

Murabaha meets SWIFT messaging

ACCEPTANCE OF ITS MESSAGING STANDARDS FOR MANY TREASURY TRANSACTIONS HAS ENHANCED SWIFT'S STANDING IN THE ISLAMIC FINANCE SECTOR. **GRAHAM BUCK** REPORTS.

Messaging service SWIFT's status within the Islamic finance sector begins 2011 on a high. In late November 2010 the Society for Worldwide Interbank Financial Telecommunication (SWIFT) announced a breakthrough, when its ISO 15022 message standards for the processing of treasury Murabaha transactions were certified as compliant with international

Islamic finance standards issued by the Accounting and Auditing Organisation for Islamic Financial Institutions (AAOIFI).

AUTOMATED PROCESSING The agreement will accelerate progress towards automated processing of Murabaha treasury transactions, which reportedly represent around 60% of all Islamic financing. Murabaha trades – widely used by financial institutions engaged in Islamic deposit taking – involve a profit margin clearly stated and agreed to at the outset by both parties. They include money transfer and commodity trade. While the former have been carried by SWIFT messaging for many years the commodity trade has always been manually completed, typically via fax, and lacked any globally agreed standard.

TREASURY DOCUMENTATION According to Norton Rose Group, which assisted SWIFT with the Murabaha project, the cost efficiencies of the new standards are considerable but require treasury management documentation to be reviewed and amended so that users take full advantage of the messaging system. It should effectively eliminate the need to send offers and acceptances out so the back office cost, which internal studies had estimated at as much as \$150 per trade, is reduced to a small fraction of that figure.

SWIFT embarked on a pilot for commodity Murabaha as recently as October 2009 and the exercise included a dozen financial institutions in the UK, the Middle East and Malaysia. Alain Raes, SWIFT's chief executive for Europe, the Middle East and Africa described Murabaha automation as "the first step on a long journey of collaboration with the Islamic financial community".

Participants involved in the Murabaha are promised the benefits of "a globally agreed electronic standard which will lead to a reduction in costs and risk, and an audit trail for Shariah compliance". SWIFT, originally set up in 1973 by banks in 25 countries to provide a cross-border electronic messaging system, is now used in nearly 100 countries. Among its members are more than 240 Islamic banks, representing 84% of Shariah-compliant assets, which between them transact around 50 million messages per year.



THE INDUSTRY SHOULD SEE THE INTRODUCTION BY SWIFT AND ITS ENDORSEMENT BY AAOIFI AS AN EXTREMELY POSITIVE STEP, REDUCING ITS BACK-OFFICE OPERATIONS COST BASE FOR EACH TRADE.

"AAOIFI is responsible for global Islamic finance industry standards and we establish best practices for the industry," commented the organisation's secretary general, Dr Mohamad Nedal Alchaar. "Our collaboration with SWIFT aims to build a well-structured and well-regulated international Islamic finance infrastructure."

BREAK WITH THE PAST Murabaha's significant share of all Shariah commodity transactions worldwide means that the agreement marks a break with the past. Until now they have typically involved a complex and manually intensive process with little standardisation. Commodity Murabaha is a treasury product that involves a number of different parties transacting more or less simultaneously, and which observes the Shariah principle of minimum uncertainty. This requires the agreement of the commodity's future price on the spot to prevent any scope for fluctuations, and the transaction must not involve any payment of interest.

TYPICAL TRANSACTION A typical transaction would involve four parties: the bank, which buys a commodity contract from a supplier and then sells the contract to a client at cost plus an added profit margin; the client then obtaining cash by immediately selling the contract to a purchaser at a price equivalent to the bank's cost, whereupon the client pays the bank either on a deferred or an instalment basis. The price for all of these transactions must be determined almost simultaneously.

The multiple steps and an absence of standardised documentation until now for this type of transaction have created the potential for operational risk. Each individual step requires an agreement between the respective parties to be secured and then documented and Shariah compliance to be established. Many Shariah-approved commodities have, along with non-complaint commodities, been traded on conventional markets such as the London Metal Exchange (LME).

BEDROCK OF LIQUIDITY MANAGEMENT The compliance agreement was initiated by Mohammed Paracha, Norton Rose's deputy global head of Islamic finance. He initially highlighted the possibility of Murabaha processing utilising SWIFT and was closely involved in developing the new service; passing on his knowledge of Murabaha and introducing SWIFT's personnel to Islamic scholars, and arranging contacts within Islamic banks and brokers.

Commenting on the launch, he said: "The Islamic finance industry continues to rely on Murabaha transactions as its bedrock form of liquidity management.

"In the absence of alternatives, the industry should see the introduction by SWIFT and its endorsement by AAOIFI as an extremely positive step, reducing its back-office operations cost base for each trade.

"In addition, the implementation of SWIFT messaging into systems could lead the way to the automation of Shariah compliance and auditing – something that the industry has yet to explore or embrace and may be the next logical step forward for the industry in commoditised product areas such as this."

SWIFT stresses that the new agreement does not change the current process between banks, their customers and brokers for the use of ISO 15022. However, it does mean that data will now be exchanged through standardised messages using SWIFT, replacing bilaterally agreed confirmations exchanged manually.

It also reports that with annual growth in Islamic finance reaching 23% to 24% in recent years the demand for Shariah-compliant messaging standards shows a corresponding increase. SWIFT is working with the Islamic financial community on new services to meet this demand, both with individual banks and in collaboration with organisations such as the AAOIFI, the Association of Islamic Banking Institutions Malaysia (AIBIM) and the International Islamic Financial Market (IIFM).

There is also keen interest in Shariah-compliant versions of SWIFT's messaging standards for foreign exchange and money market confirmations, particularly from banks in Malaysia and other parts of Asia reports Peter Ware, head of SWIFT's Islamic finance initiative. The requirements are being reviewed to determine whether existing settlement instruction and confirmation message standards meet the various needs or if some adaptations will first be needed.

Although there is, to date, less evidence of actual demand SWIFT has nonetheless noted that derivatives are now being embraced by Islamic finance and is exploring Shariah-compliant messaging for them as another potential area for development. Its particular focus is on Islamic Profit Rate Swaps (IPRSs) that are now widely used to assist in managing profit rate risks and enhancing cashflows.

Ware adds that SWIFT expects to have the fully detailed requirements to move these projects forward by the end of the first quarter of 2011. If its existing messaging can be adapted relatively easily to accommodate Shariah compliance, then additional services could be launched later this year.

Graham Buck is a reporter on Middle East Treasurer.
editor@treasurers.org