in Dubai and Abu Dhabi, in November 2007. Its findings on the presence of women banking in the Emirates are shown below:

Islamic banks	Presence of women's branches
Dubai Islamic Bank	Yes
Abu Dhabi Islamic Bank	Yes
Emirates Islamic Bank	No
Conventional banks	Presence of women's branches
Abu Dhabi Commercial Bank	No
First Gulf Bank	No
Emirates Bank	No

For women-only banks, it found that:

- The branches are not just open only to customers with a high net worth.
- The set-up is similar to that of a normal branch. In some spacious branches, there is a customer seating lounge where drinks are provided. A children's play area has been set up at one branch.
- No men, including male staff, are allowed. If male staff wish to visit the branch, they first need to inform the branch.

- ❑ The branches are staffed by women and headed by a female branch manager.
- ❑ There is no standard attire for the staff.

Customer profile

Based on its analysis, RHB Islamic drew up its own banking concept. While catering exclusively for women, the bank intended to start with selected women clients with high net worth with a view to future expansion into a full-scale women's branch open to all women.

The bank's women's section targets women at the executive and professional level, as well as businesswomen and those with a high net worth. Existing female customers of RHB Group customers that might be interested are identified. These can include gold and platinum card holders and those with substantial automobile or home financing as well as Infinity Banking members and female executives.

Products and services offered

Under the Islamic banking arm of RHB Banking Group, Az Zahra offers a customized set of sharia-based products and services for women. Such customers receive personalized and confidential services, access to RHB Islamic's dedicated Privilege Ladies Banking lounge and products at preferential rates and discounts.

Among the new privilege financing services are:

- ❑ Az Zahra Equity Home Financing-i;
- ❑ Az Zahra Mudarabah Current Account-i;
- ❑ Az Zahra Mudarabah General Investment Account-i;
- ❑ Az Zahra Hire Purchase-i.

Az Zahra Equity Home Financing-i

Using the concept of Musharakah *Mutanaqisah* or diminishing partnership, this service enables the customer to enter into a co-ownership agreement with the bank to own a house. As one of the partners, the customer's share of the property will progressively increase, until the customer finally acquires full ownership.

The minimum amount is RM 250 000 (US\$ 70,000) for a financing period of 30 years, with free acquisition cost. Benefits include Takaful coverage with extra term, flexible payment plans, longer tenure and convenience of payment at more than 196 RHB Bank and RHB Islamic branches and 540 ATMs (automated teller machines).

Az Zahra Mudarabah Current Account-i

Funds provided by the customer will be invested in activities that are permissible under sharia. The profit gained from these investments will then

be shared between both parties at a predetermined profit-sharing ratio (PSR). The initial deposit for a higher PSR is RM 50 000 (US\$ 14,000).

Benefits include a dividend paid monthly on the daily balance at a predetermined PSR, free Takaful personal accident protection up to RM 100 000 (US\$ 28,000) and a 25% discount on commission fees for traveller's checks from the bank.

Az Zahra Mudarabah General Investment Account-i

Capital provided by the customer will be invested for a fixed duration. The profit earned will be shared as dividends between the customer and the bank according to a predetermined PSR.

Az Zahra Hire Purchase-i

Based on the *Ijarah Thumma Bai* (hire purchase) concept, this allows customers to hire, and subsequently purchase, a car. The customer who purchases a car of a premium brand will enjoy attractive financing rates with special Takaful coverage. The minimum financing amount is RM 150 000 (US\$ 41,543).

At Az Zahra, the women's banking section is equipped with share trading and Bloomberg terminals, internet browsing, media displays, magazines, daily newspapers and journals, with ample seating. Furthermore, existing customers with aggregate deposits of at least RM 50 000 automatically qualify as Az Zahra members. The Az Zahra Privilege Ladies Banking is open to all Malaysians.

RHB Islamic is targeting RM 22 million (US\$ 6.09 million) and RM 24 million (US\$ 6.64 million) of project financing and deposits, respectively, during the first year of Az Zahra's operation. Az Zahra lounges can be found at its main branch in Kuala Lumpur, Johor and Kelantan. Expansion plans for other branches are under way.

Banking for women in other countries

Masrafy Bank, Bahrain

In June 2006, the Bahrain Monetary Agency granted Abu Dhabi Investment House (ADIH) a licence to open the world's first Islamic investment bank for women, with an authorized capital of US\$ 1 billion and a paid-up capital of US\$ 500 million.

The bank, which was to be known as Masrafy and located at the Bahrain Financial Harbour, targeted wealthy women in the region, providing Islamic banking products and wealth management services.

"Many banks provide commercial banking services for the region's women, but we do not have a bank dedicated to them for investment services and products. We consider Masrafy as the first bank in this field, which will be run by women banking experts with high qualifications, offering women an

opportunity to take part in regional investments,” said Rashad Yousef Janahi, Chief Executive Officer of (CEO) ADIH.

Masrafy targets women investors who tend to shy away from investments for lack of privacy. The CEO said Bahrain was chosen because it is considered the region’s financial hub and centre of Islamic banking. Recent years have seen women playing a major role in the finance and business sectors, with studies showing that women in the region hold funds worth US\$ 38 billion, he added.

Masrafy has linked up with international banks for asset management and other banking services. The bank will also tie up with institutions for risk management and deploy corporate governance practices. The shareholders of Masrafy are individuals with high net worth and financial institutions such as Qatar Islamic Bank and Kuwait Investment Company.

Emirates Islamic Bank, United Arab Emirates

In June 2007, Emirates Islamic Bank (EIB) launched Al Reem, a specialized banking service dedicated to women. Al Reem offers staff consisting only of women, exclusive lounges and service areas, a discount on bank products, discounts at retail outlets, a chip-based debit card, customized chequebook, a road side assistance programme and invitations to attend women-only social events.

Further opportunities

With the growing demand for Islamic finance and increasing numbers of women who work and are of high net worth, Islamic banking for women offers considerable future opportunities.

However, in moving forward the focus should not only be on the high end of the economic spectrum. There are also opportunities involving those with lower incomes and savings. These could follow in the footsteps of the successful Grameen Bank, which pioneered microcredit in developing countries. Its founder, Professor Muhammad Yunus received the Nobel Peace Prize in 2006. Grameen’s success in extending financial services to the rural poor has led to similar schemes by other institutions. Given that most of those borrowing from Grameen are women, there would seem to be considerable scope for Islamic banking targeted at the less well-off.

Part Two

USING ISLAMIC FINANCE

Introduction

Islamic banking, although still small in size and offerings, is evolving and growing at a rapid rate. The market for Islamic financial products grew by more than 20% a year² in 2007 and 2008. The total size of Islamic banking assets at the end of 2007 was estimated at about US\$ 580 billion;³ another US\$ 300 billion was invested in Islamic mutual funds; and the Sukuk or Islamic bond market represented over US\$ 100 billion of assets.⁴

Two general causes are behind the growth of this sector. First, the increase in Muslim populations and revival of the faith have led to an organic demand for Islamic finance. Second, the growing support of key governments such as those of Bahrain and Malaysia to provide a well-structured regulatory environment has allowed the incubation of new Islamic financial tools to meet consumer and business needs within sharia rules.

In the late twentieth century a number of banks began offering Islamic financial products within Muslim and western countries. An important focus of Islamic finance has always been to support import and export finance. This offering included a number of conventional banks with Islamic windows as well as stand-alone Islamic institutions. Today, it is not unusual to see conventional banks in key markets like Bahrain or Malaysia offering Islamic services alongside their conventional products to cater to the demands of their Muslim clients.

In the last decade, there has been a persistent increase in activity in the Islamic finance sector in GCC countries and in Southeast Asia (notably the countries of the Association of Southeast Asian Nations or ASEAN). In the Gulf alone, a number of new Islamic banks have emerged and several conventional banks have converted or are in a process of converting.⁵

This part of the book provides an introduction to Islamic banking products and a comparison to its counterparts. It reviews the principles of Islamic finance and banking, including the tools and methodologies currently utilized by Islamic banking and financial institutions within the context of trade finance. The book is intended to serve as a user's guide to managers of micro-, small and medium-sized enterprises (SMEs) in seeking financial alternatives for their banking needs.

2 'Gulf Islamic banks resilient amid global credit woes,' *www.moody's.com*, 30 November 2008.

3 *Asian Banker*, 26 August 2009.

4 Figures on banking assets and mutual fund assets are as reported in *Islamic Finance Briefing*, presented by PricewaterhouseCoopers on 11 December 2007 in Jakarta, Indonesia; data on Sukuk assets are based on statistics compiled by SHAPE™ and shown on *www.ifis.com*.

5 For instance, Bank Al Jazeera (Saudi Arabia), Sharjah Islamic Bank, Dubai Bank and Kuwait International Bank were all conventional banks, but now operate as Islamic banks. The Bank of Kuwait and the Middle East is in the process of converting into an Islamic bank.

Chapter 5

Islamic finance: what it is and where it is available to SMEs

Policymakers and bankers worldwide are increasingly focussing on micro-, small and medium-sized enterprises. Within the Islamic sector, the Islamic Development Bank (IDB) is making important efforts to nurture the micro-enterprise and SME sector and its export activities. These efforts expand knowledge through the promotion of seminars, training and expert missions with the goal of building capacity in the sector. They also finance guarantees and export insurance. IDB has three important subsidiaries serving the sector: the International Islamic Trade Finance Corporation (ITFC), Islamic Corporation for the Development of the Private Sector (ICD) and the Islamic Corporation for Insurance of Investments and Export Credit (ICIEC). Each of the IDB subsidiaries has programmes that operate throughout IDB member States.

Generally, IDB does not work in direct contact with businesses. Rather it takes advantage of existing financial and charitable institutions, including government agencies, which have on-the-ground knowledge of the local market. These institutions lack the IDB's expertise in Islamic finance and seek its financial resources to serve their constituents and clients.

Islamic finance is delivered through many intermediaries, not all of which operate with government agencies or IDB. Important tools for credit in many emerging economies are specialized microfinance entities and cooperative societies. These front-line companies are well established in countries such as Egypt, Morocco, Nigeria and the Sudan. Often micro-financiers and cooperative societies lack the resources of larger banks.⁶ Therefore smaller financiers have begun to access zakat and *sadaqat* funds organized by NGOs such as Grameen-Jameel (www.grameen-jameel.com).

Grameen-Jameel is a unique organization that provides financial assistance to and in conjunction with development entities in Egypt, Morocco and Tunisia. There are also a growing number of non-bank financial institutions and commercial banks. Although micro-enterprise and SME clients in many emerging markets have a solid record of repayment of debts, the sector – an important generator of jobs and wealth – is only recently becoming a focus of conventional banks. Because of their outlook on social responsibility, many Islamic banks are either specialized in the micro-enterprise and SME sector or have charitable funds to apply to the sector. Finally, the sector is the key to success for new Islamic banks such as First Community Bank in Kenya.

The principles of Islamic banking are derived from two primary sources: the Koran (the holy book of Islam) and the Sunna or Hadith (the examples and sayings of the Prophet Muhammad). Islamic banking refers to a system in

⁶ Often large banks are not active in micro- and SME finance.

which financial transactions are conducted in compliance with the principles of sharia.

Although similar to a legal system, sharia is applied as a value system in most markets where Islamic banking is offered. This is because most countries apply either the French-inspired civil code or an adaptation of English common law. This successful infusion of Islamic values into other established legal systems is important, as it means that there is strong evidence of the applicability of the methods described in this book under any legal regime, not just in Islamic countries. A useful approach to sharia is to see it as allowing business activities that are already present in the host legal system but are fewer in number than those traditionally accepted for banks and investment banks. As a result, the Islamic sector does not seek more rights than conventional banks: it accepts fewer.

The basic distinction between a sharia-based and conventional banking system is the application of sharia's moral guidance to financial affairs. The most prominent moral directive is the prohibition of interest or *riba*. It is understood that conventional interest-bearing deposits and loans are forbidden, and that there are clear restrictions on the exchange of currencies, including the banning of forward exchange contracts.

In addition to *riba* or interest, a concept called *gharar* is to be eliminated or avoided if possible. *Gharar* equates to a form of contractual or business uncertainty or ambiguity which impairs the rights of one contracting party by making it difficult for that party to make a proper business decision. In Islamic financial transactions, both sales and profit- and-loss-sharing contracts are applied. The desire to reduce *gharar* to a tolerable level is akin to the types of disclosure requirements required in many countries for consumer finance deals or securities sales.

Additionally, sharia rules prohibit investment in goods or services which are forbidden by Islam. In general, a product or a service would be considered *haram* (morally forbidden) if it violates a clear Koranic ruling. For instance, one is not allowed to deal with alcohol, intoxicants, pork, interest, pornographic material, certain forms of entertainment and hospitality, etc. As a result, the portfolio activities of Islamic institutions are distinct from those of conventional banks in many countries.

Why should managers of micro-enterprises and SMEs consider Islamic banking?

Many believe that financing for micro-enterprises and SMEs is a natural niche for Islamic banking as it deals directly with the real economy, creates employment, involves the productive use of resources, especially capital and finance, and contributes to the alleviation of poverty.

Many investors, non-Muslims included, are attracted to Islamic finance because it integrates ethical and moral values. Parallels are often drawn between Islamic finance and socially responsible investing, also referred to as sustainable or ethical investing. Socially responsible investing seeks to maximize both financial returns and socially responsible or ethical behaviour. Both Islamic finance and socially responsible investing, for example, prohibit business activities such as pornography, gambling, dealings in alcohol and the manufacture of weapons.

Islamic banking also advocates entrepreneurship and risk sharing. In the profit-sharing concept of a financed project, the financier and the beneficiary share the actual or net profit/loss, rather than leaving the risk burden to the entrepreneur. The principle of fairness and justice requires that the actual output of such a project be fairly distributed between the two parties. If a financier is expecting to make a claim on a project's profits, he or she is also expected to carry a proportional share of the loss of that project.

For micro-enterprises and SMEs looking for financing, Islamic banking can help promote entrepreneurial development.

Basic distinctions between Islamic and conventional banking

Islamic banking is governed by Islamic commercial rules called *fiqh al Muamalat*. The prohibitions stipulated by these rules have an impact on how operations and treasury functions should run within an Islamic bank. The key set of rules is applied to *Sarf* or monetary exchange.

For instance, if one wishes to lend money, the sharia principle is that a loan is to help and should not be for profit. Therefore, a loan of money is not permitted to earn interest.

The same applies generally to bank guarantees for payment. On the one hand, a guarantee is a promise to pay money at a later date and may be interpreted to be a loan commitment. In this view, the fee is viewed as a form of interest. On the other hand, a guarantee is a means to help another person and should not normally be compensated on a stand-alone basis.⁷

Since conventional banking activities involving loans are prohibited under these core sharia rules, credit and investment is provided to customers through sales contracts, leasing, agency accounts and partnerships. The first group of contracts – sales and leasing – is predictable in outcome, and allows for a fixed price to the customer. The agency and partnership concepts are uncertain in outcome, and allow for participation in the profit or loss of a business.⁸ As described below, these transactions can serve micro-enterprises and SMEs. Another result of the rules of *Sarf* is to restrict the forward sales of currency.

As a result of these conceptual differences between Islamic and conventional banking, the Islamic bank is more likely to be a profit-sharing institution, or

⁷ Nonetheless, there are many different interpretations and structures embedding guarantees which are subject to alternative rulings of different sharia panels.

⁸ Profit sharing is based upon a mutually agreed profit-sharing ratio (PSR), and losses are based on the contributed capital.

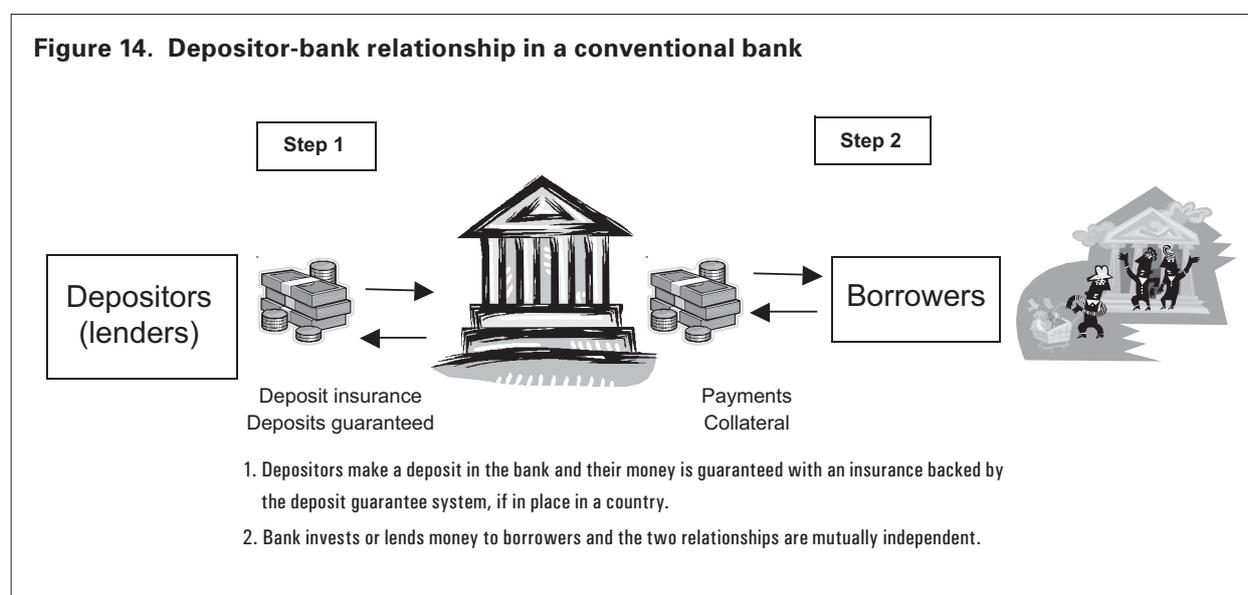
a merchant banking institution relying heavily on sales-oriented contracts. These characteristics can be attractive to banking customers, particularly in trade finance.

Deposits

In a conventional bank, a deposit represents the bank borrowing from its customers or other banks (see figure 14). Common depository instruments include checking, savings and money market accounts, fixed deposits and certificates of deposit. The interest to be paid by the bank will be based on the time period of the deposit. Normally, the longer the term of the deposit, the higher the interest paid. Checking or current accounts are usually not interest bearing. However, some financial institutions do offer interest-bearing checking accounts with a minimum balance requirement. Savings accounts and time deposits (fixed deposits and certificates of deposit) bear an interest rate yield that is based on the duration of the deposit.

In contrast, the funding of an Islamic bank involves deposits, quasi deposits and profit-sharing investment accounts (PSIA). As a deposit is a loan, it is not entitled to a contractual return. Typically, Islamic banks offer *wadiah* accounts, which include checking or current accounts. A *wadiah* safekeeping account will not pay any return or interest.

For savings and time deposits, some Islamic banks collect deposits as *wadiah*. In these cases, there are no contractual returns. But many Islamic banks seek the permission of depositors to apply the deposited money to the business of the bank. This will be found in the deposit contract. Then, should the bank make a profit, it may elect to pay a return to the depositor as a *hiba* or gift.

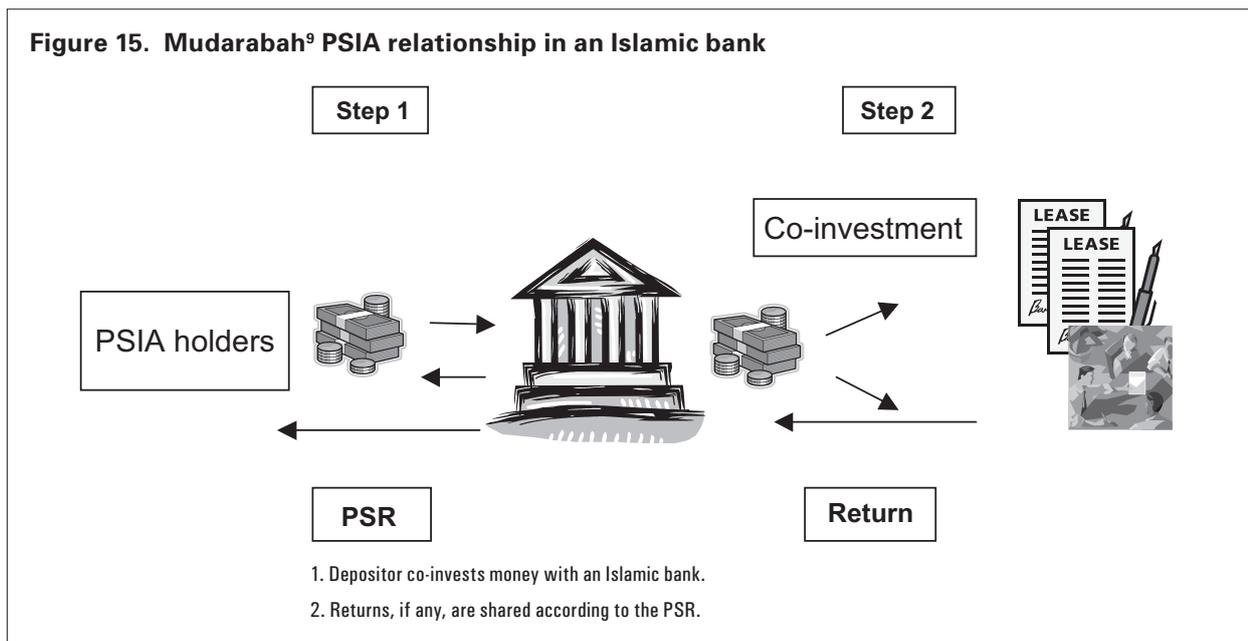


The key point is that the gift is non-contractual and the depositor has no claim on a profit, even if the bank is very profitable. In contrast, should the bank lose money in its operations, the *wadiah* contract is essentially a contract of safekeeping, and the bank must return to the customer the same amount deposited.

Wakalah or agency accounts are a new trend among Islamic banks. These are similar to deposits in that the customer will not invest in the bank, but will appoint the bank as agent to apply the customer's money to profitable transactions. These could be leasing or sales or other businesses of the bank. In the agency deposit, the money belongs to the customer and should be returned. But there is a risk of loss if the bank loses money in the business to which it applied the money. Hence, one might consider this a quasi deposit. Several key central banks including those of Bahrain and Kuwait have approved Wakalah deposits for consumers and businesses.

Typically, Islamic banks have used a form of deposit called Mudarabah. This is a form of a profit-sharing investment account or PSIA. In this method, the customer co-invests with the bank and the bank manages the customer's money. The bank normally posts a profit-sharing ratio or PSR. The returns, if any, are based on how the invested funds perform.

For example, a PSIA deposit investing in the leasing business may return an attractive yield at a moderate risk. In contrast, a PSIA investing in the purchase and sales of commodities in a secured environment may yield a very low return with virtually no chance of loss. These accounts can be viewed as being similar to equity.



Wakalah and PSIA are often supported by special reserves at Islamic banks. These reserves are designed to protect depositors from “displaced commercial risk”. The reserves are often called the profit equalization reserve (PER) and the investment risk reserve (IRR). In countries where it is permitted, the bank can draw from the PER to improve returns if the Islamic bank is yielding less than the market. And should the Islamic bank suffer a loss, it can draw from the IRR to cover the PSIA and Wakalah account holders. Not all Islamic banks establish such reserves. But when they do, the reserves make these risk-sharing accounts much more like conventional deposits. These reserves are finite, and the account holders are at risk of loss should the reserves be exhausted.

⁹ The outcome would be similar with a Wakalah PSIA account.

As a result of the significant structural difference between the accounts that fund an Islamic bank and the deposits at a conventional bank, an Islamic bank's risk and liquidity profile differs from that of a conventional bank. This is because the Islamic banking account holder may be exposed to the risk of loss of capital by contract. This obliges an Islamic bank to be careful in its risk taking lest its account holders flee during a period of poor performance or business losses.

Lending contrasted to credit and investment

Unlike conventional banking, Islam forbids lending money for money with an extra amount or an interest payment. As Islamic banking differs from conventional banking in its collection of funds from the market, so the application of funds is substantially different. Instead of lending money borrowed at a fixed rate of return or an interest rate, the Islamic bank will engage in commercial transactions based on sales, agency accounts or partnership. As a result, the bank does not trade money for money with a profit. Rather it must take some form of asset or business risk. This will oblige the Islamic bank's prospective customers to have a specific purpose. Chapter 6 reviews each of the key methods of Islamic finance applicable to the micro-enterprise and SME and export finance sectors. Despite the primary focus on micro-enterprises and SMEs and trade finance, the examples given may also apply to the retail and large enterprise sectors.

The qualification criteria and structure of credit transactions differ in conventional and Islamic banks. In a conventional bank, the borrower is qualified on the basis of his or her credit score. The customer's ability to repay the loan (debt-to-income ratio) usually determines the amount of the loan (credit line). Collateral may not be necessary. The payment and terms are based on the credit worthiness and risk factor of the borrower. For example, a borrower with a low credit score may pay a higher interest rate than a borrower who has a better score and a more favourable debt-to-income ratio.

Furthermore, the term of the loan has an impact on the amount to be repaid by the borrower. Additionally, there are penalties for late payment and some loans have stipulations that allow the lender to increase the interest rate on the borrower in the middle of the term based on different scenarios. For example, if a borrower is late on his payment on a credit card line of credit, the lender may increase the interest rate to a higher rate and add a penalty, thereby increasing the principal amount on the loan that was originally granted. Some lenders may even have a schedule of rate increases that penalize the borrower by increasing the interest periodically for missing single or multiple payments.

The text table below compares credit concepts as used in conventional and Islamic banking.

In an Islamic bank, the qualification criteria include conventional credit analyses such as debt-to-income ratio analysis and creditworthiness of the customer. But since the Islamic bank does not lend money, there has to be a purpose for commercial relationship between the bank and the client. For example, the prospective client must have an asset (car, business activity and so on) to be purchased or for which he or she seeks funding. The Islamic bank would structure the deal by applying sales-, agency- or partnership-based transactions to fund the client. These methods of funding, rooted in classic

Islamic and conventional banking: credit concepts compared		
Credit concepts	Islamic banking	Conventional banking
Money	Means of transaction	Object of the transaction
Goods or property	Object of the transaction	Collateral
Sales	Means to profiting	Not applied
Partnership	Means of investment, risk of loss in the ordinary course of business	Not normally applied
Agency	Means of investment, risk of loss in the ordinary course of business	Not normally applied
Profit and profit sharing	Outcome of selling, leasing, partnership or agency	Not allowed except from interest or fees
Guaranteed profit or interest	Forbidden	Basis of profit

trade finance from the pre-Islamic period, are significantly different from conventional lending in their steps and risks, even if the economic outcomes are similar.

For example, if the financing is sought for goods to be exported, then the structure of the financing may be based on an instrument called Istisna (manufacturing or construction financing). In this method, the bank might contract to manufacture and sell the property to the client. The economics might be similar to a pre-export loan, but the bank has a significantly greater risk as a project vendor than it would have in a conventional pre-export loan.

Concluding observations

There are some regional variations in the models applied to Islamic banking and finance. These do not radically affect the true difference between a conventional and an Islamic bank. The underlying character of the Islamic financial business proposition is an orientation to the sharing of asset risk and profit and loss. This is precisely the opposite of a conventional bank transaction, in which the risks are solely meant to be credit risks.

Chapter 6

Key products and how they compare to conventional counterparts

The common methods used in Islamic financing include sales contracts such as Murabahah (cost-plus sale), leasing (Ijarah), Salam (forward sale) and Istisna (construction or manufacturing sale). They also include Wakalah (agency), Musharakah (joint venture or partnership), and Mudarabah (managed partnership). These contracts are used to manage credit and investment processes. They are frequently joined with some form of undertaking or promise to synthesize a bias towards credit risk as compared to asset risk. This chapter examines each of these methods by way of concrete examples, presented both textually and in illustrations, and shows how they fit in an Islamic bank. All the methods have been tested in micro-enterprise and SME markets and all may be used to support trade finance activities.

Murabahah (cost-plus sale)

The most widely used contract at Islamic banks, Murabahah is a sale in which the seller's cost and profit are disclosed to the buyer. In some countries, this is permitted by specific laws governing Islamic banks. In other countries it is applied by banks under their instalment credit powers because it may be used as an instalment credit sale contract in which the bank relies on the client to act as a buying agent.

There are several common variations of the Murabahah contract practised by modern Islamic banks. These include the simple Murabahah, agency Murabahah, Murabahah to purchase order, Tawarruq and Bai al Inah. These variations are widely used for trade and pre-export finance. Agency Murabahah and Murabahah to purchase order are common tools for trade finance, whereas the simple Murabahah is often used for open account export finance. Each of these concepts is described in this chapter by means of an example in a business situation involving micro-enterprises and SMEs.

In all Murabahah transactions, the parties are the principal or seller of the goods, usually an Islamic bank, and the end-user or buyer of goods, usually a customer seeking credit. Typically, the customer approaches an Islamic bank for financing. The Islamic bank purchases goods needed by the customer, who is aware of the cost to the bank and agrees on a purchase price from the bank in which the bank's profit is disclosed to the consumer.

Theoretically, these transactions are collateral based so the risk of loss to the bank may be limited. Although a bank may seize the sold goods or other collateral in the event of a payment default, the bank may not – according

to sharia – charge a penalty to cover its cost of funds in the event of a late payment. The maturity of a Murabahah deal occurs when the client completes all the instalments to the principal (the Islamic bank).

Even though the “basic” Murabahah may create term credit, it is unlike a conventional loan in which cash is granted to the consumer who then buys the goods. In the basic Murabahah transaction, the financial intermediary buys the goods and sells them to the consumer on instalments at a mark-up. The sale is immediate, not prospective or conditional upon future events. No contingency may be embedded in a sales contract, including for reduction in price if there is early curtailment or prepayment.¹⁰ This interposition of a financier as a **merchant** in the purchase and sales process is what makes the credit transaction legitimate under Islamic law in the banking context. Unlike a conventional loan, this process may cause the financier to assume certain risks between purchase and sale. Murabahah, because of its nature, enjoys widespread use for import and export finance.

For a sale to be valid, there are several primary conditions. Foremost, the object of the sale must be permissible under sharia rules. It must also exist at the time of the sale (with the specific exceptions discussed later in relation to Salam and its derivative Istisna) and be owned by the seller. It may be possessed by an agent on behalf of the seller. Then, it must have a contract consisting of at least an offer at a specific price, and an acceptance of the offer.¹¹ As is standard in the banking context, there is a written contract of which there may be many variants.

A sale may have reasonable conditions, if the goods are specified and exist, that they may be delivered to a specific place within a specific time frame. In this case, the sale is immediate, instant and absolute.¹² All Islamic sales transactions have a specific post-acceptance condition which is the buyer’s option to inspect the object of the contract. If any defects are found, then the buyer may reject the goods or renegotiate the price.

Key distinctions

There are four distinctive features of a Murabahah sale compared to a loan of money:

- ❑ The banker, as seller in a Murabahah, must have some form of factual possession, registered, constructive or physical;
- ❑ A Murabahah transaction may be extended. But, the extension or rollover may not result in an increase in price or profit to the seller. This is the basic rule of *riba*, which forbids the creditor to offer a further deferral in payment for more money;
- ❑ If the payment is late, no form of penalty may be charged for the profit of the creditor;¹³

10 There is some debate over this as, in certain markets, regulators require that a buyer paying off a credit Murabahah ahead of schedule should be able to know what his or her reduced price will be.

11 Title may be *registered* as is the common case with real property, a house, a car and other large personal property. It may also be *bare legal* as in rightful possession.

12 Muhammad Imran Ashraf Usmani, *Meezan Bank’s Guide to Islamic Banking* (Karachi, Darul Ishaat, 2002), p. 76.

13 Although some Islamic banks charge a penalty interest, this is given to charity on behalf of the client. The payment is not a form of income to the bank. It is meant to encourage customers to pay on time.

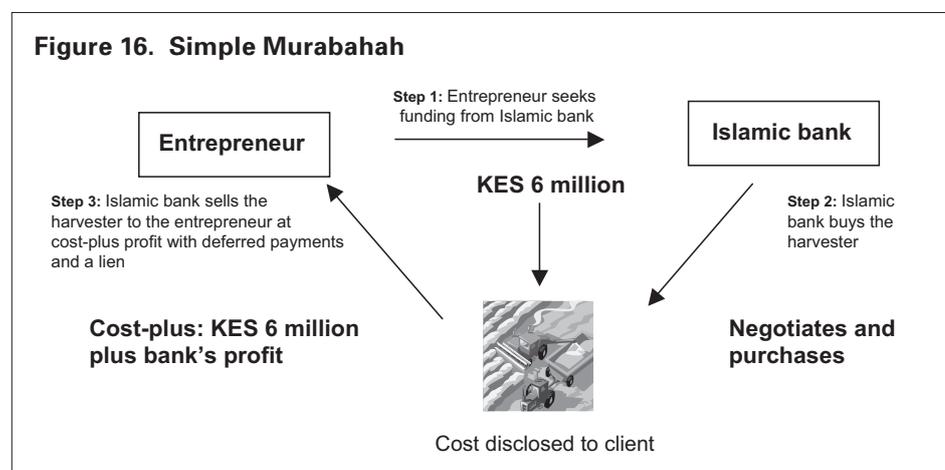
- ❑ Most Islamic scholars do not like net sales, sales discounts or early payment discounts when these are structured into the contract. But Islamic scholars do not mind if the financier elects to give discounts.¹⁴

Simple Murabahah

A small business owner who is an organic foods exporter in Kenya needs KES 6 million (approximately US\$ 75,700) to purchase an additional harvester for his or her business. The business owns 10 harvesters, each subject to a mortgage, as well as a garage, also mortgaged. The owner has been in business for over 10 years and has good credit based on a good payment history vis-à-vis suppliers as well as positive net worth, but low cash reserves (i.e. not enough to buy one more harvester).

If the business owner approaches an Islamic bank, he will enter a Murabahah transaction. The process can happen in the following way:

- ❑ The bank will purchase the harvester directly from the dealer.
- ❑ The bank will offer the harvester to the client.
- ❑ The client will inspect and accept the offer.
- ❑ The bank will deliver the harvester.
- ❑ The client will make instalment payments subject to a chattel mortgage or other applicable lien.



Strengths and weaknesses for micro-enterprises and SMEs

Strengths: The simple Murabahah is an attractive business tool that has the same credit dynamics as a conventional loan for the entrepreneur. The means of credit is an unconditional sales contract, which means that the bank cannot change the price if it grants the client more time to pay, and the bank cannot charge penalty interest.

Weakness: For many export-oriented businesses, this method cannot deliver working capital and is necessarily linked to an asset.

¹⁴ Usmani, op. cit., p. 130.

Alternative applications of simple Murabahah

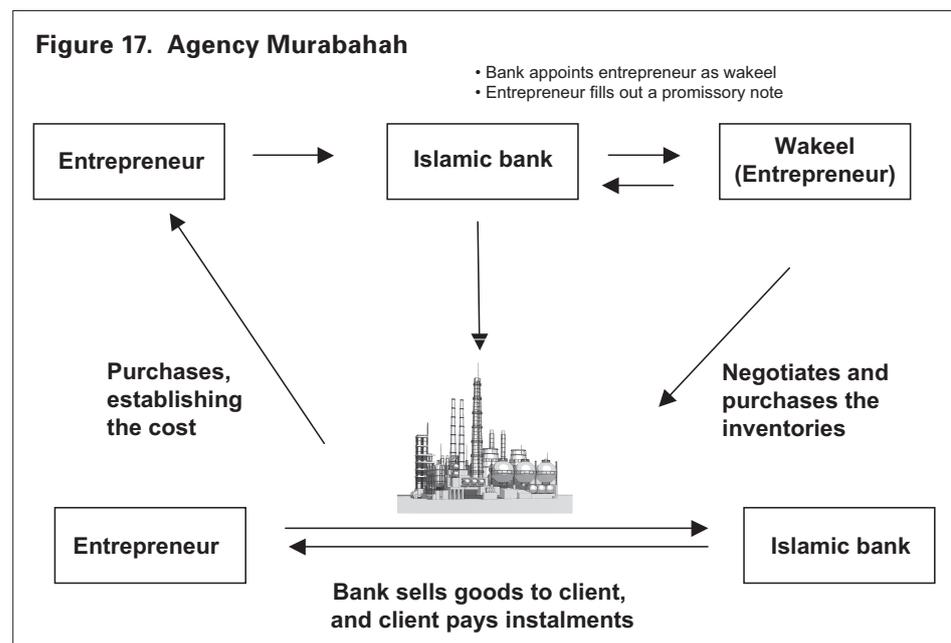
In some cases, the means to finance the client is for the client to sell his or her crop upon harvest to the bank. The client will now have cash, and the bank will sell the crop to the client's export buyer. This method will not achieve pre-export finance, but it will effectively create a financing that is economically equivalent to the discounting of a receivable. In such a case, the client may be asked to guarantee the customer's payment if there is no import letter of credit or other collateral support for the bank's onwards sale. The bank may secure an export credit guarantee from the Islamic Corporation for the Insurance of Investment and Export Credit (ICIEC).

Agency Murabahah

Agency Murabahah is frequently used in import trade finance. This is because the client has established vendor relationships. It is easier for the bank to provide a credit service to the client than to be a principal buyer, as the bank may not achieve terms and conditions which are as attractive as those secured by the client.

For instance, an entrepreneur wishes to buy supplies for her light manufacturing business. The supplies will be used to manufacture solar panel stands for export. This will be similar to the simple Murabahah in terms of credit risk and ultimate deal risk but the steps will differ:

- ❑ The client approaches an Islamic bank for credit and her application is approved.
- ❑ The Islamic bank appoints the client as buying agent, or *wakeel*, to source the supplies.
- ❑ Then the client signs a promissory note to buy the goods once the bank has purchased them.
- ❑ The client, as agent for the bank, will inspect and purchase the inventories directly from the dealer. The bank is the buyer.



- The bank will then offer the goods to the client.
- The client forgoes inspection having just inspected the goods as agent for the bank, and the client accepts.
- The bank sells the goods to the client with a mark-up or disclosed profit.
- The client makes instalments or payments to the bank.

Strengths and weaknesses for micro-enterprises and SMEs

Strengths: Like simple Murabahah, agency Murabahah is a useful credit tool with characteristics similar to those of a conventional loan for the entrepreneur. Again, the credit method is an unconditional sales contract, which means that the bank cannot change the price if it grants the client more time to pay, and the bank cannot charge penalty interest.

Weakness: For many export-oriented businesses, this method cannot deliver working capital and is necessarily linked to an asset.

Alternative application of agency Murabahah

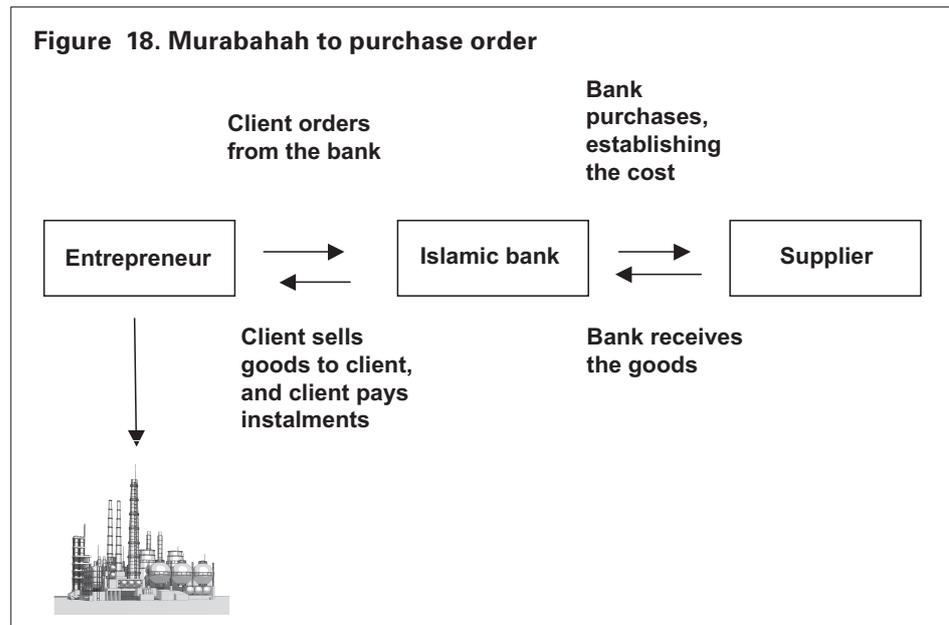
As with simple Murabahah, agency Murabahah may be used to sell goods through the bank in a way that mimics the economics of discounting. In this alternative, the client will sell his or her product to the bank spot, and then be appointed as agent of the bank to sell the goods to the end-buyer. The client will now have cash and the bank will have the importer's credit risk. If that risk is unacceptable to the bank, it may be possible for the bank to secure an export credit guarantee from ICIEC.

Murabahah to purchase order

But some Islamic banks do have supplier relationships. These Islamic banks may choose to use Murabahah to purchase order. This too is commonly used in trade finance. For certain Islamic banks, this is the preferred method of engaging in trade finance as they may cover all their traditional costs of trading in the sales price. Such costs include the cost of foreign exchange and the issuance of letters of credit, charges that are not allowed on an independent basis.

The steps for Murabahah to purchase order differ from agency Murabahah:

- The client approaches an Islamic bank for credit and gets approval.
- The Islamic bank receives a promise from the client or a purchase order binding the client to purchase the goods that the bank will buy.
- The bank buys the goods and offers them to the client.
- The client inspects and accepts.
- The bank's profit is disclosed to the client.
- The client will make instalments or payments to the bank over the agreed period.



Strengths and weaknesses for micro-enterprises and SMEs

Strengths: Like other forms of Murabahah, Murabahah to purchase order is an instalment credit with the economic characteristics of a loan. As discussed, Murabahah methods are all based on the use of an unconditional sales contract. As a result, the seller, in this case the bank, cannot change the price if it extends the instalment period, and it may not charge penalty interest for late payments.

Weakness: For many export-oriented businesses, this method cannot deliver working capital and is necessarily linked to an asset.

Alternative application of Murabahah to purchase order

As with other forms of Murabahah, Murabahah to purchase order allows the exporter to sell his goods through the bank in a way that mimics the economics of discounting. In the unique case of Murabahah to purchase order, the client will sell his product to the bank spot and grant assignment of the importer's purchase order to the bank. The bank will then sell the goods to the importer and instruct the export manufacturer to ship the goods. Once more, the exporter will receive cash and the bank will take on the importer's credit risk. As before, the bank may find it possible to mitigate importer payment risk through an export credit guarantee from ICIEC.

Musawamah

In some cases, the bank receives vendor discounts and does not wish to disclose these to the client. In such cases, the bank uses Musawamah, a concept similar to Murabahah except that, in the former, the cost price is not disclosed to the buyer. The rest of the terms are the same as those of either the simple Murabahah or the Murabahah to purchase order.¹⁵

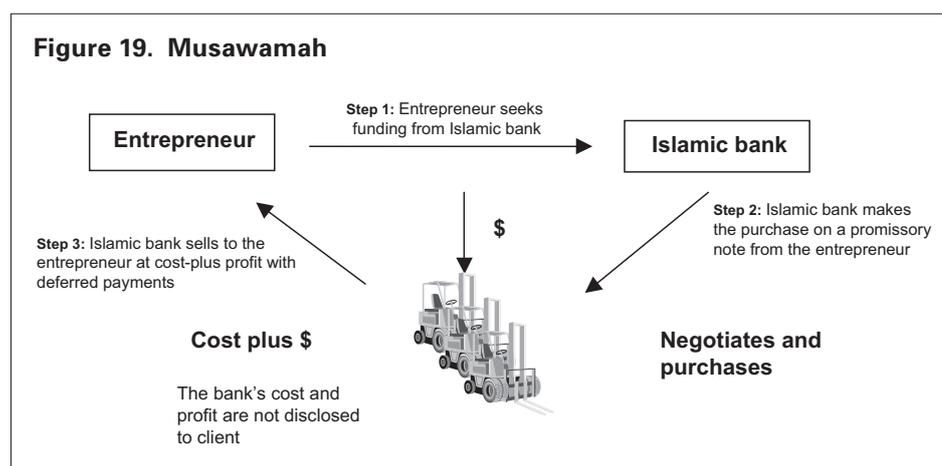
¹⁵ Musawamah would not be applicable for agency Murabahah as the client will always know the bank's cost basis in an agency purchase.

To give an example, a manufacturer requires forklift trucks to serve her expanded plant and increase production for export. The Musawamah process may be almost the same as the Murabahah to purchase order in this example:

- ❑ The client approaches an Islamic bank for credit and gets approval.
- ❑ The Islamic bank receives a promise from the client or a purchase order binding the client to purchase the forklift trucks.
- ❑ The bank buys the forklifts and offers them to the client.
- ❑ The client inspects and accepts.
- ❑ The bank's price is a single "all-in" quote to the client.
- ❑ The client will make instalments or payments to the bank over the agreed period.

Strengths and weaknesses for micro-enterprises and SMEs

The Musawamah contract will have the same sets of strengths and the same weakness as the Murabahah methods.



Foreign exchange dealings

Whenever the Murabahah and other Islamic transactions are import-export transactions, the questions of hedging and currency transacting arise. These may require that the client make a purchase in one currency, but is earning his or her income in another currency. The rules of currency exchange in Islam allow the client to make a spot purchase of the foreign currency against local currency. But, there is a significant challenge when it comes to hedging forward currency payment obligations. This is because currency transactions must be spot.

One alternative commonly applied to structure a hedge is for the Islamic bank to purchase a commodity in the local currency, and sell it on a Murabahah with deferred payment for the foreign currency. In this case, the Islamic bank will receive a specific volume of foreign currency at the time that the client needs to make payment. At that date, there will be a spot sale of currency. This is one of a few hedging concepts applied using the Murabahah sales method.

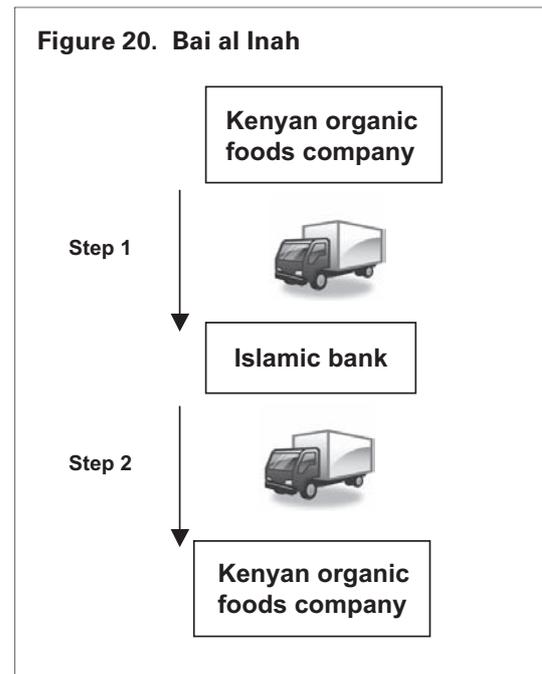
Alternative applications of Murabahah for working capital

There are two alternative forms of Murabahah applied to generate working capital for businesses and consumer credit. These are called Bai al Inah, which

is used in Malaysia, and Tawarruq,¹⁶ which is common in GCC countries. These methods are generally disliked by Islamic scholars, who prefer that businesses and consumers use less contrived methods to finance their activities. These two forms of credit are more clearly parallel to conventional loans and may be structured to have “rate” resets, rollovers and to accommodate late payment recoveries.

Bai al Inah

A Kenyan organic food exporter requires pre-export working capital. Under Bai al Inah, the company might sell one of its assets, for example a truck, to the bank for KES 6 million and thus generate the working capital required. However, it would have to agree to buy back the truck for KES 6.6 million for spot delivery but deferred payment. The two sales contracts may be considered valid if they stood on their own. But, the two are linked to form a synthetic loan and the bank has neither an interest in nor a desire to possess the truck except as collateral.



Step 1: The Kenyan organic foods company sells truck to the Islamic bank for KES 6 million.

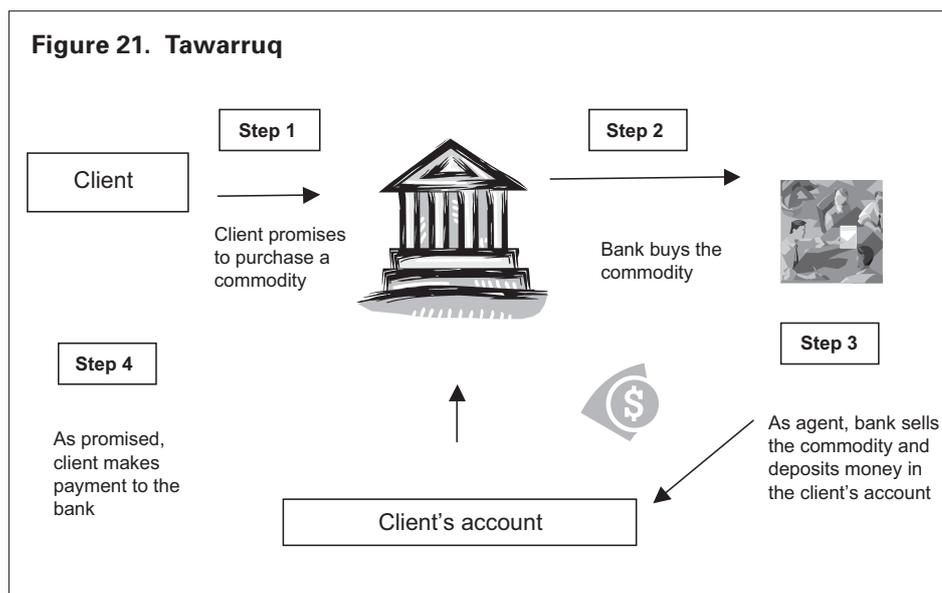
Step 2: The Islamic bank sells the truck back to the Kenyan company for KES 6.6 million with spot delivery and deferred payment.

Tawarruq

In the case of Tawarruq, the process is a little more complicated. The process applies the rules of agency and Murabahah to generate cash for the client. The process follows:

- ❑ The client appoints the bank as agent to buy and sell commodities.
- ❑ As agent, the bank buys a commodity against the client’s promise to purchase.
- ❑ The bank sells the commodity on behalf of the client to a third party and deposits the proceeds in the client’s account.
- ❑ The client completes payment due to the bank under the client’s promise to purchase.

¹⁶ Tawarruq is also referred to as “Reverse Murabahah”, “Double Murabahah” and “Commodity Murabahah” in the market.



Strengths and weaknesses for micro-enterprises and SMEs

Strengths: Although Tawarruq has the same credit characteristics as a loan, it also allows the generation of cash for the exporter, thereby resulting in discounting. Because the deal has not deviated from the process of selling, the bank cannot change the price if it extends the instalment period, and it may not charge penalty interest for late payments.

Unlike the other sales tools, Murabahah and Musawamah, Tawarruq is able to generate working capital without there being an actual open market sale of the underlying goods.

Weakness: Tawarruq still requires an asset to be traded and cannot be executed without a number of steps beyond those required by a conventional loan.

Concluding observations

Murabahah sales contracts effectively parallel some of the credit dynamics of conventional loans. As a result, Murabahah is the most widely used form of credit in Islamic banking. Nonetheless, the concept has a few challenges:

- ❑ The term of the debt created by a Murabahah instalment sale may be extended, but without a change in price;
- ❑ No penalty is permitted on late payments; and
- ❑ The debt created is akin to money and may not be discounted.

As the Murabahah contract is inflexible, despite its ease of use, Islamic banks are frequently involved with leasing. While Murabahah methods are perhaps more commonly used for import finance, these methods may also be applied for exporters to enable them to access funds ahead of their customers' scheduled payments.

Ijarah – leasing

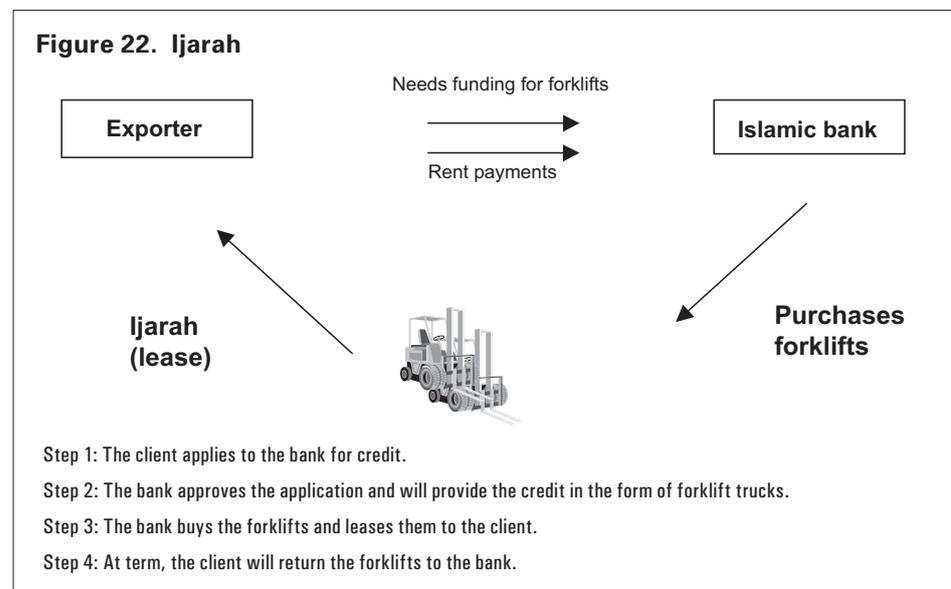
“Ijarah” is the Arabic word for a wage or leasing contract. In Ijarah contracts, the owner of an asset allows the use of sharia-compliant assets by the user for sharia-permissible purposes. The user or lessee pays rent for the use of the asset to the owner (lessor). In the event of a loss, the lessor bears the loss unless it is due to the negligence of the lessee. At maturity, the asset returns to the lessor. In Ijarah, the ownership does not change from the lessor to the lessee. A general principle of sharia is to view Ijarah transactions as **operating leases**.

At the conclusion of an Ijarah agreement, there are four possible choices for the bank and client:

- Renew the lease with a new contract;
- Conclude the Ijarah agreement and return the asset to the lessor;
- The lessor may sell the asset to the former lessee; or,
- The lessor may give the asset to the lessee after completion of the lease term.

In the case of an operating lease, these choices are made at the end of the lease.

Take the example of an exporter who needs two more forklift trucks to improve his warehousing operations. The exporter approaches an Islamic bank. The banker offers an Ijarah (lease) solution in lieu of financing. The bank purchases the forklifts and rents them out to the exporter for an agreed period. The bank earns its profit and covers its costs of maintenance, insurance and taxes in the rental rate.



Strengths and weaknesses for micro-enterprises and SMEs

Strengths: The client is able to improve operations and access credit, but not make a capital expenditure, thereby conserving cash. If the client’s business slows down toward the end of the lease, he or

she will not be obliged to retain and maintain the extra forklift trucks. At the end of the lease, the client will be able to return them to the bank.

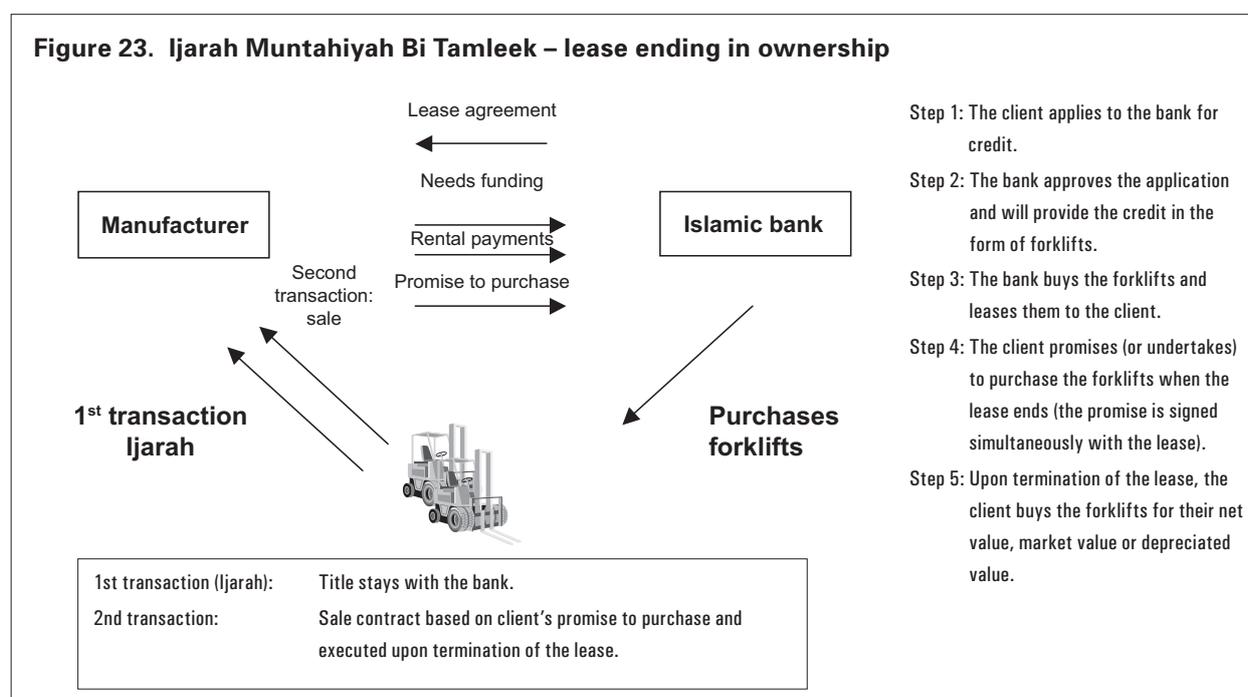
Weaknesses: The credit support to the client's export activities is indirect. The client will not have an additional asset which may be mortgaged and will not generate fresh cash to support his or her export business.

Ijarah Muntahiyah Bi Tamleek – lease ending in ownership

Since the approach to leasing in Islamic finance is based on operating leases, financial leases are problematic. The two key problems are that financial leases do not necessarily enable the lessor to retain ownership, and as they may combine the equivalent of lease and a sales contract, they have the characteristics of a loan of money.

The economic parallel to a conventional financial lease is established in sharia-compliant banks by applying the concept of a lease ending in ownership or *Ijarah Muntahiyah Bi Tamleek*¹⁷ (IMBT). This is a two-step process involving a contract of lease and the lessee's promise to purchase the leased asset after the lease is completed. This concept relies on the sharia principle that a contract is a two-party relationship binding on both parties whereas a promise is solely binding on the person or party who gives it, the promisor.

As in the example given for *Ijarah*, the client requires more forklifts to improve his warehouse operations. But, the client also desires to take ownership of the forklifts in the long term. In this case, the bank and client will take an approach that differs from a simple operating lease agreement.



¹⁷ This has alternative names in Arabic such as *al Ijarah thumma al bai* (a lease, then sale) and *Ijarah wa iqtina* (lease and acquisition). The term used here is that applied by the Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI).

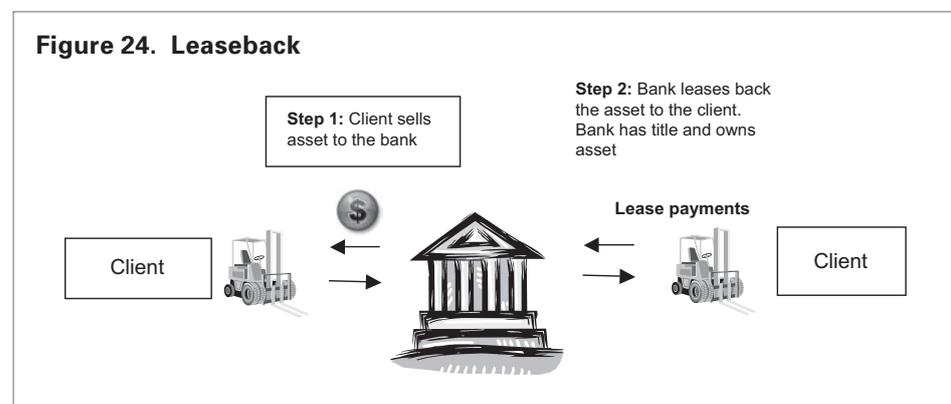
Strengths and weaknesses for micro-enterprises and SMEs

- Strengths:** Just as with the operating lease, the client is able to improve operations and access credit. The client has no cash outlay (the purchase price and the normal incidental costs to put it into operation, such as charges for delivery, taxes, installation and flooring), but does not have fresh working capital.
- Weaknesses:** The credit support to the client's export activities is indirect. The client will not have an additional asset which may be mortgaged and will not generate fresh cash to support his export business. If the client's business slows down, he will be obliged to fulfil his promise and purchase the forklifts that he is leasing.

Sale leaseback

Sometimes balance sheet management, tax management or cash flow issues will cause the client to seek to sell an asset that he or she owns and needs. In this case, the client will sell the asset to the bank, and then lease it back from the bank. The general rule for sale leaseback is that the bank should take registered ownership of the asset.

Again, this is not a direct means to support export finance. But it may be a useful means to free up cash which is tied up on an exporter's balance sheet in the form of real estate or equipment. As such, sale leaseback arrangements may support export finance by generating cash from the balance sheet for pre-export financing.



Strengths and weaknesses for micro-enterprises and SMEs

- Strengths:** In this case, the client has a choice of how to improve operations. As the client is accessing credit in the form of cash, the client may choose to buy a new forklift or apply the cash to pre-export activities.
- Weaknesses:** The client has a single choice of how to proceed: cash for pre-export activities or acquisition of new assets. And the cash may be applied to non-export activities or taken out of the business.

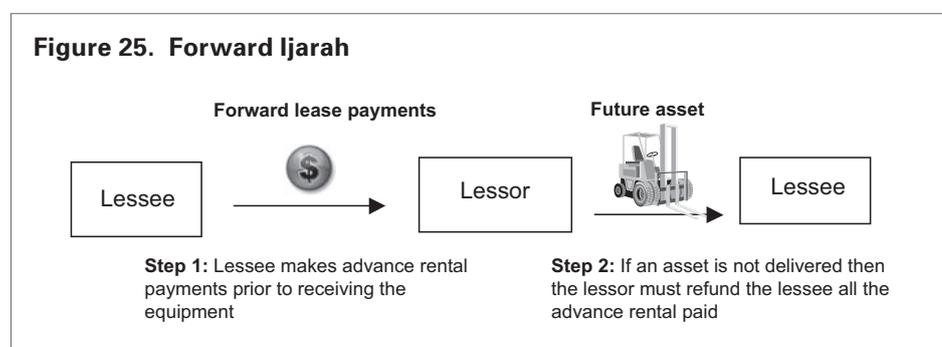
Forward Ijarah – forward lease

In both Murabahah and Ijarah, the rule is that one must own and directly or via an agent possess the asset that is the object of the contract. But, a creative interpretation of the rules of leasing, and agreed by sharia scholars, is the forward lease or Ijarah *Mawsoofa Bi Dhimma*. In this method, the lessor accepts rent prior to delivering an asset. The rent may be partial or the full rent expected for the asset over the asset's life.

The exception to the rules is permitted on two grounds:

- ❑ The asset may reasonably be delivered according to the contract; and
- ❑ Should the asset not be delivered, the rent paid would be refunded.

This method has been used in relation to the construction of major projects in Saudi Arabia in the hospitality and petrochemical sectors.



Alternative application of forward Ijarah

Although forward leases have been used mostly in large-scale project financings and real estate projects, the concept works well with any form of capital equipment. Hence, an exporter might arrange an untraditional plan whereby it will enter into a lease for equipment under manufacture. The following steps take place:

- ❑ Lessee specifies equipment to be manufactured;
- ❑ Lessee makes advance payments;
- ❑ Lessor manufactures equipment;
- ❑ Lessor makes final delivery of equipment and lessee makes periodic payments as agreed in the lease.

Often, the manufacturer enters into the forward lease with an Islamic bank. This institution then enters a parallel lease with the importer, thereby taking the importer's credit risk on behalf of the exporter.

Strengths and weaknesses for micro-enterprises and SMEs

Strengths: Forward Ijarah generates pre-export finance for the exporter. Because the payment is rental, there is no financing charge to the exporter, and his sole deliverable is the equipment. When structured through an Islamic bank, the client is able to rely on

the bank's credit instead of the importer's. Unlike a Murabahah or Musawamah sales contract, the terms of a lease may be modified by mutual consent, allowing the exporter to manage anticipated delays in production or delivery.

Weaknesses: Should the exporter fail to deliver the equipment as specified or on time, then he may be obliged to refund 100% of the rent received in advance.

Concluding observations

Leasing is an exceptionally flexible financial tool applied in the Islamic banking industry. Unlike a sales (Murabahah or Musawamah) contract, a lease contract may be extended or modified by mutual agreement. The changes to the lease do not impair the lessor's ability to charge rent, continue rent or adjust the rent as contracted. Unlike assets in sales contracts, the Ijarah asset may be sold at a discount or premium in a manner that moves the rental, risks and rewards to the buyer. As a result, Islamic banks have found Ijarah to be a preferred method of investing whenever they operate in an asset-rich environment. The Islamic approach to leasing is easily understood in the conventional leasing environment and has robust means to provide finance to micro- and SME exporters.

Bai al Salam – forward sale

Although the general rule of sales in Islamic banking is that the seller must possess the item to be sold, *Bai al Salam* is an exemption granted by the Prophet¹⁸ to ease farmers' access to credit. The method pre-dates Islam.

This is a customized, privately negotiated forward contract for commodities, whether agricultural or mineral. This contract may be used for trade finance, pre-extraction/pre-planting commodities finance, and even mergers and acquisitions in the commodities sector. According to the rules of Sarf governing monetary exchange, the objects of a Salam sale are any commodity except gold, silver or currencies. The underlying commodities must be fungible, or indistinguishable from one another. The buyer may secure the seller's delivery commitment with a mortgage, guarantee, letter of credit or other form of charge or lien.

Bai al Salam is based upon a 100% advanced payment of the agreed price against future delivery of the agreed commodity. The date of delivery may be approximate. The quality and quantity are specified in the Salam sales contract. Variations in quality or quantity may open the contract to renegotiation or cancellation if the quality is worse or the quantity less than contracted. In the event of early delivery the contract may not be revised. But should the commodities be delivered late, the contract may be terminated with the advance payment refunded.

In addition to its role as a means of financing, the Salam sales contract effectively provides a hedging vehicle allowing the supplier/seller to have certainty of price and sale. The buyer also receives certainty of price and quantity.

¹⁸ Usmani, op. cit., p. 133.

In a few rare cases, banks are willing to take open commodity risk in a Salam transaction. This means that the bank will receive the commodity and sell it at the then market price. Most banks, however, do not desire commodity risk.

Therefore, banks have two common structures for the provision of Salam financing to clients:

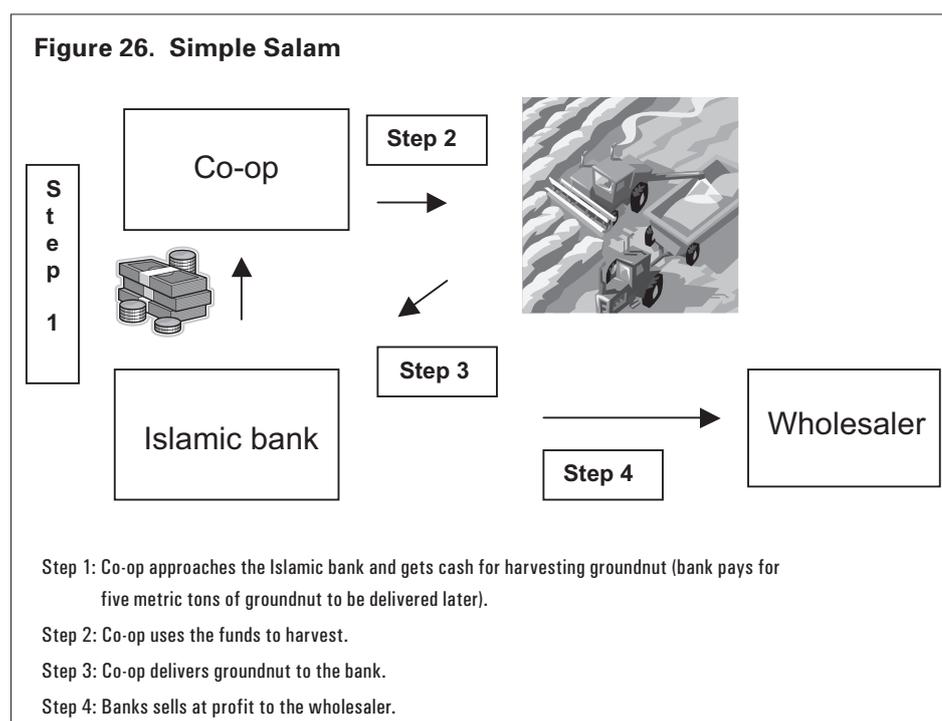
- Enter into a parallel Salam;
- The bank purchases commodities on a Salam basis from the client and secures an undertaking from a third party to purchase the commodities at a pre-arranged price on delivery to the bank. Periodically, the bank will appoint a third party specialist or trading house to organize the bank's exit from the commodity risk.

For micro-enterprises and SMEs active with primary commodities or processed commodities, Salam is an effective means of providing financing.

Simple Salam

The client is a groundnut-producing farmers' cooperative in Uganda. The co-op's expected output will be 10 metric tons. The co-op would hope to sell these at market for U Sh 1,900 (US\$ 0.96) per kilogram or U Sh 19 million (about US\$ 9,500). But, the co-op requires cash of approximately U Sh 10 million (US\$ 5,050) to hire labour, organize irrigation, and purchase plants and fertilizer. The Islamic bank might purchase five metric tons of the groundnuts for U Sh 9.5 million (US\$ 4,800) under a Salam contract.

In this case, the bank will pay the U Sh 9.5 million (US\$ 4,800) on signing the contract and expect to receive the five metric tons at harvest within the time frame agreed in the contract. The bank will, on receipt of the groundnuts, seek to sell for a profit.



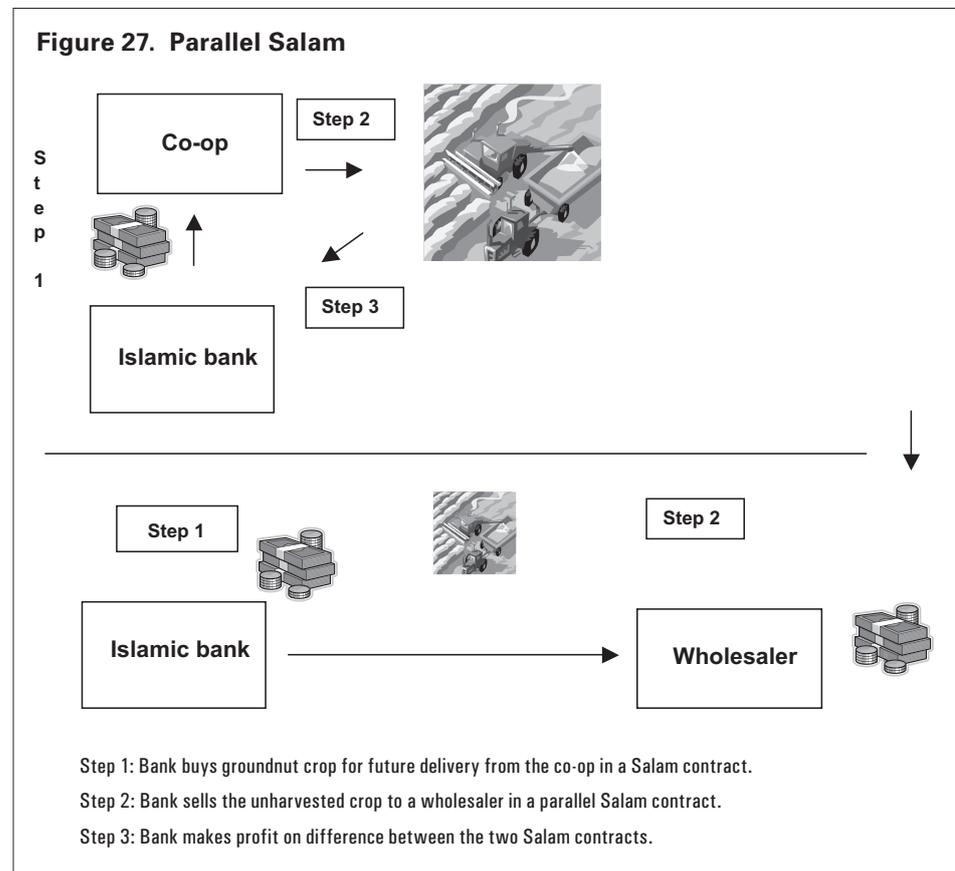
Strengths and weaknesses for micro-enterprises and SMEs

Strengths: This method provides 100% advance finance to the co-op, assuring it the financial means to finance pre-planting and production activities. The co-op has certainty of sale.

Weaknesses: Because the bank takes on commodity risk, there is an incentive for it to underpay by a substantial amount.

Parallel Salam

In the case of parallel Salam, the process is exactly the same except that the bank will find a user of the groundnuts willing to purchase them under a parallel Salam contract. The purchaser will pay 100% of an agreed price, say U Sh 1 950 (US \$0.98) per kilogram to the bank in advance, generating a profit to the bank of U Sh 250 000 (US\$ 126) on the spot.



Strengths and weaknesses for micro-enterprises and SMEs

Strengths: Parallel Salam has the same strengths for the co-op as Salam, except that it should generate a more attractive price than simple Salam.

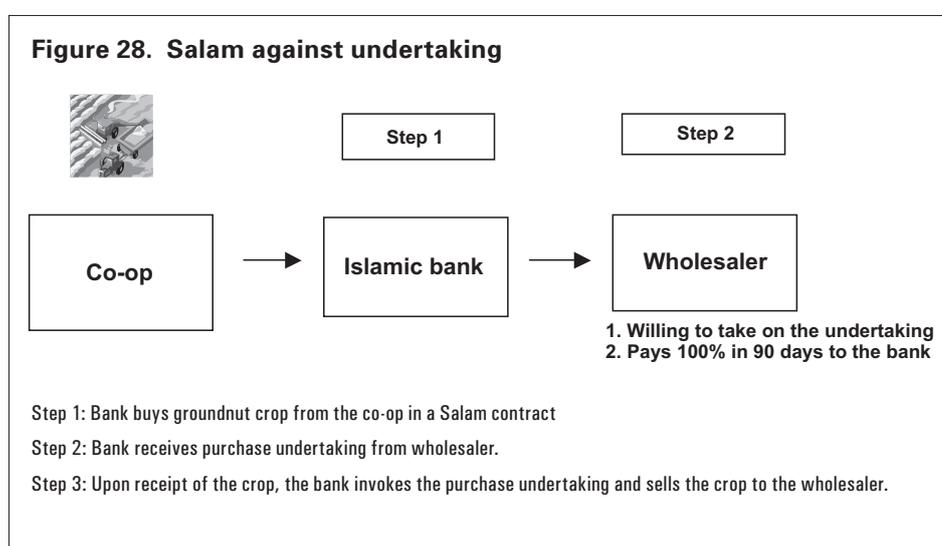
Weaknesses: Since the parallel Salam requires the purchaser to pay 100% of the price, it is often difficult to find an ultimate buyer. Hence the method is not too easy to implement.

Salam against undertaking

Parallel Salam is often difficult to organize as most wholesalers of commodities either seek credit themselves, or they are not willing to pay 100% of the commodity price in advance. It should be noted that conventional markets allow much lower levels of margin for commodity forward purchases.

Salam against undertaking is more commonly used. In this process, the bank will find a user of the groundnuts willing to undertake to purchase them at a predetermined price upon delivery.

For instance, the purchaser will pay 100% of an agreed price, say U Sh 1 950 (US\$ 0.98) per kilogram, to the bank at delivery, generating a profit to the bank of U Sh 250 000 (US\$ 126) or 10.5% per annum if the purchase takes place 90 days from execution (funding).



Strengths and weaknesses for micro-enterprises and SMEs

Strengths: Salam against undertaking has the same strengths for the co-op as the other Salam methods. Since the purchaser has more favourable terms, the bank or co-op should find better prices and more opportunities to sell the groundnuts.

Weaknesses: Salam against undertaking requires the bank to take on delivery and the commodity risk from the co-op as well as the purchaser's credit and performance risk.

Concluding observations

Salam is widely used in several emerging economies in the agricultural sector, commodities exporting sector, and has enjoyed increasing use in the petrochemical and industrial metals sectors. The contract is practical, but shares some of the same limitations as Murabahah.

For instance, the Salam contract represents an obligation to deliver. This makes it a form of debt. Therefore, the contract may not be discounted. It may be extended without any change in price or quantity. Thus its application

is focused on the raw commodities sector in a manner that requires care in calculating quantities, qualities and expected deliveries.

In contrast to conventional forward contracts, the Salam contract may only be used for non-monetary commodities and requires 100% advance payment or margin. A conventional forward contract would have a relatively low margin payment with mark-to-market margin calls and could be used to buy virtually anything that can be sold, including currencies.

Bai al Istisna (construction/manufacturing)

An adaptation of the Salam concept is permitted in sharia for manufacturing and construction. This is called *Bai al Istisna*. This method allows for incremental payments to be made while a project is constructed or a product is being manufactured.

In Salam, the price must be paid 100% in advance, but in Istisna, it may be paid partially in advance, according to progress reports or inspections. As with Salam, the Istisna contract has some flexibility with respect to time of delivery. But the Istisna contract is more rigid with respect to the quality and quantity of goods or the property under contract.

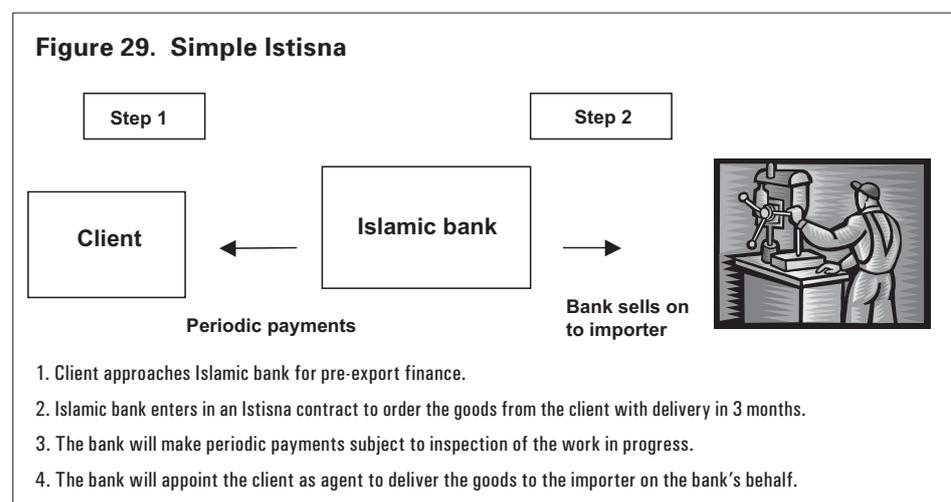
In an Istisna contract, the bank is actually selling to the client. As a result, the bank is taking construction or manufacturing risk. As with Bai al Salam, the bank will seek to mitigate its risk via a parallel Istisna contract.

For instance, the bank will contract with the client, and then seek to contract with the appropriate manufacturer or contractor at a lower price. Periodically, it may suit the bank to appoint the client to act as the bank's agent to deal with the contractor or vice versa.

Because of its flexibility compared to both Murabahah and Salam, Istisna is frequently used for pre-export finance.

Simple Istisna

A South African micro- or small and medium-sized manufacturer requires funding to fill an order for R 1.2 million, but does not have the full amount



of funds needed to produce the equipment. It turns out that the local Islamic bank is willing to order the goods and pay on instalment. The bank will contract to buy the goods for R 1.15 million and take delivery on completion in three months. The bank will pay the instalments and appoint the exporter as the bank's agent to sell the goods to the company making the order. The client may be asked to provide collateral.

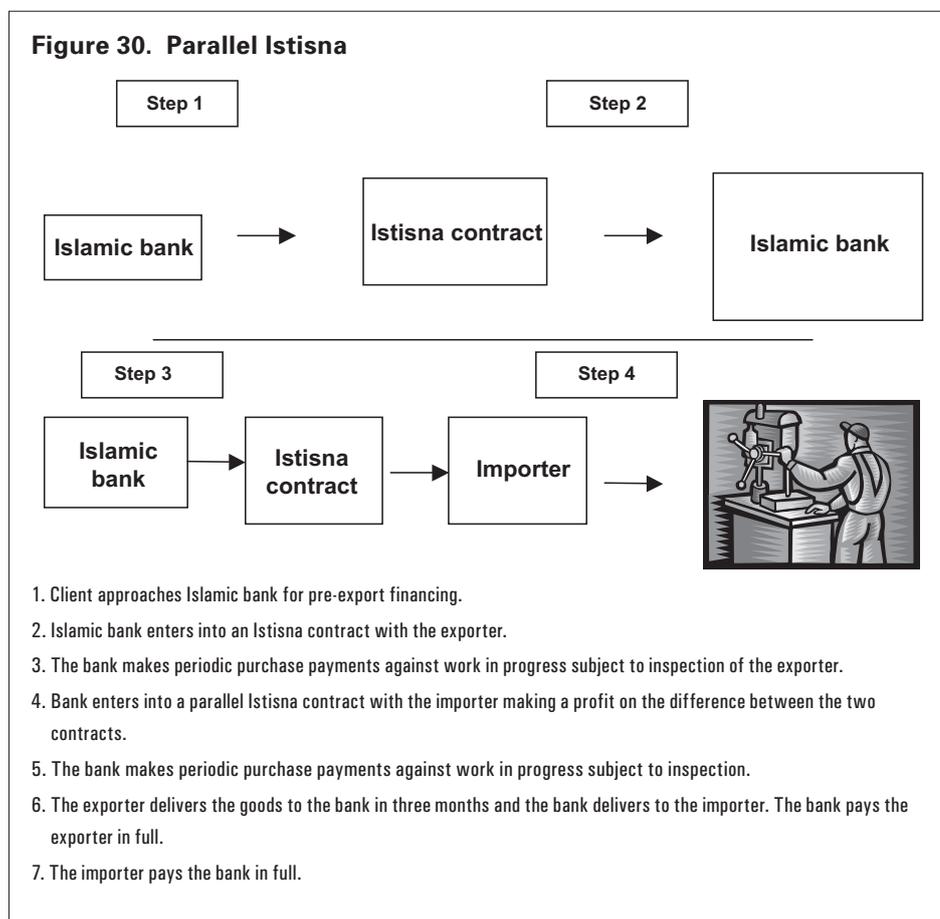
Strengths and weaknesses for micro-enterprises and SMEs

Strengths: The client receives finance as and when the production process requires. The client's risk regarding the importer is passed on to the bank.

Weaknesses: The bank is exposed to the importer's risk and needs to be able to evaluate the capacity of the exporter to manufacture the goods properly.

Parallel Istisna

In an alternative scenario, the bank is prepared to take the importer's risk and may have secured export credit support. In this case, the bank may enter into a parallel Istisna contract with the importer under which the bank contracts to receive the goods from the exporter for R 1.15 million and will sell them to the importer for R 1.25 million. As the bank calls for the down payment, and later the periodic payments from the importer, a portion of these will be passed through to the exporter, thus constituting pre-export finance.



Strengths and weaknesses for the micro-enterprise and SME

Strengths: The client receives finance as and when the production process requires. The exporter's risk on the importer is passed on to the bank.

Weaknesses: The bank is exposed to both the importer's and the exporter's risk and needs to be able to evaluate the capacity of the exporter to manufacture the goods properly.

Concluding observations

As with Bai al Salam, all specifications, delivery options, payment conditions and pricing must be agreed in the Istisna contract. Orders may be cancelled prior to start of production, and delivery need not be specific, but should fit within a maximum time frame and not a minimum. This allows for guaranteed maximum contracts.

The debt arising from Istisna is not explicitly a financial relationship, rather it is the obligation to deliver manufactured goods or constructed property. This places some restrictions on discounting but gives more flexibility. As a general rule, the liabilities to the bank in an Istisna deal are quite high, and Islamic banks have been shifting to forward leases, Wakalah and Musharakah contracts to manage these risks.

Like Murabahah, Istisna is a sales contract which mirrors some of the economics and procedures of pre-export finance, and construction and project finance. Nonetheless, its sales characteristics make it a unique transaction from the perspective of risk and process flow.

Musharakah (joint venture/partnership)

Musharakah is a relationship between two or more parties, each of whom contributes capital to a business or business activity. They contract to share profits based on a profit-sharing ratio (PSR). Losses are borne according to their capital contribution. Musharakah is often used in trade finance, project finance, working capital finance and the purchase of real estate. All providers of capital are entitled to participate in management, but not necessarily required to do so.

The concept is a highly flexible tool for organizing business interests between business partners. Classically, multiple partnerships were crafted with variable terms and conditions as a means of venture management that had more in common with merchant banking, and synthesized lending but with greater risk and reward factors for the bank. There are generally two forms of Musharakah applied in Islamic commerce: *shirkat al milk* and *shirkat al aqd*. There are also credit-driven derivatives of the concept, such as the declining balance partnership. Although the modern applications of Musharakah are typically limited liability entities, the traditional concept is of an unlimited liability business venture.

Shirkat al milk is a partnership of two or more owners of a property held in common, structured in a way as to make it impossible to know which partner

owns which part of an asset. This form of partnership may be established without a specific contract, as in the case of inherited property. The primary limitation is that the object of the partnership, the underlying property, is not divided or unitized. This creates restrictions for use or specific division of the property.

Shirkat al aqd, however, is a mutual partnership by contract. This form of Musharakah is widely used in modern Islamic banking. Although capital contributions may be in kind or by services provided, they are typically cash and valued at an agreed par value which is independently verifiable. There is no obligation to value the disparate components of capital equally.

The basic rules for all methods of Musharakah stipulate that the capital is quantified and specific, and the PSR is agreed in advance.

Although profit cannot be structured to give a guaranteed rate or yield to one party, the investor and investee may agree to set the PSR on the basis of gross sales as opposed to net income.¹⁹ Indeed, if the PSR generated a certain return to investors, they are permitted to give a bonus to the client if the client is the manager. This reflects the principle of partnership in sharia that allows partners to choose not to manage the Musharakah. They may hire an independent third party or one of the partners, most likely the client, to manage the project or activity. These contractual elements allow the Musharakah method to replicate the credit risk environment with which banks and customers are often most comfortable.

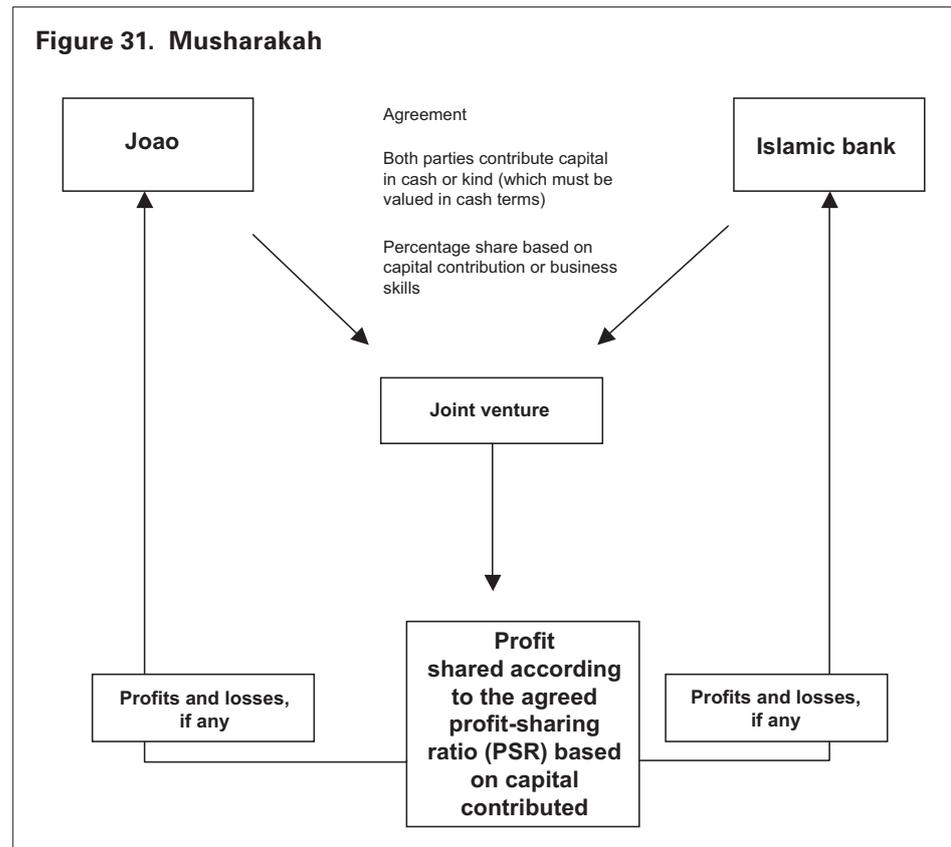
In typical examples of Musharakah arrangements, there is a presumption of an indefinite relationship, serving a similar purpose to equity in a modern corporation. A classical stipulation is that a partnership may not be dissolved without the knowledge of all partners. An equivalent to this in a modern corporation would be a notice of bankruptcy.

The Musharakah model has proven an important tool for financing import and export operations in Islamic markets. This ranges from micro-enterprises and SMEs to large enterprises.

Simple Musharakah

In Angola, Joao's business manufactures small generators useful for the generation of residential and small office electricity. His plant operates at 50% capacity and he believes that his domestic order book reflects the amount of credit and business risk that he is willing to take. Upon further inquiry, he learns that there is demand in neighbouring countries supported by NGOs and local governments that would allow him to increase capacity utilization to 75% or 80%. He has won his first order, valued at US\$ 150,000. But he has limited working capital and requires local currency financing of Kz 5 500 000 (US\$ 75,000) of his pre-export working capital. He approaches his local Islamic bank and is offered a Musharakah in his venture. He and his brothers will contribute time and resources and the bank will invest Kz 5 500 000. The PSR will be 95:5 between Joao and the bank based upon his export order.

¹⁹ This is not accepted by AAOIFI, but has been permitted by Mufti Muhammad Taqi Usmani in the cases of accounting uncertainty and markets with high degrees of moral hazard. Mufti Usmani is the chairman of the AAOIFI sharia board. See Usmani, Muhammad Taqi, *An Introduction to Islamic Finance* (Karachi: Idaratul Ma'arif, 1998), p. 66.



In the example, the bank will make Joao manager of the enterprise. The partnership might last for a sufficient period for the bank to recover its invested capital along with a profit. And Joao might be given performance bonuses for good returns. Once the importer has paid for the goods, the partnership will be dissolved, or may engage in a new export transaction. Often this form of Musharakah is documented as an operating agreement or contract for services.

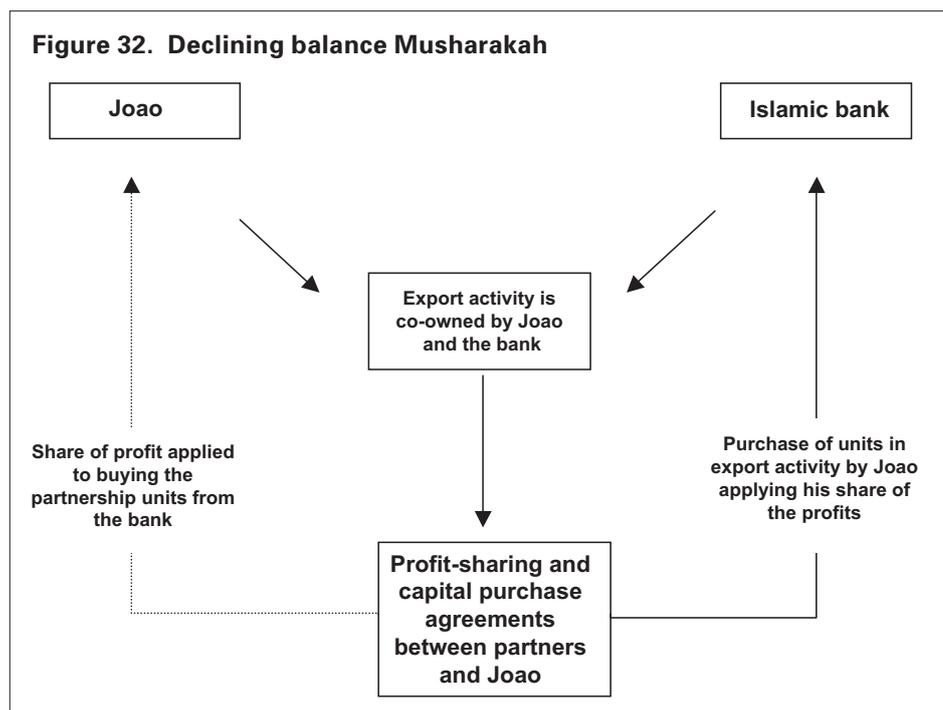
Strengths and weaknesses for micro-enterprises and SMEs

Strengths: This method allows Joao to access the needed capital for pre-export manufacture and secure his order. As the appointed manager, he will be in control of his manufacturing activities, as before. And the PSR assures Joao that he will enjoy the type of return that he is accustomed to. The PSR also allows the bank to compensate itself for the services that are part of a traditional export deal within the realm of sharia.

Weaknesses: Because this is a form of partnership, there may be local law impediments to assuring that the partnership is enforceable. And partnerships often entail non-traditional risks for a bank.

Declining balance Musharakah

In the previous example, it is more likely that Joao will prefer a clearer relationship with the bank and to make payments to the bank over time so as to extend credit to his buyer or manage his cash flow cycle better.



Strengths and weaknesses for micro-enterprises and SMEs

Strengths: This method allows Joao to access the needed capital for pre-export manufacture and secure his order. As the appointed manager, he will be in control of his manufacturing activities as before. He is also able to give terms to his buyer and manage his cash flow cycle more efficiently. And, the PSR assures Joao that he will enjoy the type of return that he is accustomed to. The PSR also allows the bank to compensate itself for the services that are part of a traditional export deal within the realm of sharia.

Weaknesses: Because this is a form of partnership, there may be local law impediments to assuring that the partnership is enforceable. And partnerships often entail non-traditional risks.

Alternative application of declining balance Musharakah

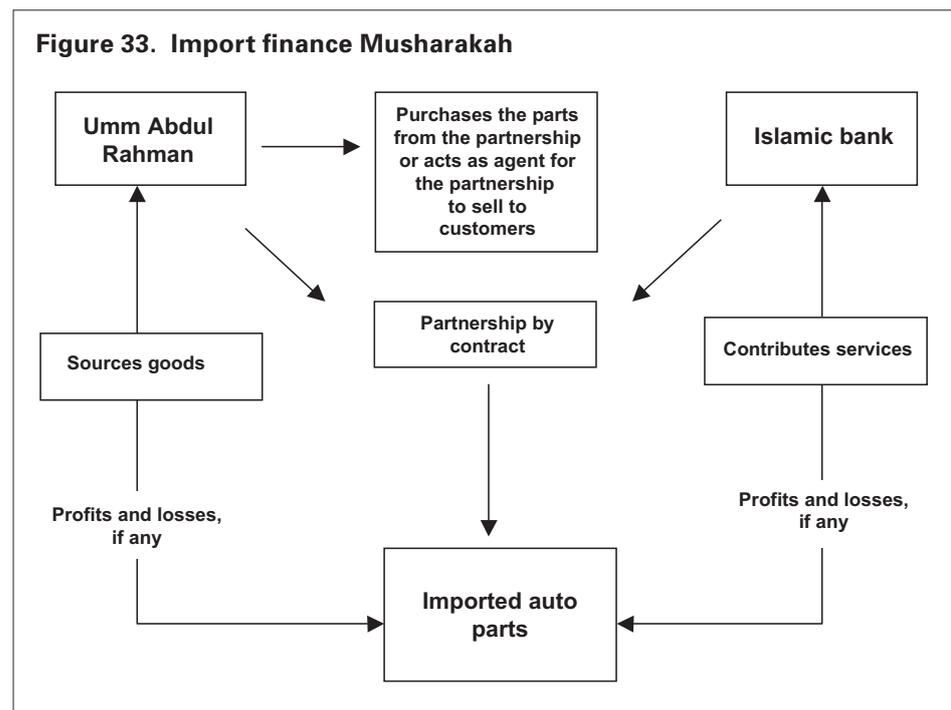
The concept of declining balance partnership is often used to finance fixed assets and projects. For example, Joao wishes to fund an expansion of his physical plant and acquire capital equipment. In this case, the Musharakah will differ in one aspect. Instead of being partners in an operating business and engaging in trade, the bank and Joao will be partners in the assets – the plant and equipment. This will make the contract one of co-ownership. The partners will then lease the plant and equipment to Joao for a set period of time, during which he will pay rent and buy out the banking partner in his business.

Import finance Musharakah

Musharakah is often applied to import finance. Take the example of Umm Abdul Rahman who is in the automobile business. She owns a workshop in

Kano and buys spare parts for Toyota Hilux pick-up trucks which are popular in her area. Every month she needs to import Naira 3 135 000 worth of parts (approximately US\$ 25,000 or ¥ 2 375 000). She generally has Naira 800 000 available for her imports and requires credit for the balance.

Umm approaches her local Islamic bank and forms a trade Musharakah. The bank will contribute cash and services worth Naira 3 135 000 (the services may include a letter of credit and foreign exchange at a fixed cost embedded in the value of the partnership units) and Umm will contribute Naira 800 000 in cash as well as her expertise.



Although Umm will be the managing partner and order the parts, the bank will contribute the services needed to facilitate the goods purchase, including Japanese yen and any required letter of credit. When the goods arrive in Kano, Umm may choose to buy on a spot or deferred basis from the partnership, or she may be appointed as agent of the partnership to sell the parts in the market.

Strengths and weaknesses for micro-enterprises and SMEs

Strengths: This method allows Umm Abdul Rahman to access the needed capital for import finance and to secure payment terms. As the appointed manager, she will be in control of distributing the parts as usual. She is also able to give terms to her buyers and manage her cash flow cycle more efficiently. And the PSR assures Umm that she will enjoy the type of return she is accustomed to. The PSR also allows the bank to compensate itself for the cost of the services that are part of a traditional import deal within the realm of sharia, namely the costs of the letter of credit and foreign exchange.

Weaknesses: Because this is a form of partnership, there may be local law impediments to assuring that the partnership is enforceable. Partnerships also often entail non-traditional risks for banks.

Concluding observations

Trade Musharakahs and declining balance partnerships are widely used by Islamic banks. General Musharakahs have been introduced more recently with strong management contracts and other features allowing the segregation of risks that are more akin to conventional credit risk. Many members of the Islamic community feel that partnership structures such as Musharakah represent the real spirit of Islamic finance. At the same time, the recent experience of Islamic banks demonstrates that Musharakah structures can be managed to control risk in a “bankable” manner. This last point should not obscure the fact that the Musharakah structures are financial arrangements that are closer to equity than they are to debt. As a result, the risks in the event of transaction failure are not at all the same as those of a conventional loan and the bank may be likely to lose money.

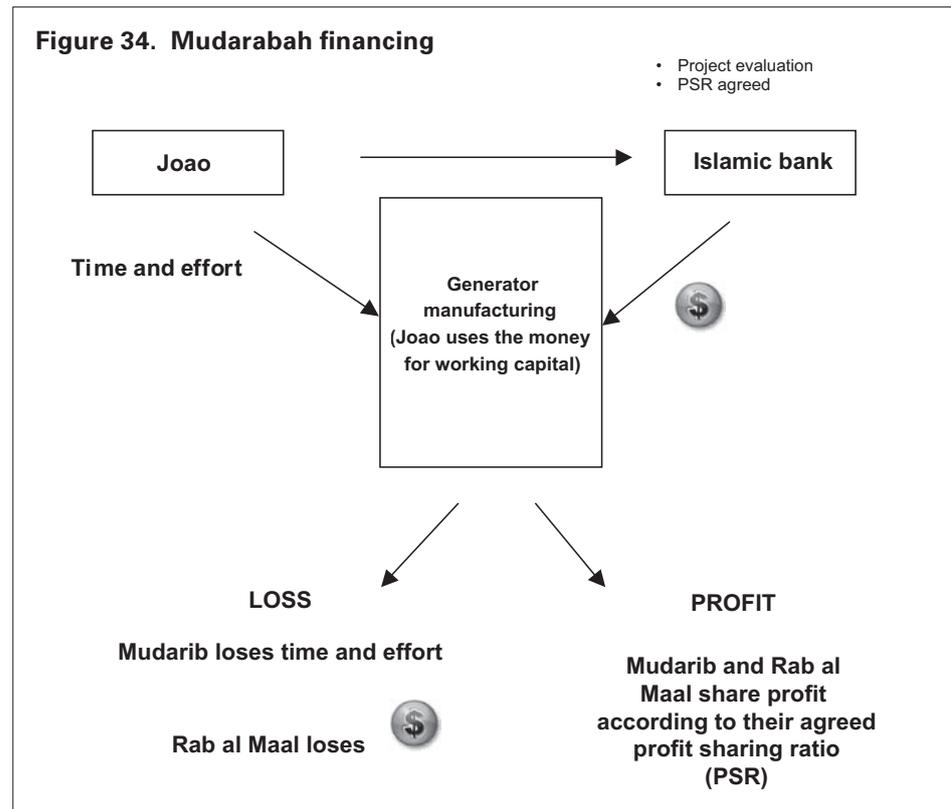
Mudarabah (managed partnership)

Mudarabah is a concept similar to Musharakah, except in the case of the former, one partner (the Rab al maal, or investor) contributes capital and agrees to compensate an entrepreneur or investment manager (the Mudarib) through profit sharing. The capital provider funds the venture and the entrepreneur provides his or her expertise. In these types of partnerships the capital provider bears financial risk and the entrepreneur bears risk in the form of his or her time and effort. The investor and the manager set a PSR to govern their revenue streams.

Mudarabah has three common applications: working capital for a business, PSIA deposit collection for a bank and fund structuring. This section discusses the first two.

In the first case of working capital finance, a Mudarib approaches a bank for funding. Upon completion of its due diligence, the bank will make a sharia-compliant investment in the client’s business. Profits are shared according to the PSR agreed when the contract is signed. But if there is a loss, the bank as Rab al maal will lose its money and the client as Mudarib will lose his or her efforts. Upon the termination of the Mudarabah, the same rules of profit and loss sharing apply. A Mudarabah may be continuous or for a specific period of time.

Returning to the example of Joao in Luanda, instead of a Musharakah, the bank might form a Mudarabah with Joao. In this case, the bank will invest Kz 5 500 000 with Joao under a Mudarabah contract. Joao will be the Mudarib or investment manager. The two parties will still agree on a profit-sharing model. But now the bank bears all of the financial risk and Joao risks losing only his efforts.



Strengths and weaknesses for micro-enterprises and SMEs

Strengths: This method allows Joao to access the needed capital for pre-export manufacture and secure his order. As the appointed manager, he will be in control of his manufacturing activities as usual. He is also able to give terms to his buyer and manage his cash flow cycle more efficiently. And the PSR assures Joao that he will enjoy the type of return that he is accustomed to. The PSR also allows the bank to compensate itself for the services that are part of a traditional export deal within the realm of sharia.

Weaknesses: Because this is a form of partnership, there may be local law impediments to ensuring that the partnership is enforceable. Furthermore, partnerships often entail non-traditional risks.

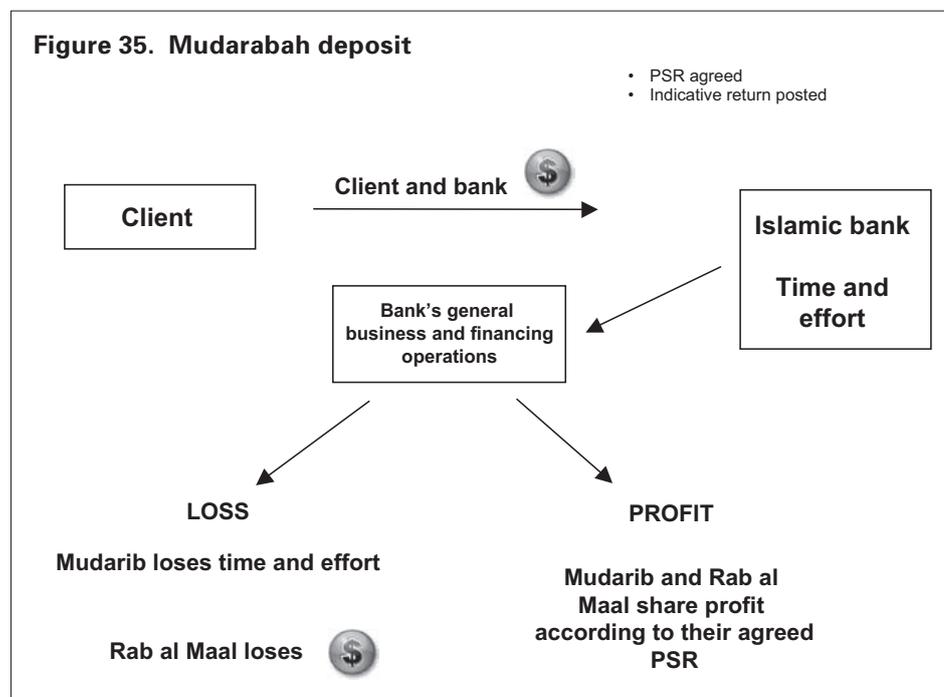
Just as with Musharakah, the parties entering into a Mudarabah contract have a number of contractual freedoms. The Mudarib may elect to set a limit to the profits that he or she will realize, or the Rab al maal may grant the Mudarib a bonus for achieving a target. A Mudarib may also hold reserves that allow income to be spread across reporting periods, where allowed by law, so as to generate a certain level of profitability for investors.

Mudarabah deposit

The traditional method of contracting PSIA deposits at Islamic banks was to offer a Mudarabah deposit. This is a form of unrestricted Mudarabah through which the depositor's money is shared with that of the bank. The

bank typically posts a PSR and may indicate a possible return based upon past performance or the type of instrument applied though the Mudarabah (for instance, the Mudarabah may be used to finance the bank's trade finance activities with a fixed and predictable income).

In these deposits, the bank does not have to tell the depositor how it will apply the depositor's funds.



Wakalah

A recent trend among Islamic banks is to apply the concept of Wakalah, or agency, to both financing and deposit taking. While Wakalah bears strong resemblances to Mudarabah, there is a key difference: a Wakeel, or agent, merely represents the party that has the money.

For instance, if the bank appointed Joao as Wakeel instead of Mudarib, then Joao would be eligible for a salary, not just a share of the profits. As an agent of the bank, Joao uses the bank's money, but owes it back (unless there is a loss). Here the financial dynamics are more like those of a loan.

Conversely, if after many successful years, Joao wishes to deposit his funds with the bank, he may place them in a Wakalah deposit. This too is a PSIA, except that it is one in which the funds belong to Joao and are applied by the bank. The bank is able to pay itself a fee akin to margin. If the bank loses money, so may Joao. If not, the bank must return his money at the term of the Wakalah.

The main difference beyond the fee concept is that the Mudarabah is either a formal partnership or a business operation contract. As a formality, the Mudarabah must be terminated and the partnership dissolved or bought out. The Wakalah, however, ends without a business operation terminating or

a partnership being formally dissolved. The Wakalah simply ends with the repayment of funds.

Concluding observations

As with Musharakah, the Mudarabah and Wakalah structures often parallel the risk and reward profiles of loans and deposits. Nonetheless, these financial structures are closer to equity than to debt (see text table below). As a result, the risks in the event of transaction failure are not at all the same as in a conventional loan, and the bank or “depositor” may lose money.

Comparing equity and agency structures				
	Musharakah	Declining Musharakah	Mudarabah	Wakalah
Equity or debt	Equity	Equity with strong debt features	Equity	Debt with equity features
Profit sharing	According to PSR	According to PSR, unless one partner rents the asset, then profit-sharing is deferred to the termination of the partnership or lease	According to PSR	Not required
Loss sharing	According to the capital invested	According to the capital Invested	According to the capital invested, manager loses time and effort	The agent is not exposed to loss of capital
Fees	Not allowed	Not allowed	Minimal	Allowed

Chapter 7

Providers of Islamic financing

Islamic banks have been expanding rapidly. There are now three distinct approaches to providing customers with Islamic financial services: fully fledged Islamic financial institutions; Islamic windows at conventional banks; and limited Islamic service offers by conventional banks. Each model has enjoyed success depending on the market in which it operates, the degree to which regulators are prepared to allow full-fledged Islamic banking and the shareholders are prepared to take up the Islamic banking business proposition.

Throughout Africa, these approaches are becoming more common. The growth of Islamic alternatives is notable particularly in Kenya, Nigeria and South Africa. Well-established Islamic financial institutions operate in most of the countries that are members of both the Organization of African Unity and the Arab League, with a well-established offering in the Sudan.

Fully fledged Islamic banks

Banks that exclusively offer a full suite of sharia-compliant depository, investment and financial products can be classified as fully fledged Islamic banks. The number of such banks is increasing, as Islamic banks are established in new markets, new Islamic banks enter established markets and conventional banks convert to Islamic banking. Islamic banks are found in over 70 countries.

Islamic windows

Conventional financial institutions have often recognized the importance of the Islamic market and, as a result, opened Islamic windows. These are dedicated units within the bank that only offer sharia-compliant products. Typically, the window has its own balance sheet, income statement, staff and back office. The window must be governed by its own sharia advisory board.

The main goal of the window is for the bank to maintain its market share in the face of growing Islamic service offerings in markets such as Malaysia or Saudi Arabia. It also allows banks to serve a unique Muslim clientele in a predominantly non-Muslim market.

In the past decade banks have opened up Islamic windows. Among them are HSBC's uniquely branded "HSBC Amanah". These windows offer a

competitive suite of sharia-compliant products to their clients. As conventional banks offering Islamic products, their focus tends to be limited compared to the offering available from a full-service Islamic financial institution.

Limited Islamic product offerings

Conventional banks often enter the Islamic market space with a single product. For instance, University Bank in the United States began with an Ijarah Muntahiyah Bi Tamleek home acquisition product. Over the course of three years, the bank added new one-off products according to consumer demand. In 2006, University Bank launched its Islamic window in the form of a subsidiary University Islamic Financial Corporation.

The one-off product offering is a useful way for a bank to test the market, and it is encouraged by most Islamic scholars. This model has been applied by numerous banks in markets as diverse as Malaysia, the United Arab Emirates and the United Kingdom.

The Islamic Development Bank Group

The IDB Group is committed to supporting export and trade finance initiatives serving its member States and their business operators. IDB provides a strong series of platforms to allow government, NGO and business operators to network, build capacity and secure financing. Historically, trade finance constitutes 20% – 25% of the IDB Group's income. In the field of trade finance, three subsidiaries of the IDB are dedicated to this process:

- ❑ Islamic Corporation for Development of the Private Sector (ICD). ICD has many mandates including financing, equity investment and advisory services. This is the key capacity-building subsidiary of IDB.
- ❑ International Islamic Trade Finance Corporation (ITFC). The latest addition to the IDB family, ITFC offers financing for specific trade transactions and expands on many of IDB's existing programmes to make more trade funding available to a larger pool of exporters operating in areas under the IDB mandate. This is the key trade financing subsidiary of IDB.
- ❑ Islamic Corporation for the Insurance of Investment and Export Credit (ICIEC). ICIEC covers shariah-compatible export credit and insurance, investment insurance and reinsurance for its 35 member countries. These 35 countries are members of the Organization of the Islamic Conference and span the Middle East, Africa, Central Asia and Southeast Asia. ICIEC supports three customer groups with specific needs. It does this by:
 - Protecting exporters and banks against the risk of nonpayment of an export receivable.
 - Offering investors three different types of foreign investment insurance policies.
 - Protecting the confirming bank of a letter of credit against the risk of non-payment by the issuing bank.

IDB programmes are offered in conjunction with governments, NGOs and banks. The key to access is that the applicant and transaction must have a business connection with an IDB member country.

Concluding observations

The capacity of the Islamic financial sector is growing rapidly throughout the world, even after the global credit crisis. One of the reasons for this is the ability of Islamic banking to address finance in new ways which may reduce systemic risks. Another is the dedicated role of multilateral organizations such as IDB in promoting the knowledge and resources that make Islamic finance accessible. As a result, more OAU banks are offering Islamic finance or are willing to begin doing so, and more regulators are welcoming this trend.

In a practical sense, as seen in the case of the University Bank in the United States, limited offerings may lead a bank to form an Islamic window. Over time, this may bring about the establishment of a stand-alone Islamic bank.

The rapid evolution of the Islamic banking market has led to a growing number of resources that can help locate the best or nearest provider of Islamic financial services. Three of the most useful are:

General Council of Islamic Banks and Financial Institutions

www.cibafi.org

This industry group provides research and market data on the current state of the Islamic financial services market. Its website provides information in Arabic and English.

Islamic Finance Information Service

www.securities.com/ifis

This specialist website is rich in research data relating to Islamic financial services. It is part of the Euromoney Institutional Investor Group.

Islamic Finance News

www.islamicfinancenews.com

This website specializes in news, market trends and analysis of Islamic financial services. Its weekly online publication provides a comprehensive review of latest market developments, while the website offers extensive research resources.

Chapter 8

Accessing Islamic finance

On the one hand, the method of accessing Islamic finance is similar to that of conventional finance, given that an Islamic bank will require the same types of basic credit and collateral evaluation procedures as a conventional bank. On the other hand, the process may differ regarding a number of important details. Most notably, as Islamic finance follows the values defined in the Koran, an Islamic bank will not be able to participate in certain business activities, even indirectly.

Role of sharia compliance

It is important to underline that it is not necessary to be Muslim or have a business that is 100% sharia compliant to deal with an Islamic bank or enter into an Islamic financial relationship. Whenever an Islamic bank deals with a company that is not explicitly sharia compliant, the onus of observation is on the Islamic bank. This means Islamic financial institutions are permitted to work with non-Islamic companies, that is to say companies that are not explicitly governed by sharia. But the Islamic bank must be certain that the application of its funds is consistent and in accordance with the sharia rules dealing with commerce.

This means that the purpose of the deal must comply with sharia, even if it is a “religiously” neutral activity such as the example of Umm Abdul Rahman’s auto parts business discussed in chapter 6. It also means that the form of contract and steps of execution taken to deliver the funding must be followed correctly and subjected to periodic audits by the sharia auditor of the bank’s sharia board. This last step ensures that the bank and its stakeholders are following its religious mandates.

If the non-Muslim micro- or SME operator is complying with the terms of his or her contract, this is a non-invasive process and may cost little more than time to facilitate a sharia review of documents or a visit to facilities by the sharia auditor.

This chapter examines the process of applying for Islamic finance, from the point of view of a micro- or small and medium-sized enterprise. It considers the implications of sharia compliance, sets out the practical steps involved in applying to an Islamic bank and considers the potential benefits of using Islamic finance.

Considering Islamic finance

There are two distinct approaches to sharia compliance. In the first, a company seeks simply to access the services of an Islamic financial institution. Alternatively, a company seeks to operate as fully sharia compliant. The second approach requires a very different strategy and has a different cost, including the cost of ongoing engagement.

In the second case, the company must adopt sharia compliance as part of its articles of association and by-laws. The company then undertakes, as a part of

its ordinary course of business, to follow the rulings of its sharia adviser, who may be internal or external. The company will also subject itself to periodic sharia audits of its behaviour, activities and business processes. Naturally, the company will not sell or make things forbidden by sharia and it will not lease space for forbidden activities. Moreover, the company will commit itself to a capital structure that complies with sharia.

Even if some elements of sharia compliance vary from region to region, the main steps that a business must take to deal with an Islamic bank are remarkably similar. The credit and investment process, for instance, will be identical. And a company approaching an Islamic bank for financing will need to be able to demonstrate that the money will be applied according to the sharia guidelines of the Islamic bank. These will govern the steps of the deal, the way the money may be used and how the transaction is to be followed up. From time to time, both the Islamic bank and the customer must adapt to prevailing local regulations, taxes and laws which do not explicitly allow for the expected application of sharia financing tools as described in this book. Such adaptations are generally practical.

Honouring the obligations linked to Islamic financing will place some extra demands on the manager of a micro-enterprise or an SME. These primarily involve additional reporting and, periodically, extra transaction steps. In addition, documentation will differ from conventional loan documents. For instance, a working capital loan for pre-export finance may only require a loan agreement. But a Murabahah to supply the exporter may require a series of documents, including a sales contract, warehouse receipts and title deeds.

Fortunately, most Islamic transactions are supported by modern banking systems, ensuring that there are standardized forms and contracts. Nonetheless, the operational steps may incur costs which are different from a loan closing. Sometimes these costs are somewhat higher than with a loan. These costs may reflect either the additional steps of closing a deal or the fact that the transaction involves selling, leasing or engaging in a partnership or agency.

These differences naturally require some changes in accounting, funding and post-closing reporting. The structures of Islamic transactions are unique as they generate cash flow and risk profiles that are distinct from those of a conventional bank. Likewise, the accounting and risk treatments for Islamic deal structures, deposits and institutions demand a special approach. These fundamental differences in style and substance mean that Islamic banks need special accounting and risk management approaches, which have led to the formation of specialized bodies such as the Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI) and the Islamic Financial Services Board (IFSB).

Choosing Islamic finance

In a time of financial uncertainty among conventional institutions, the characteristics of Islamic banks have shielded them and their clients from such ambiguity. The main advantage, therefore, for micro-enterprises and SMEs is that Islamic banking opens up new financial resources and possibilities that may prove solid in a time of instability for conventional banks. Flowing from this, there may be new markets and new opportunities for the micro- or small and medium-sized exporter when he or she begins dealing with Islamic banking.

In examining the typical credit process, it is possible to see how Islamic finance is similar to or distinct from conventional finance. The financing process has four clear steps:

Step 1: Pre-application

Understanding a company's financial needs
 Determining the right financial instrument
 Pre-application: finding the right financier and service provider

Step 2: Application

Documentation and funding

Step 3: Approval and post-closing

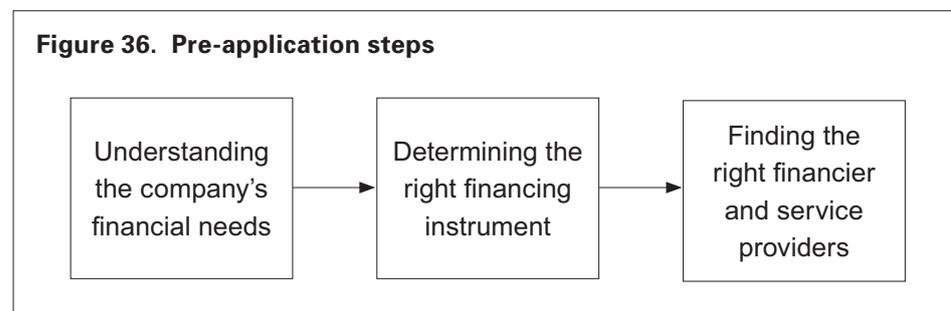
The websites of Islamic trade finance institutions may carry a checklist of project information requirements at various steps of the financing process. A sample checklist is given in the annex to this chapter.

Step 1: Pre-application

Ensuring that a company is in a position to access financing is largely the same for any form or style of finance. Preparing orderly financial records, having a well-structured business plan and evidence that one is able to manage or adapt it accordingly are key to any credit process. Demonstrating that a company's collateral or business process has value lends support to the success of an application. However, Islamic finance will require an extra one, if not two steps:

- The activity or asset to be financed must comply with sharia.
- The character of the activity or asset must remain compliant with sharia.

As a general principle, the micro-enterprise or SME must be able to demonstrate the compliance and the viability of the asset or the process. It will be critical for the asset or process to remain so for the life of the Islamic financing. This will require a sharia audit at the onset and throughout the relationship.



Step 1.1 Pre-application: understanding the company's financial needs

The applicant for Islamic finance (export or pre-export, working capital or capital expenditure) will follow similar pre-application steps as for a conventional loan. The applicant must correctly understand his or her business financial needs, as well as the realistic benefits of securing Islamic

finance to meet those needs. Because Islamic tools are unique, the applicant must understand if the choice should be, for example, a sales contract such as Murabahah to purchase order, or another instrument.

Step 1.2 Pre-application: determining the right financial instrument

For instance, is capital expenditure better funded by a lease, releasing operating cash flow for pre-export activities? Or, should the exporter work with the financier to lease the yet-to-be produced goods to the end-user via a forward lease? If the exports are commodities, for example, should and could Salam be the best tool for this undertaking? Would Istisna be suitable for processed commodities like groundnut oil?

Each of these questions may result in an answer that changes the exporter's choice of institution. And each answer results in a clear and well-defined set of choices when it comes to understanding what documentation and due diligence will be required at the Islamic financial institution.

Step 1.3 Pre-application: Finding the right financier and service provider

The growing number of international and specialist Islamic banks that offer Islamic banking services are often identifiable on the Internet or through the association of local banks. In some countries there are also a number of brokers and agencies that assist with the securing of Islamic financial services. When it comes to export and trade, the best websites are those of the Islamic Development Bank (IDB):

❑ www.itfc-idb.org

❑ www.icd-idb.com

❑ www.iciec.com

IDB has a number of important programmes, all of which will help the micro-enterprise and SME to find local partners and learn the specific terms of eligibility for IDB support. Some IDB programmes allow applicants to apply online.

Step 2: Application

Once the exporter has identified the best financing tool, it is time to proceed to the next phase, application.

Step 2 Application: Documentation and funding

Beyond the specific criteria of any IDB programme, the factors that make a proposal bankable in Islamic banking are identical to those of conventional banking, except for the specific issues that relate to sharia compliance. Such issues include whether the goods to be traded are permissible in sharia and whether their use is acceptable according to Islamic principles. The answers to these critical questions will also lead to a unique deal structure. The application documentation will mirror conventional credit applications, but the closing and deal execution documents will differ according to the deal structure and Islamic moral requirements.

Depending upon the programme, standardized forms are available for certain Islamic trade finance products, especially those provided by IDB programmes. The same programmes will tend to have available standardized contracts. But given that Islamic finance is new in many countries, micro-enterprises and SMEs may find that contracts must be negotiated for the initial deal from scratch, and perhaps improved or tinkered with on subsequent deals.

Whenever non-standard documents are used, the costs of documentation will reflect the development of new documents in that market. These may take up to three to four weeks to develop if a *de novo* legal opinion is required.

A manager of a micro-enterprise or SME should proceed with Islamic financing if he or she is prepared to take the extra steps and bear the marginal costs. The advantages of new financial resources and new markets should overcome the drawbacks of more transactional steps. In order to proceed, it may be beneficial to engage a person or firm experienced in sharia advice.

This will allow the manager to understand the activities forbidden to Islamic financiers; for instance, why the Islamic bank can engage in a Salam deal for groundnuts, but not for pork or alcohol. The advisers will also help the manager to understand which Islamic financing concept is best suited. At this stage the manager should be ready to approach any local bank or local Islamic bank for Islamic finance.

The micro-enterprise or SME should anticipate the conventional credit process, in which the bank will seek to understand the company's credit risk, the need for the money, the risk of loss to the bank and the proper risk reward characteristics for the bank and the micro-enterprise or SME.

If the risk and credit metrics cannot be met, the enterprise's application will be rejected and it will have to restart the process. But if the company and the bank are able to reach a common agreement, they may move on to the next phase.

Murabahah to purchase order

Preparing for Islamic finance and the application of the micro-enterprise or SME to the bank for credit

The entrepreneur has to be directly focused on the asset and prepare a clear description of how the business process will lead to a successful outcome for both the company as a buyer – in the case of Murabahah to purchase order – and the bank as a seller. Each of the Islamic modes with its particular focus on the asset or business process will demand a change from simple credit analysis of the company to a more detailed analysis of the assets to be bought and sold, or leased, or the business process to be followed.

In a conventional loan, the documentation requirements are often much simpler than an Islamic transaction. However, a Murabahah to purchase order requires a number of unique deal documents representing the actual steps for the purchase and sale of the supplies to the exporter. As a result, once approved, the bank will not necessarily execute a loan and take the collateral.

Instead the bank will receive a promise or binding purchase order, and then register any collateral or guarantees. Next the bank will buy the supplies on its own account, offer them to the customer, and then sell them. These procedural steps are often executed with efficiency, but may also require both more documents and more attention to detail. Perhaps the most important aspect is that the "funding" refers to the delivery of goods as opposed to cash.

Step 3: Approval and post-closing

Once the bank in a Murabahah to purchase order transaction has completed its sale to the client, the client will have acquired goods, but not yet paid for them. At this stage of the credit relationship, there are truly different outcomes which may affect the company's and the transaction's risks:

- ❑ The client performs and maintains the payment schedule as agreed.
- ❑ The client generates revenues faster than expected and wishes to redeem the debt ahead of schedule. Because the debt arises from a sales transaction, and is not from a loan, the seller (in this case a bank) has no sharia obligation to reduce the price. But many Islamic banks will elect to do so in the case of early redemption to maintain a good customer relationship.
- ❑ The client is able to perform, but not as planned. In this case, the bank may elect to reschedule the client's payments over a longer period. If the bank does so, it may not charge a higher price or penalties. Indeed, if the bank gives the customer more time, the bank may maintain the debt at a constant value, or reduce it.
- ❑ If there is no hope of the customer honouring his or her obligations, the bank may seek to collect on guarantees, foreclose on any collateral, or repossess the asset.

Annex

Application and closing checklist for the micro-enterprise and SME

The Islamic trade finance company may provide the following useful checklist of required project information on its website:

1. General

- Legal structure and laws governing the activity of the company
- Licence requested to undertake the contemplated activity
- Year of establishment
- Contact information

2. Owners/sponsors

- Name, nationality and ownership percentage of main shareholders
- Experience in the sector, industry and product lines
- Technical partner
- Experience in company management

3. The company

- Brief company history
- Products or services
- Technology used
- Labour force
- Production and sales pattern (five years)
- Sales distribution (local/foreign; market segments, etc.)
- Market information (supply, demand, prices, distribution strategy, main competitors)
- Principal suppliers and customers
- Comparative and competitive advantages
- Historical financial information (audited statements for the last three years)

4. The project

- Detailed description of the project
- Project feasibility studies: technical, market and financial
- Comparative and competitive advantages

- Major sources of competition
- Technology arrangements
- Employment (projected)
- Foreign exchange generation (projected)

5. Investment costs

- Costs of the project and its breakdown
- Basis for estimating costs
- Potential sources of local and imported equipment/machinery

6. Financial projections

- Five-year pro-forma financial statements for the project, and consolidated statements for the company (cash flow, balance sheet and income statement)
- Assumptions used for financial projections
- Cost of goods sold and unit cost analysis

7. Implementation

- Mode of procurement
- Monthly/annual schedule for project implementation
- Risks envisaged

8. Financial plan

	\$'000	%
EQUITY		
Owners/sponsors		
Other investors		
Subtotal		
LONG TERM DEBT		
Local banks		
Foreign banks		
Other sources		
Subtotal		

9. Operating and working capital financing

- Trade/commodity/crop, etc. finance
- Short-term lines of credit for working capital needs (receivables plus inventories minus suppliers' credit)

10. Proposed security arrangements

- Mortgage/liens on project assets
- Insurance
- Sponsor guarantees
- Project completion guarantees
- Offshore escrow account
- Security sharing with other financiers

Chapter 9

The role of a sharia adviser

An important aspect of the rapidly growing and evolving Islamic banking industry is that financial institutions offering Islamic financial products are advised by sharia scholars. The knowledge and ability of these scholars to provide advice is improving. Modern scholars may undergo specialized training at a number of institutions, participate in a variety of scholarly and regulatory colloquia and pursue specialized designations in sharia audit, such as that offered by AAOIFI. This increasingly sophisticated body of scholars is able to advise clients, banks and regulators in a way that is business friendly. These scholars and advisers help bankers and customers to develop new products as well as to confirm that business activities and transactions are carried out in a sharia-compliant manner.

When it comes to product development, the client and the Islamic bank pursue an iterative process with the sharia scholars. This usually will start with a business description of the product indicating why it is to be developed, what it will do, how it will work and the related legal issues. Once an agreement on the initial business description is agreed with the sharia adviser, lawyers may be engaged to draft documents and meetings may be held with regulators to finalize key issues. Sometimes there will be extensive market testing of the concept and the initial business proposal. This should lead to a final product white paper, a sample set of documents and perhaps a live test case.

The sharia adviser will then provide a final *fatwa* (religious decree) approving or declining a product. If the product meets AAOIFI standards, the process is likely to flow smoothly, as the AAOIFI standards represent the consensus among leading modern Islamic scholars. If not, the process may prove more complicated as the sharia adviser needs to understand the points of difference from the agreed standards of his peers.

Regarding compliance issues, the sharia adviser monitors the overall compliance of a bank's or business's products and services. The sharia adviser will rely on the bank's or client's own compliance department or counsel to assure conformity with applicable laws and regulations. The sharia adviser solely examines the business with respect to whether it meets the prior fatwa given governing its operations, and continues to maintain sharia compliance. To this end, a sharia board serves in a review or audit capacity.

Product development usually entails unique steps that involve solving a problem in law or procedure or business. New products often require a great deal of attention from sharia scholars and take time to deliver. Sharia compliance is based on the existence and implementation of sharia products and procedures. Therefore, actual compliance is based on checking and certification.

In conclusion, sharia scholars and panels perform research to enhance existing sharia-compliant operations and to discover new ones. They provide guidance on product development and serve as auditors of sharia compliance. When it comes to a micro-enterprise or SME, sharia advisers are a valuable resource in understanding how sharia rules affect the business and what the preferred means of transacting are. Finally, sharia scholars can serve in assuring customers that the business or banking operations are sharia compliant.

Chapter 10

Regulations, tax implications and jurisdictional guidelines

The merchant character and profit-sharing activities of Islamic banks mean that regulation and governance of these institutions and their deal structures differ from those of conventional banks. There are also tax-related issues in countries that have value added taxes, stamp duties and asset transfer taxes. In addition, regions and countries have taken vastly different approaches to authorizing and enabling Islamic banking and finance. As a result, the manager of a micro-enterprise or SME and his banker can face higher operational costs. In addition, the manager may not be able to access as many services from the Islamic bank as from a conventional bank.

Regulators

There is no single regulator for modern Islamic banking and finance. The Bank for International Settlements (BIS) and the International Organization of Securities Commissions have set up task forces on Islamic banking and securities. Nonetheless, the standard of regulation is national. Countries such as Bahrain and Malaysia have comprehensive domestic regulation and easy access to data at the relevant regulators' websites (see below). The Central Bank of Sudan also presides over an active Islamic banking sector.

Bank Negara Malaysia	http://www.bnm.gov.my
Securities and Exchange Commission of Malaysia	http://www.sc.com.my/
Central Bank of Bahrain	http://www.cbb.gov.bh
Central Bank of Sudan	http://www.bankofsudan.org/

To guide the international community and various national regulators, the industry has established its own best practices, which might be characterized as an emerging Islamic financial regulatory framework. This evolving regulatory constellation is led by the Accounting and Auditing Organization for Islamic Financial Institutions (www.aoifi.com) and the Islamic Financial Services Board (www.ifsb.org). AAOIFI and IFSB are independent governance bodies housing their own expert sharia panels, typically led by the most experienced and acknowledged scholars serving the financial services. These two bodies set standards for products and services offered by Islamic financial institutions, windows at conventional banks and conventional banks offering Islamic services.

AAOIFI is a Bahrain-based pan-Islamic, non-profit membership organization providing accounting, auditing, governance, ethics and sharia standards for

the industry. AAOIFI's more than 150 members from over 40 countries include central banks, Islamic financial institutions and other participants from the financial services, legal, accounting and associated industries.

Most micro-enterprises and SMEs will apply local accounting standards or International Financial Reporting Standards (IFRS). But these will not necessarily accurately report an Islamic transaction. AAOIFI standards provide the correct means to account for the Islamic transaction in terminology that is consistent with the IFRS style. This approach may help a manager to deal with tax or other issues.

IFSB, based in Kuala Lumpur, is a pan-Islamic, membership-based body that sets standards for the Islamic financial services industry (banking, capital markets and insurance). It is non-profit and focuses on defining the risk and capital adequacy requirements relating to Islamic transactions and institutions. While it mainly focuses on Basel II²⁰ issues, its mandate accommodates broader governance and risk management issues. Its more than 150 members include over 35 regulatory and supervisory authorities from Islamic, OECD (Organisation for Economic Co-operation and Development) and other countries. The International Monetary Fund (IMF), the World Bank and the Islamic Development Bank are also members.

Tax implications

There are two fundamental challenges raised by the various Islamic contracts applied in finance. The first is that many of the Islamic finance tools are sales contracts. Depending on the jurisdiction, this may give rise to both value added and transfer taxes. Many countries, including Malaysia and the United Kingdom, have passed explicit tax exemptions for certain types of Islamic transactions to give them tax neutrality. In some cases, such as in the United States, certain Islamic structures, including Murabahah and Ijarah Muntahiyah Bi Tamleek (lease ending in ownership), are exempted from certain taxes through regulatory rulings treating them as loan structures. In countries which have not adopted such exemptions or rules, a Murabahah or other Islamic structure may be subject to significantly higher taxes than a loan.

Secondly, the income from the profit-sharing modes of Islamic finance may generate capital gains taxes and taxes on dividends. This can restrict the availability or cost of Musharakah and Mudarabah structures in some countries.

Jurisdictional issues

Islamic banks typically operate in either civil law or common law jurisdictions. Only Saudi Arabian Islamic banks operate in a sharia-only jurisdiction.

²⁰ The Basel II Framework, issued by the Basel Committee on Banking Supervision, sets minimum standards for prudential regulation. Among other goals, these seek to align regulatory capital requirements more closely to the underlying risks that individual banks face.

Islamic transactions tend to be more easily executed in common law countries, as concepts like beneficial title and trusteeship exist within the broad legal framework. As shown with agency Murabahah and Wakalah deposits, beneficial ownership is an important tool in Islamic finance. In contrast, civil law jurisdictions require explicit new laws to enable Islamic finance. With the exception of Bahrain (civil law) and Malaysia (common law), most of these jurisdictional issues are being addressed only in key markets at the time of this book's writing. As a result, not every product described in the book may be available.

Conclusion

The regulatory, tax and legal issues relating to Islamic finance are only now being addressed in many countries. The best practices developed by AAOIFI and IFSB are important guides to the international market on the development of applicable accounting treatment and regulation for Islamic banks and their unique deal structures. As a result, these bodies provide useful resources to the broader market on best practices for the regulation and taxation of Islamic transactions as well as a clear sense of the most suitable type of legal framework. In the meantime, as regulatory, tax and legal issues for Islamic finance are not widely addressed, there may be fewer products and higher costs for managers of micro-enterprises and SMEs seeking to apply Islamic finance in their businesses.

Appendix

Frequently asked questions

Q: Do Islamic banks only deal with Muslims?

A: No. Islamic banks deal with any person or company willing to abide by the rules and apply the structures used in Islamic banking. As discussed in this book, these include moral prescriptions as well as commercial rules.

Q: Will an Islamic bank necessarily share losses in my business?

A: No. Certain forms of Islamic finance apply sales or leasing transactions. The Islamic bank in these cases will focus on credit and asset risk.

Q: Is my deposit at an Islamic bank necessarily exposed to the risk of loss?

A: No. Some investments at Islamic banks are meant to protect a depositor from the risk of loss. Others may be covered by special reserves that the Islamic bank holds to protect you from their risk of poor performance or loss, and its transmission to you.

Q: Do the regulators in my country have to change the laws to allow Islamic financial instruments?

A: In some cases, the laws and tax regulations of a country may penalize the various Islamic methods. Nonetheless, it is often the case that Islamic institutions are able to operate on a limited basis without a country changing too many of its rules and regulations. The optimal performance of Islamic banks arises when Islamic banks are able to operate in a regulatory and tax framework that gives them equal treatment with conventional banks and their structures.

Q: Are Islamic banks forbidden to take collateral? If they do, may they keep more than the size of my obligation if they foreclose?

A: No. In many transactions, such as the Murabahah contract, an Islamic bank will take collateral. If forced to seize the collateral, the bank is allowed to recover only the amount due to it and any fees relating to recovery such as legal fees.

Q: Are international Islamic banks able to work in countries in which they do not have branches or subsidiaries?

A: Over the years, Islamic banks have operated in different capacities as offshore financiers, fund investors and asset managers in countries where they are not physically established.

Q: Are conventional banks able to provide me with Islamic financial services and products?

A: Since the inception of modern Islamic banking, major international banks including Citibank, HSBC, Deutsche Bank, and Development Bank of Singapore have provided Islamic financial products to the global market. Islamic scholars are pleased that these and many smaller conventional banks provide such services as they help the market to grow.

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