RELEVANT TO ACCA QUALIFICATION PAPER F9

Studying Paper F9
Performance objectives 15 and 16 are relevant to this exam

Introduction to Islamic finance

The Paper F9 syllabus now contains a section on Islamic finance (Section E3). All components of this section will be examined at intellectual level 1, knowledge and comprehension.

Although the concept of Islamic finance can be traced back about 1,400 years, its recent history can be dated to the 1970s when Islamic banks in Saudi Arabia and the United Arab Emirates were launched. Bahrain and Malaysia emerged as centres of excellence in the 1990s. It is now estimated that worldwide around US $1 trillion of assets are managed under the rules of Islamic finance.

Islamic finance rests on the application of Islamic law, or Shariah, whose primary sources are the Qur'an and the sayings of the Prophet Muhammad. Shariah, and very much in the context of Islamic finance, emphasises justice and partnership.

The main principles of Islamic finance are that:
- Wealth must be generated from legitimate trade and asset-based investment. (The use of money for the purposes of making money is expressly forbidden.)
- Investment should also have a social and an ethical benefit to wider society beyond pure return.
- Risk should be shared.
- All harmful activities (*haram*) should be avoided.

The prohibitions

The following activities are prohibited:
- Charging and receiving interest (*riba*). The idea of a lender making a straight interest charge, irrespective of how the underlying assets fare, transgresses the concepts of risk sharing, partnership and justice. It represents the money itself being used to make money. It also prohibits investment in companies that have too much borrowing (typically defined as having debt totalling more than 33% of the firm's stock market value over the last 12 months).
- Investments in businesses dealing with alcohol, gambling, drugs, pork, pornography or anything else that the Shariah considers unlawful or undesirable (*haram*).
- Uncertainty, where transactions involve speculation, or extreme risk. This is seen as being akin to gambling. This prohibition, for example, would rule out speculating on the futures and options markets. Mutual insurance (which relates to uncertainty) is permitted if it is related to reasonable, unavoidable business risk. It is based upon the principle of shared responsibility for shared financial security, and that members contribute to a mutual fund, not for profit, but in case one of the members suffers misfortune.
- Uncertainty about the subject matter and terms of contracts – this includes a prohibition on selling something that one does not own. There are special financial techniques available for contracting to manufacture a product for a customer. This is necessary because the product does not exist, and therefore cannot be owned, before it is made. A manufacturer can promise to produce a specific product under certain agreed specifications at a

determined price and on a fixed date. Specifically, in this case, the risk taken is by a bank which would commission the manufacture and sell the goods on to a customer at a reasonable profit for undertaking this risk. Once again the bank is exposed to considerable risk. Avoiding contractual risk in this way, means that transactions have to be explicitly defined from the outset. Therefore, complex derivative instruments and conventional short sales or sales on margin are prohibited under Islamic finance.

The permitted
As mentioned above, the receipt of interest is not allowed under Shariah. Therefore, when Islamic banks provide finance they must earn their profits by other means. This can be through a profit-share relating to the assets in which the finance is invested, or can be via a fee earned by the bank for services provided. The essential feature of Shariah is that when commercial loans are made, the lender must share in the risk. If this is not so then any amount received over the principal of the loan will be regarded as interest.

There are a number of Islamic financial instruments mentioned in the Paper F9 syllabus and which can provide Shariah-compliant finance:

- *Murabaha* is a form of trade credit for asset acquisition that avoids the payment of interest. Instead, the bank buys the item and then sells it on to the customer on a deferred basis at a price that includes an agreed mark-up for profit. The mark-up is fixed in advance and cannot be increased, even if the client does not take the goods within the time agreed in the contract. Payment can be made by instalments. The bank is thus exposed to business risk because if its customer does not take the goods, no increase in the mark-up is allowed and the goods, belonging to the bank, might fall in value.
- *Ijara* is a lease finance agreement whereby the bank buys an item for a customer and then leases it back over a specific period at an agreed amount. Ownership of the asset remains with the lessor bank, which will seek to recover the capital cost of the equipment plus a profit margin out of the rentals payable.

Emirates Airlines regularly uses *Ijara* to finance its expansion

Another example of the *Ijara* structure is seen in Islamic mortgages. In 2003, HSBC was the first UK clearing bank to offer mortgages in the UK designed to comply with Shariah. Under HSBC's Islamic mortgage, the bank purchases a house then leases or rents it back to the customer. The customer makes regular payments to cover the rental for occupying or otherwise using the property, insurance premiums to safeguard the property, and also amounts to pay back the sum borrowed. At the end of the mortgage, title to the property can be transferred to the customer. The demand for Islamic mortgages in the UK has shown considerable growth.

- *Mudaraba* is essentially like equity finance in which the bank and the customer share any profits. The bank will provide the capital, and the borrower, using their expertise and knowledge, will invest the capital. Profits will be shared according to the finance agreement, but as with equity finance there is no certainty that there will ever be any profits, nor is there certainty that the capital will ever be recovered. This exposes the bank to considerable investment risk. In practice, most Islamic banks use this is as a form of investment product on the liability side of their statement of financial position, whereby the investor or customer (as provider of capital) deposits funds with the bank, and it is the bank that acts as an investment manager (managing the funds).

- *Musharaka* is a joint venture or investment partnership between two parties. Both parties provide capital towards the financing of projects and both parties share the profits in agreed proportions. This allows both parties to be rewarded for their supply of capital and managerial skills. Losses would normally be shared on the basis of the equity originally contributed to the venture. Because both parties are closely involved with the ongoing project management, banks do not often use *Musharaka* transactions as they prefer to be more 'hands off'.
- *Sukuk* is debt finance. A conventional, non-Islamic bond or debenture is a simple debt, and the bondholder's return for providing capital to the bond issuer takes the form of interest. Islamic bonds, or *sukuk*, cannot bear interest. So that the *sukuk* are Shariah-compliant, the *sukuk* holders must have a proprietary interest in the assets which are being financed. The *sukuk* holders' return for providing finance is a share of the income generated by the assets. Most *sukuk*, are 'asset-based', not 'asset-backed', giving investors ownership of the cash flows but not of the assets themselves. Asset-based is obviously more risky than asset backed in the event of a default.

There are a number of ways of structuring *sukuk*, the most common of which are partnership (*Musharaka*) or lease (*Ijara*) structures. Typically, an issuer of the *sukuk* would acquire property and the property will generally be leased to tenants to generate income. The *sukuk*, or certificates, are issued by the issuer to the *sukuk* holders, who thereby acquire a proprietary interest in the assets of the issuer. The issuer collects the income and distributes it to the *sukuk* holders. This entitlement to a share of the income generated by the assets can make the arrangement Shariah compliant.

The cash flows under some of the approaches described above might be the same as they would have been for the standard western practice paying of interest on loan finance. However, the key difference is that the rate of return is based on the asset transaction and not based on interest on money loaned. The difference is in the approach and not necessarily on the financial impact. In Islamic finance the intention is to avoid injustice, asymmetric risk and moral hazard (where the party who causes a problem does not suffer its consequences), and unfair enrichment at the expense of another party.

Advocates of Islamic finance claim that it avoided much of the recent financial turmoil because of its prohibitions on speculation and uncertainty, and its emphasis on risk sharing and justice. That does not mean, of course, that the system is free from all risk (nothing is), but if you are more exposed to a risk you are likely to behave more prudently.

The Shariah board

The Shariah board is a key part of an Islamic financial institution. It has the responsibility for ensuring that all products and services offered by that institution are compliant with the principles of Shariah law. Boards are made up of a committee of Islamic scholars and different institutions can have different boards.

An institution's Shariah board will review and oversee all new product offerings before they are launched. It can also be asked to deliver judgments on individual cases referred to it, such as whether a specific customer's business proposals are Shariah-compliant.

The demand for Shariah-compliant financial services is growing rapidly and the Shariah board can also play an important role in helping to develop new financial instruments and products to help the institution to adapt to new developments, industry trends, and customers' requirements. The ability of scholars to make pronouncements using their own expertise and based on Shariah, highlights the fact that Islamic finance remains innovative and able to evolve, while crucially remaining within the bounds of core principles.

Developments

Perhaps the main current problem is the absence of a single, worldwide body to set standards for Shariah compliance, meaning that there is no ultimate authority for Shariah compliance. Each Islamic bank's adherence to the principles of Shariah law is governed by its own Shariah board. Some financial aspects of Shariah law, and, therefore, the legitimacy of the financial instruments used can be open to interpretation, with the result that some Islamic banks may agree transactions that would be rejected by other banks. Therefore, a contract might unexpectedly be declared incompatible with Shariah law and thus be invalid.

In Malaysia, the world's biggest market for *sukuk*, the Shariah advisory council, ensures consistency to help creating certainty across the market. Some industry bodies, notably the Accounting and Auditing Organisation for Islamic Financial Institutions (AAOIFI) in Bahrain, have also been working towards common standards. To quote the AAOFI website: 'AAOIFI is supported by institutional members (200 members from 45 countries, so far) including central banks, Islamic financial institutions, and other participants from the international Islamic banking and finance industry, worldwide. AAOIFI has gained assuring support for the implementation of its standards, which are now adopted in the Kingdom of Bahrain, Dubai International Financial Centre, Jordan, Lebanon, Qatar, Sudan and Syria. The relevant authorities in Australia, Indonesia, Malaysia, Pakistan, Kingdom of Saudi Arabia, and South Africa have issued guidelines that are based on AAOIFI's standards and pronouncements.'

However, despite these movements towards consistency, some differences between national jurisdictions are likely to remain.

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