Flexible conduit

THE CORE OF SHARIAH FINANCING IS THAT ANY STRUCTURE MUST UTILISE AN UNDERLYING ASSET, OR POOL OF ASSETS, AND THAT THOSE ASSETS MUST BE PUT TO USE TO GENERATE A RETURN TO THE FINANCIER. **DAVID TESTA** EXPLAINS THE PRINCIPLES OF ISLAMIC FINANCE.

In a report of November 2008, Moody's stated: "Islamic banks' reputation has benefited from the current crisis … reflecting their conservative approach to business … and their focus on [the] basics of banking." Islamic finance now has a once-in-a-generation opportunity to demonstrate its capabilities before a wider audience as the funding gap in the conventional banking sector forces borrowers across the globe to seek alternative sources of funding.

SHARIAH PRINCIPLES One reason for this resilience is simply pragmatic; no Islamic banks have any sub-prime assets on their balance sheets. A second reason is potentially far more interesting and relevant to financing opportunities and the sector's continued growth. All Islamic financial institutions (IFIs) are obliged to conduct their business, and in particular their financing activities, in accordance with Shariah principles (see Box 1). These principles ensure that IFIs operate on an innately more conservative banking model than their conventional peers.

The core of Shariah financing is that any structure must utilise an underlying asset, or pool of assets, and that those assets must be put to use to generate a return to the financier. The core principles also forbid gambling and restrict IFIs from indulging in undue speculation or entering into transactions with an element of uncertainty. In addition, IFIs cannot finance more than 100% of the value of the underlying assets. This works to restrict the amount of leverage a corporate is able to raise on its balance sheet using Shariah-compliant structures, thereby avoiding the infinite leverage model available to conventional banks.

A WORLDWIDE SOLUTION? The conservatism inherent in Islamic structures is a message which is resonating widely in the financial world. For example, the US Federal Reserve has recently issued a public statement relating to its review of Islamic finance as a possible model to assist in the rehabilitation and restructuring of the global financial sector. It is almost the first time that any US authority has publicly acknowledged Islamic finance.

The situation in the UK is very different. Since 2000 the UK government has undertaken a considerable amount of work to ensure that nobody in the UK is denied access to competitively priced financial services due to their religious beliefs. The promotion of Islamic finance in the UK has been further bolstered by the government's policy objective of establishing the City of London as Europe's gateway to international Islamic finance.

Since 2003 the UK government has passed a raft of legislation to ensure a level playing field for Islamic financing structures. This is to ensure that, from a taxation perspective, issuers and investors can treat Shariah-compliant retail and wholesale products – and most recently Islamic bond (or Sukuk) issues – in the same way as conventional debt products. That initiative is continuing, with further measures being put forward for inclusion in the Finance Bill 2009.

UNDERSTANDING ENCOURAGES GROWTH This encouragement of the industry in the UK has been met with equal enthusiasm by the private sector, with five standalone IFIs now having been set up and regulated by the Financial Services Authority. The Islamic Bank of Britain was the first to be established, in 2004, and was followed by four wholesale commercial banks, with Gatehouse Bank being the most recent entrant, in April 2008. It is against this background that the IFIs in the UK are facing 2009 with cautious confidence.

There are several reasons for this. First is the breadth of opportunities for financing in a market where cash is king. The UK IFIs are themselves liquid and represent access to the Gulf States, where countries such as Qatar and Saudi Arabia continue to demonstrate strong investor appetite and provide foreign direct investment flows into the UK economy. This represents an exciting opportunity for corporate and other institutions in the UK looking to diversify their funding base.

Second, previous reservations about a possible mismatch on pricing expectations have now disappeared in the repricing of risk during 2008. UK borrowers now have a global Islamic marketplace to approach, with investors both in the Gulf countries as well as the ever expanding Shariah universe in south-east Asia, originating in Malaysia but expanding rapidly to Hong Kong, Japan, South Korea and Singapore.

FLEXIBILITY Another major consideration is that the flexibility of Islamic products allows their wide use for corporate fundraising in the UK. Shariah-compliant structures can be utilised in bilateral arrangements, club deals, syndicated financings and Sukuk issues

(referred to by HM Treasury as alternative finance investment bonds or AFIBs). The structures can also be used across the whole capital spectrum, from senior finance to mezzanine to equity positions, while Islamic funding can benefit from security or be unsecured, and can be provided on a drawn or stand-by basis.

There is also little limit to the purposes such financings can be used for, from project finance to asset finance and fixed-income equivalent products. Islamic structures have also been used in acquisition finance and leveraged buy-outs, most notably in the UK in the May 2007 acquisition of Aston Martin, which was bought by Kuwaiti investors using a wholly Shariah-compliant structure. This precedent has been followed in the UK, most recently with a buy-out of a water additives company in September 2008.

Clearly, there are limitations, not least that the Islamic finance sector globally is characterised by a large number of small banks, with only a handful of IFIs with balance sheets in excess of $20bn. For that reason, at least initially, Islamic finance will be providing funding solutions for UK corporates in tens of millions of pounds rather than billions. Companies need to view the Islamic finance sector as a long-term option (rather than opportunistically) and make assets available for use in the structures; they will also need to invest additional management time in closing their first Shariah transaction; and they will preferably already be active in the Middle East and Gulf countries (or otherwise have a "household" profile).

In those cases, Islamic financing will be available, with access to one of the most dynamic sectors of the global financial market today. While no-one can look forward to 2009 with unbounded optimism, there are perhaps reasons to be cautiously optimistic for the Islamic finance sector and the financing solutions for UK corporates it is able to represent.

John F Kennedy pointed out that, when written in Chinese, the word "crisis" is composed of two characters: one represents danger and the other opportunity. We are indeed living in interesting times.

BOX 1: PRINCIPLES OF ISLAMIC FINANCE

The Shariah (the way or the path) guides Muslims in all aspects of life, including financial and commercial activities. Islamic finance applies the Shariah to the modern-day financial activity of muslims and is derived primarily from the Qur'an and the Sunnah, as recorded by the Hadith (the sayings of the Prophet Muhammad, peace be upon him). Secondary sources of Shariah are devised by scholars through consensus ('ijma), analogy (qiyas) and extrapolation (ijtihad).

There are five key characteristics of Islamic finance:

- Contract-based: contracts are given great importance in the Qur'an and the Hadith.
- All structures involve the utilisation of assets, with a bank earning money by the provision of goods and services (rather than making money from lending money and charging interest on it).
- Risk sharing: the investor and investee must share the risk of all financial transactions.
- Capital should not be left idle but put to use while profit is encouraged. All Islamic structures generate a return – for example, rent or profit.
- Goods should be in existence and rightfully owned before sale. This prevents IFIs from short-selling, for example.

There are particular restrictions which should not form part of any Shariah-compliant financing transaction:

- **interest (riba):** the best-known Shariah restriction but, as noted above, the generation of profit from the use of an asset is encouraged;
- **uncertainty (gharar):** all parties to a transaction should be adequately informed and not cheated or otherwise misled;
- **gambling (maysir)**; and
- **sector restrictions** (no pork, alcohol, armaments, etc).

THE KEY STRUCTURES

Murabaha: The sale of an asset between two parties where the seller of the asset discloses to the purchaser the asset's original cost price, often referred to as a cost-plus contract. The sale of the asset must be immediate although invariably the price payable by the purchaser is deferred.

Ijara: The act of leasing in which the owner of the asset transfers its usufruct to another person for an agreed period and for an agreed rent. The subject of the lease should be valuable, identifiable and quantifiable. The ijara structure is the most widely used in Islamic finance.

Musharaka: The act of establishing a partnership. In the context of a financing, the financier provides capital to the joint venture partner, who contributes assets. The parties agree to share the profits of the joint venture between them and must also share the losses of the joint venture.

Mudaraba: A form of limited partnership where one partner gives money to another for investing in a commercial enterprise. The profits generated by the investment are shared between the partners in a predetermined ratio.

David Testa is CEO of Gatehouse Bank.
david.testa@gatehousebank.com
www.gatehousebank.com