ISLAMIC FINANCE
AN INTRODUCTION

THIS IS THE FIRST OF TWO ARTICLES INTRODUCING ISLAMIC BANKING AND FINANCE CONCEPTS WRITTEN BY MARK ANDREWS, HEAD OF ISLAMIC BANKING AND FINANCE, RISK REWARD LTD. PART 2 WILL APPEAR IN THE NEXT RISK UPDATE Q3 2009.

There is much to both admire and praise about Islamic Finance. Its stated ethos and principles are probably as close to a model for truly ethical and moral banking that has yet been developed and actually implemented on a large scale.

Based on the Quran, Islamic Finance offers its clients Shari'ah compliant banking but the real meaning and to be fair, the true benefits of this, are often lost on Western observers, some of whom have tended to dismiss the sector as yet another example of fundamentalist religious doctrine applied to real life. But this cynical view is not only undeserved it is also mostly inaccurate. In reality, even a cursory study of Islamic Finance and its guiding principles will confirm it is indeed probably the most successful model for ethical banking to date. But it is not without its weaknesses, not least of which is whether any institution can actually achieve the blueprint and live up to its full potential. The answer is almost certainly "no" but does this detract from its merits?

The whole concept of Shari'ah compliant banking is by Western terms still very much in its infancy. Some conventional banks have been trading for more than 400 years, most for at least 50 and it is often a surprise to many observers that modern Islamic Finance actually started in its present format as recently as 1985. Of course trading and commerce in the Islamic world is actually thousands of years old and pre-dates not only banking but Islam itself. The remarkable legacy of this ancient history is that the basic trading contracts have been refined over millennia and still survive, still work (in the main) and still underpin Islamic Finance.

The guiding principle of Islamic Finance is to provide banking and financial services which are compliant with Shari'ah. Shari'ah is the Divine Law as revealed in the Quran (Book of Allah SWT) and Sunnah (words or acts) of His Prophet Muhammad (PBUH).

The primary authority for Shari'ah is the Quran which means "the text of God" and is actually a blueprint for running a society with detailed rules covering every aspect of a Muslim's life including religious, family, community and of course trading obligations. It stresses fairness, honesty, integrity and morality to all, even towards non-believers, which comes as a surprise to some people.

Next is the Sunnah which means 'well known path'. It covers the words, acts and tacit approvals of the Prophet (PBUH) as recorded at the time and subsequently and includes the Sayings

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(Hadith) which He used to lay down the law and give moral guidance.

Next comes Ijma or "consensus/agreement" under which suitably qualified Islamic Scholars or Jurists are asked to rule on points of Shari'ah law where the answer is not immediately available from the two senior sources. Then follows Qiyas or "analogy", which extends the law by applying common underlying attributes. Finally there is Ijtihad or "interpretation ", where Islamic Scholars are asked to rule on an apparently unique problem.

This structure seems to be comprehensive enough until you are reminded that the primary sources, the Quran and the Sunnah, are actually 1,400 years old and chronicle the moral, commercial and religious challenges of that time. Even though the Prophet (PBUH) was clearly a pragmatist and may well have accommodated some of the modern structural differences, it is obviously a matter of faith that the historical texts are doctrine and must be applied literally and strictly.

Having to apply ancient standards to modern banking is and has been a real challenge. Critics say it is disingenuous involving replication and retrospective "shoe horning" to make it fit, but this dismissive swipe cheapens unreasonably the value of what has been achieved in a very short time. If you study the subject in detail it is hard not to congratulate most scholars for reaching remarkably successful compromises even where the challenge seemed incapable of being resolved.

Underpinning Islamic Finance are several basic rules which cannot all be listed in detail in this article but the main ones are:

- No uncertainty
- Trade must be in real goods and assets
- Sellers must be honest, totally frank and actually own what they sell
- There can be no speculation or gambling
- No trade in activities or products considered Haram or un-Islamic

These prohibited activities are generally well known and include no trade in pork, alcohol, armaments, pornography, etc.

The most significant basic rule and the one that perhaps most defines the ethos of Islamic Finance, is that all commerce must involve the real sharing of both profits and losses so that all parties, including the bank, have a real and tangible stake in the outcome of the transaction being undertaken. Consequently, and unlike a conventional bank which does, an Islamic Bank does not have a debtor or creditor relationship with its depositors and customers.

With one exception (Amanah or Trust accounts which are safe custody deposits and are not usually significant in numbers or amount) "depositors" are actually investors, all of whom agree to invest alongside or via the Islamic bank and whose return is based on a share of the banks actual profit and losses. Investors place money in the Islamic bank as trading partners and are given a profit (and loss!) sharing share based on the term, purpose, maturity, etc of the investment.

The actual investor accounts are based on the ancient contracts of Amanah, Wikala, Wadia, Mudaraba and Musharaka but are generally also reported as current accounts, investment accounts and special investment accounts by many Islamic Banks.

The key difference between Islamic "investors" and the "depositors" in a conventional bank is that Islamic investors agree to share profits and losses whereas conventional depositors do not, especially the loss part! In theory, therefore, a loss making Islamic Bank could and should pass on these losses to its investors who would see their investments reduced as a consequence.

So far, this has not been put to the test in a major way and it is debatable whether an Islamic Bank could actually pass on losses on a large scale, given that in reality most investors regard their stakes as a one way bet. Would it trigger a Northern Rock exodus? Possibly.

There are many myths about Islamic Finance principally that it is banking for Muslims only. This is not true at all. Anyone can open an investment account and apply for the full range of services on offer. Non-Muslims are welcomed.

The biggest challenge facing the sector is liquidity but not in quite the same sense that we use when looking at conventional banks. In a conventional bank liquidity is needed to repay depositors and liquidity "difficulties" usually means the bank cannot meet their withdrawal requests. It is fear that drives this process and usually triggers panic, which in turn starts a wholesale stampede as depositors jostle to get their money out first. Restoring confidence, very quickly, is the only solution, something the authorities failed to do with Northern Rock.

Faced with bank collapses in the West, all Islamic jurisdictions made it clear in unequivocal terms that they stood fully behind the Islamic banks in their territories. As these territories included some of the richest countries in the world, most Islamic investors are now satisfied that the risk of losing their money is minimal. Anecdotal evidence from various institutions suggests investors having seen the worst are now relaxed and no major withdrawals have been reported.

The liquidity challenge in Islamic banks is actually a treasury and profitability problem. There is no effective Islamic inter-bank market and banks cannot lend to or borrow from each other in conventional terms. As a result a bank that finds itself with too many investments or is short of cash, has limited options. The issues posed by this are beyond the scope of this article but typically surplus funds have to be held in low or nil yielding cash form and shortfalls are met by seeking discreet deposits from sovereign departments on a "lender of last resort" basis. This "super tanker" approach to liquidity management will be a real constraint on future growth.

Islamic Finance: Part 2

In the next quarterly Risk Update we consider Riba or the banning of interest and the asset side of an Islamic Bank, including Musharaka which should be the star of Islamic banking but sadly is not.