Greater opportunities for Islamic finance

Duncan Smith and John Sheridan of ABCIB Islamic Asset Management explain how Islamic finance can be easily accessed by corporate treasuries.

Islamic finance has been subjected to increasing media exposure over the past number of years. Coupled with the recent proliferation of Islamic financial institutions (either as standalone entities or within conventional banks), you might think of it as being a relatively new phenomenon. But to do so is to miss the point because the basic principles have been around since as early as the 7th Century AD. However, it is no surprise that the increased profile recently enjoyed by Islamic banking has coincided more or less with the increased wealth of Arab states as a result of the oil boom and the development of their other natural resources from the 1970s onwards.

This newfound wealth has provided the backdrop against which Muslims have started to develop – or in some cases rediscover – their own Islamic banking system which complies with the Sharia'a (the body of Islamic law, including the Koran). All told, the move towards an independent financial system has so far resulted in the evolution of more than 200 Islamic banks and finance houses worldwide, stretching from the US through Latin America, Africa and the Gulf States into Asia and the Far East. Banking liabilities as at the end of 1998 were reported at some $148bn and are estimated to be growing at a rate in excess of 15% a year.

Basic principles

A number of basic principles underpin the Islamic banking system, the most common of which refers to the prohibition of 'riba'. While riba is perhaps most readily translated as *usury* (or interest), it more accurately refers to a (wrongful) increase in an amount owed – a debt. The most important word in this description is 'wrongful', given that there is nothing within Islam to suggest that earning a profit is wrong. The earning of profit is, in fact, actively encouraged – but it should be directly related to the risk being assumed by the financier rather than a fixed, passive rate. Further prohibitions relate to unknown elements of a contract (Jahala) and to speculation or gambling (Gharar). To enable business to proceed, the Sharia'a Supervisory Boards of Islamic Banks, which are made up of scholars, will issue Fatawa (opinions or rulings) based on the transactions that have been put before them. While the above seems to present stumbling blocks to Western businesses wishing to enter or interact with the Islamic market, it should not be viewed so.

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The Prophet Mohammed was himself a successful trader, and the Koran includes guidance on the various risks involved in trading goods and commodities. Consequently, it should come as no surprise that Islamic finance provides a natural framework for trade-related business.

It is well documented that traders utilised Islamic finance throughout the Muslim world during the Middle Ages. These traders extended the practices throughout the Mediterranean and beyond, in the process introducing European traders to concepts such as the promissory note and assignment/transfer of debts. Rather than being a derivation of conventional banking, Islamic finance has introduced many concepts to the Western world that have since become standard practice. Indeed, the very origins of Islamic finance within a trading environment make it a viable alternative in the modern world for those seeking to finance trade-related activities.

Many Western companies already employ Islamic financing for a variety of their activities and it has become a very real and viable option for funding for UK and European companies.

Opportunities leading to co-operation

Because Islamic banks have no secondary market through which they can manage their liquidity, they are basically

Types of transaction

While there are four primary transaction areas common in the Islamic financial services sector – equipment leasing; real estate development/ownership; equities/securities; and trade/commodities financing – we will concentrate on the last of these for the purposes of this paper. This financing of trade and commodities constitutes the area where the highest percentage of Islamic institutional funds are currently deployed and is probably the best access point for utilisation by the treasury/finance departments of Western companies. Despite the belief that Islamic finance is only available to Islamic institutions, this is not the case. So long as certain taboo areas, such as alcohol, pork products and gambling, are avoided, Islamic modes of financing are available to anyone who engages in legitimate trading of goods and services that are not repugnant to the Islamic faith.

Because of the desire to maintain religious integrity, Islamic finance focuses very closely on precise contractual forms. A variety of contracts exist that relate to the area of trade and listed below are the three most common, along with their Western equivalent, and a brief description.

Murabaha – working capital

This contract involves the purchase of goods from a supplier and their subsequent sale to a third-party at a mark up. In essence, the deal revolves around the provider of finance (the bank) taking a commercial/credit risk on the buyer. The transaction takes place on day one with title to the underlying commodity/goods passing through the bank immediately to the buyer. Payment for the goods plus the bank's mark up (economically analogous to the interest component) by the buyer is deferred until the agreed maturity date for the transaction. This effectively creates a straightforward debt instrument – the only difference with the conventional markets being that any such debt is unlikely to be tradable, and where it is tradable, it must be traded at par. Frequently when arranging Murabaha transactions banks will appoint their clients to act on their behalf on the purchase and sale of the goods to minimise commercial dislocation.

Istisna'a – production finance

The Istisna'a contract covers the manufacture of goods for a buyer whereby the financier intermediates the process from raw material through to finished product. A parallel contract will probably be arranged for the sale of the finished product to the buyer. The essence of the deal is that the goods must be developed in a certain way, for example, the production of aluminium from alumina or the refining of crude oil. Some transformation must be seen to have taken place in the original raw material and this triggers an increase in the value of the goods, a pre-agreed percentage portion of which uplift can legitimately be claimed by the financier as their profit.

The financier is clearly taking performance risk on the manufacturer/processor while, at the same time, accepting payment risk on the buyer. There is no restriction, however, on the means by which the goods are paid for – so long as the terms are agreed and the price fixed, prior to draw down.

As with Murabaha, banks will frequently arrange for their client to deal with the product-related areas and risks and will concentrate itself on the financial modelling.

Bay Al Salam – pre-payment financing

While the Istisna'a contract is for the future delivery of manufactured goods, the Bay al Salam contract is for the future delivery of goods that do not yet exist. Originally used to finance the purchase of seeds with settlement being provided by way of the crops grown, the contract is readily applicable to more conventional scenarios, such as the extraction of minerals. Naturally, this does not preclude the contract from being used in its original context as a means of financing the production of soft commodities, such as cocoa or sugar.

As with Istisna'a, the contract insists on the prior specification of quantity, quality, price and point of delivery. The difference between the cash advanced by the bank and the (future) value of the commodity grown or produced again will give the bank the Sharia'a-compliant opportunity to collect a pre-agreed margin.

To re-emphasise the point made, in all the cases mentioned above, it is not unusual for the bank providing the finance to appoint the financed party as agent (under what is known as a Wakala agreement) to arrange either the purchase or sale side of these transactions. ■

Indicative outline term sheet

Facility type	Syndicated revolving Murabaha facility to be arranged on a best efforts basis (the Facility).
Availability	Twenty-four months from signing of the Murabaha agreement.
Conditions	Subject to no adverse material change in the Obligor's business following the first 12-month period.
Extension	The facility may be extended for an additional 12-month period at the end of the 24th month at the sole and absolute discretion of the respective participants.
Commodity	[non prohibited commodity].
Amount	Up to \$100m or amount agreed post-pre-marketing if market appetite is lower than expected.
Arranger	Usually the Islamic finance team of a Western bank
Obligor	European Corporate Plc (EC Plc)
Guarantor	EC Plc
Drawdown period	Drawings are available throughout the life of the facility with each of the underlying transactions to have a minimum tenor of either 90 or 180 days. All payments made by ABC under each Murabaha transaction to EC Plc will be made on the last business day of any month.
Drawdown amounts	limited to a minimum of \$10m per drawdown.
Murabaha margin	Equivalent to the relevant dollar libor + (x%) margin each year for each transaction carried out under the facility.
Documentation	To include: 1. Mudaraba agreement. 2. Murabaha agreement to include, but not limited to, all relevant documentation relating to each purchase and sale. 3. Agency agreement. 4. Guarantee from EC plc. 5. All necessary legal opinions. 6. Copy of the obligor and guarantor's Memorandum and Articles of Association, Certificate of Incorporation. 7. Board resolution ratifying agreement with list of authorised personnel and specimen signatures. 8. Certified copies of the latest (three years where possible) audited financial statements for guarantor and obligor.
Jurisdiction	Exclusive jurisdiction of the English Courts.
Arrangement Fees	(x%) on drawn amounts payable upon drawdown.
Legal Fees	Up to US\$ ————- will be applied to any legal expenses incurred on the setting up of this facility.

compelled towards direct maturity matching of their various liabilities. Given that most Islamic customers' deposits are short-term (the same as the rest of us), the Islamic banks are naturally constrained by the need to match these short-term liabilities with short-term assets. While this situation may change over the coming years with the development of a secondary Islamic market through asset-backed securitisations, a big percentage of current requirements for the market are satisfied by short-term trade-related business (that is, tenors of less than one year). Furthermore, given that the Islamic banking sector worldwide is growing so rapidly, there is a ready supply of growing funds to be deployed.

In terms of volumes that the various Islamic organisations are willing to place in the sort of deal described above, the range extends from $500,000 (although $5m is a more realistic starting point) up to $100m per transaction.

If an amount in excess of this were required, the most likely route would be by way of a Mudaraba, which is essentially a managed pooling agreement akin to a syndication.

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While Islamic finance should not be viewed as a cheap version of conventional funding, it does have a number of other advantages:

- it is a largely untapped and growing source of alternative finance providing diversity to a funding base;
- it offers the potential to remove transactions from the borrower's balance sheet (this can be achieved through trade finance structures or through use of various leasing possibilities that are equally well established through Islamic banking); and
- it offers the potential for passing on risks that might be otherwise difficult to quantify for the borrower (for example, certain credit risks might be acceptable to the Islamic financier by virtue of regional knowledge that a corporate supplier might not be as comfortable with).

We have included (on page 52) an indicative outline term sheet of the sort that you might expect to see for an Islamic proposal. The terms are by no means exhaustive but will hopefully serve to show Islamic finance as being adaptable and acceptable to the needs of treasurers. ■

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