

# Islamic finance



**Y**ou don't need to know about Islamic finance if your company does not borrow money and does not anticipate any future need for external funding. Otherwise, you may be missing out on an opportunity to diversify your funding sources and possibly access cheaper finance.

It has been estimated that there are now some \$500-\$800bn of funds seeking investment which is compliant with Islamic religious guidelines. This major pool of liquidity has historically been short of investible assets. Accordingly, treasurers who can create assets for purchase by Islamic investors may be able to reduce their funding costs due to the investor appetite for suitable assets.

**PROHIBITED ACTIVITIES** Before going any further, you need to ask yourself whether your business qualifies for Islamic finance. Some business activities are inherently prohibited (*haram*) from an Islamic perspective. Obvious examples would be businesses producing or distributing alcohol, gambling or pornography. However, such specific prohibitions are relatively few. In most cases your company is likely to be carrying on activities which are not *haram* at all but perfectly acceptable from an Islamic perspective.

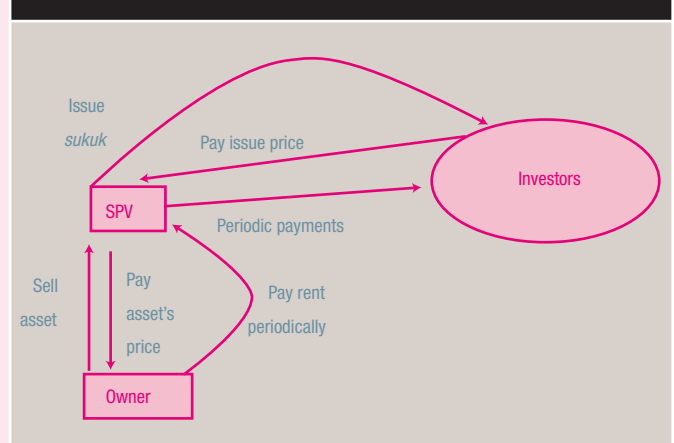
**BASIC PRINCIPLES** *The Koran* prohibits an activity which in Arabic is called *riba*. *Riba* is generally understood to be the lending of money at interest. Where the borrower is an individual suffering personal hardship and needing a loan, charging interest is considered oppressive and Muslims are enjoined to make such loans interest-free as an act of charity.

More relevant to treasurers is the lending of money in a commercial transaction. Here the general explanation for prohibiting interest is that a lender charging pre-specified interest (whether fixed rate or floating rate) has no concern for the success or failure of the borrower's commercial activities, as long as the borrower can repay the loan. This is regarded as unjust because if the borrower's business does badly, the borrower suffers all the loss while the lender has the loan repaid and receives all the pre-specified interest. Likewise, if the borrower's business does very well, all the excess rewards accrue to

the borrower while the lender receives only the repayment of the loan and the pre-specified interest.

**ISLAMIC COMMERCIAL FINANCE** Given the prohibition of *riba*, over the last 1,400 years Islamic economies have devised a number of ways of providing commercial finance. They include:

Figure 1. Typical *sukuk* structure





MOHAMMED AMIN PROVIDES  
A BASIC INTRODUCTION TO  
ISLAMIC FINANCE FROM  
THE PERSPECTIVE OF THE  
CORPORATE TREASURER.

### Executive summary

- The total value of funds that are compliant with Islamic religious guidelines is estimated at \$500-\$800bn.
- Over the last 1,400 years Islamic economies have devised a number of ways of providing commercial finance.
- The *sukuk* is the form of Islamic finance which is potentially of greatest interest to treasurers.
- Tapping Islamic finance will remain attractive as long as there is a shortage of *sharia*-compliant investment assets.

**Sale on deferred payment terms (*morabaha*)** You wish to buy a machine costing £1m for immediate delivery. You and the seller agree a price for the machine of £1,050,000 payable in 12 months' time. This transaction is economically equivalent to financing the purchase of the machine with a 12-month loan at 5%, but your contract involves no payment of interest.

**Finance in exchange for a share of the profits (*modaraba*)** You have £2m for investment in a new venture but need £2m in additional finance. Your company will provide all the management expertise – all you need from a financier is the extra £2m. The two of you set up a joint venture with 75% of the cashflows generated from the joint venture accruing to your company and 25% to the external financier. The differential from the capital ratios recognises the contribution that your company is making by managing the project.

In this arrangement, the external financier is a true participant in the risks and rewards of the venture. If the financier wishes to have a lower level of risk and reward, there may be scope for redesigning the allocation of the cashflows from the venture to ensure that most of the risk and reward falls upon your company. The challenge for the designer is to minimise the financier's risks without reducing the risk sharing so far that the contract has so little risk sharing that it no longer qualifies as being compliant with Islamic law (*sharia*).

The UK tax analysis of *morabaha* and *modaraba* contracts was

relatively uncertain until earlier this year. For example, payments to the external investor under a *modaraba* contract often failed to be tax-deductible since interest linked to the results of the business is regarded as a distribution under corporate tax law. However, specific legislation was introduced in Finance Act 2005 for what are called "alternative finance arrangements". While the text of the legislation is "religion-neutral" and does not mention Islam in any way, it has the effect of regularising the corporation tax treatment of *morabaha* and *modaraba* contracts where your counterparty is a financial institution. The detailed definition of a financial institution can be summarised as being a bank, a building society, a wholly owned subsidiary of a bank or building society, a licensed consumer credit business, or an overseas authorised deposit taker.

**A lease (*ijara*)** The payment of rent on a building or other asset is generally not regarded as giving rise to *riba*, regardless of whether the rent is fixed rate or computed at a floating rate such as being linked to Libor.

**Instruments similar to bonds (*sukuk*)** The Arabic word for bond is *suk*, and *sukuk* is the plural. These instruments are the form of Islamic finance that is potentially of greatest interest to treasurers as it allows you to access the Islamic capital markets directly to raise medium or long-term funding.

*Sukuk* are typically issued by a special purpose vehicle and are certificates, whether tradable or non-tradable, that give investors a specified share of the cashflows received by the vehicle. As an investor is fully exposed to the business risks of the special purpose vehicle, they are not regarded as lending money at interest. A typical structure for a *sukuk* is illustrated here (see Figure 1), where the owner of an asset raises funding by setting up an *ijara* lease on the asset.

*Sukuk* structures have been used increasingly often by Islamic governments to raise funds. For example, in September 2003 a special purpose vehicle raised \$700m by issuing *sukuk* and using the cash to purchase from the Qatar government land which was leased back to it for seven years. The proceeds were used by the Qatar government to develop medical facilities in Doha. Under the terms of the lease, the Qatar government contracted to repurchase the land at the end of the seven years so that the investors' only real economic exposure was to the sovereign risk of Qatar. A *sukuk* structure was also used by the government of Pakistan to raise \$500m at a cost lower than that of issuing conventional international bonds. In August 2004 the German state of Saxony-Anhalt became the first state government in Europe to issue a sub-sovereign *sukuk* raising €100m.

The challenge for corporate treasurers and their advisors is to devise *sukuk* structures which provide funding at a lower cost than conventional finance, due to the investor appetite for *sharia*-compliant assets. This needs to be achieved without having the benefit dissipated in transactional costs on moving the assets to create the *ijara* lease structures (or other *sharia*-compliant investments) that are required by the special purpose vehicle. My personal view is that tapping Islamic finance in this manner will remain attractive as long as there is a shortage of *sharia*-compliant investment assets taking account of the significant and growing demand from both traditional Islamic countries and the growing Islamic communities in the west.

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