THE ISLAMIC ALTERNATIVE

Acquaint yourself with sharia-compliant finance today in case you need it tomorrow, advises Sarah Boyce

Islamic, or more accurately sharia-compliant, finance is one of those topics that, in non-Islamic countries, seems to slide in and out of fashion. But a well-prepared treasurer needs to be aware of, and understand, as many alternate financing solutions as possible to ensure that they can access funds whenever they are needed, whatever the market conditions. This means they should have a grasp of sharia-compliant finance.

Principles of Islamic finance

Under Islamic principles, sharia law defines the framework within which Muslims should conduct their lives. This includes all areas of commercial activity. The basic principle of Islamic banking is based on risk sharing rather than risk transfer as is the case with conventional banking.

To be sharia-compliant, finance arrangements have to be approved by appropriately qualified Islamic scholars and the following principles must be adhered to in order for a transaction to be compliant with Islamic requirements:

- **Profit sharing** – the underlying principle is that Islam encourages investments where the community as a whole may benefit. It is therefore unwilling to reward those who do not wish to invest and take risks, but rather are content to deposit cash in a bank in return for receiving interest for no risk.

The lender and the borrower of capital should share the risk of any investment on agreed terms, and divide any profits or losses between them. In banking terms, this means that the depositor, the bank and the borrower should all share the risks and the rewards of financing business ventures.

- **Interest (riba)** is prohibited. Under Islamic law, acceptance of interest or fees for loans of money is forbidden (and so financing structures have been developed to address this).
- **Speculation** (excessive risk taking) is prohibited. This can be a slightly complicated area since speculation in a commercial trading context is acceptable, but, for example, any uncertainty with regard to a fundamental term of a contract (such as the price or description of goods) will not be permitted. This effectively prohibits the use of derivative contracts.
- **Investments** should only support practices or products that are not forbidden or discouraged by Islam. Thus, for example, trading in alcohol, armaments, financial services, gambling, pork, pornography and tobacco are forbidden in Islamic finance. This is to encourage ethical investments.

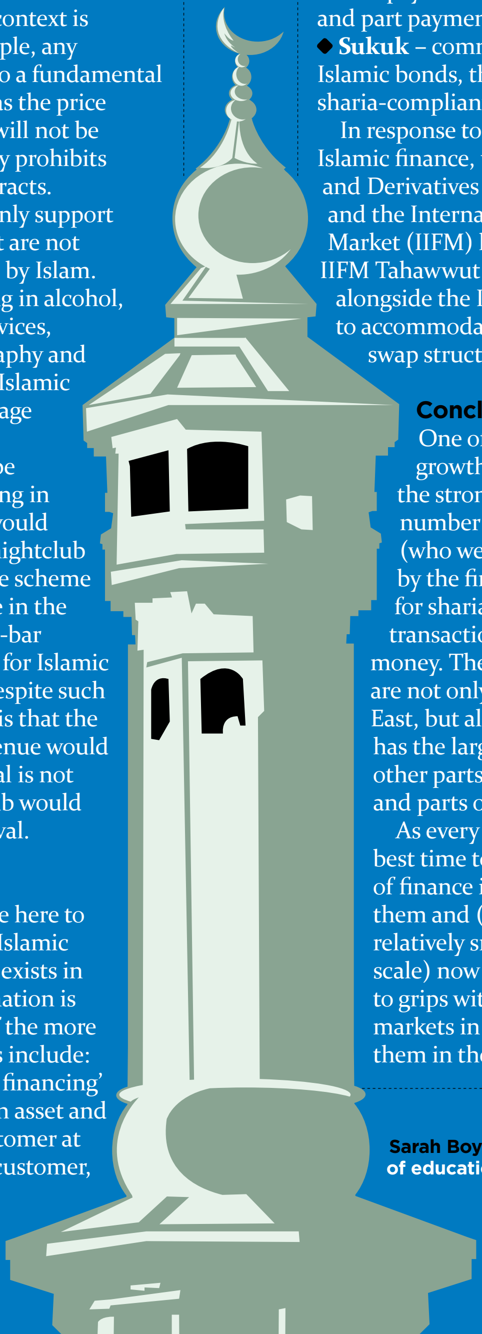
Therefore, in order to be sharia-compliant, investing in the financing of a hotel would be subject to debate if a nightclub was planned as part of the scheme or if alcohol was available in the rooms as part of the mini-bar stock. It has been known for Islamic finance to be approved despite such mini-bar sales on the basis that the proportion of overall revenue would be tiny – but that approval is not guaranteed. The nightclub would be unlikely to gain approval.

Instruments

There is not enough space here to cover the wide variety of Islamic finance instruments that exists in detail, but further information is widely available. Some of the more commonly used products include:

- **Murabaha** – 'cost plus financing' whereby the bank buys an asset and then sells it on to the customer at an agreed mark-up. The customer, who could not otherwise afford to buy the asset, pays in instalments.
- **Ijara** – a leasing arrangement whereby the bank acts as lessor and the customer makes payments that cover both rental and part payment for the asset.
- **Sukuk** – commonly referred to as Islamic bonds, these are the primary sharia-compliant capital market tools.

In response to the increased use of Islamic finance, the International Swaps and Derivatives Association (ISDA) and the International Islamic Financial Market (IIFM) have published an ISDA/IIFM Tahawwut Master Agreement alongside the ISDA Master Agreement to accommodate sharia-compliant swap structures.



Conclusion

One of the reasons for the growth in Islamic finance is the strong demand from a large number of Muslim investors (who were largely unaffected by the financial crisis of 2008) for sharia-compliant financial transactions as a use for their money. These potential investors are not only based in the Middle East, but also in Malaysia (which has the largest sukuk market) and other parts of the Far East, Pakistan and parts of Africa.

As every treasurer knows, the best time to look for new sources of finance is when you don't need them and (although this remains a relatively small market on a global scale) now is a good time to get to grips with the Islamic finance markets in case you want to access them in the future.

Sarah Boyce is associate director of education at the ACT