Modern Islamic Finance: An Introductory Overview

Michael J.T. McMillen

NATIONAL COUNCIL ON U.S.-ARAB RELATIONS

26 YEARS OF PROMOTING *UNDERSTANDING*

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Overview

- It Is Business, Both Practical And Principled
- It Is In The Context Of A Developed Jurisprudential and Legal Framework
- It Is Structured Finance, Both Ancient And Modern (defined before the term was appropriated by the derivatives business – structuring to allocate risk to those most capable to bear and manage the risk)
- All Of Which Is To Say: There Are More Similarities Than Differences
- It Is A Competitive Edge and Culturally Enriching

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Introduction
Background – Foundation Elements

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Introduction

- Practitioner's Vantage
- Client and Transactional Base
- Infant and immature industry – on the finance side, mid-1990s – I began working in this field in 1996

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A Story

- Camels and Petrochemicals

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What is the Point of the Story?

- A Few Points (there are many):
  - This is about business – and business has been conducted in the same way for a very long time – there are few things new under the sun (and the moon)
  - As we will note, this is about business that is firmly based on an ethical paradigm
  - This is about a legal system (and more), one that has existed for a very long time and is comprehensive, as the *Shari'ah* is comprehensive in every way – there are few things new under the sun (and the moon)
  - It is relevant – the scope of modern Islamic finance (we will get to the markets)

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Industry Objectives in Global Markets

- Commerce and finance in accordance with the *Sharī`ah*
  - Different risk-reward paradigm: risk sharing without preferences
  - Partnerships and trading (sales) as transactional paradigms – although they are not the only paradigms (e.g., leasing)
  - Asset based – absence of derivatives
- Realization of returns that are equivalent to those in conventional markets
  - Transaction costs of *Sharī`ah*-compliant transactions
- Use of leverage or gearing to enhance returns
  - Leverage providers: conventional financial institutions and *Sharī`ah*-compliant institutions: relative sizes, market penetration, market predominance

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Foundation Elements - Notable Developments

- Three themes to consider as we move through our discussion
  - Nominate contracts – historical contractual and transactional forms
  - "Permissible variance" or "permissible impurity" and "cleansing" or "purification"
  - Capital market developments – equity and finance sides: Dow Jones *Fatwā* and *Sukuk*
- Subsumed in and integral to those concepts: the roles and importance of the *Sharī`ah* scholars

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Nominate Contracts

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Foundation Elements – Nominate Contracts

- Historically, under the *Sharī`ah*, there were a limited number of contractual transactional forms for the conduct of business
- These were very much trade-based structures – quite rigid
- They included:
  - Loans (*qard hassan*)
  - Gifts
  - Sales (*bay*), such as *murābaha* (sale at a mark-up)
  - Leases – a type of sale of the usufruct (*ijāra*)
  - Joint ventures and partnerships (*s<u>h</u>arikāt*, *mu<u>d</u>āraba*)
  - Manufacture or construction contracts (*'istiṣnā`*)
  - Agency (*wakālah*)
  - Others

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Nominate Contracts – The Ancient and Modern

- One of the major developments of the mid-1990s: scholars and practitioners began moving away from a conception of the nominate contracts as being immutable and rigid, moving toward a more flexible conception of these structures

- The different nominate contracts have become "building blocks" in composite structures – which has made an enormous difference in the ability to structure to modern market demands and to meet legal and regulatory requirements

- The remain as significant elements, and the study of some history is important to the understanding of modern Islamic finance

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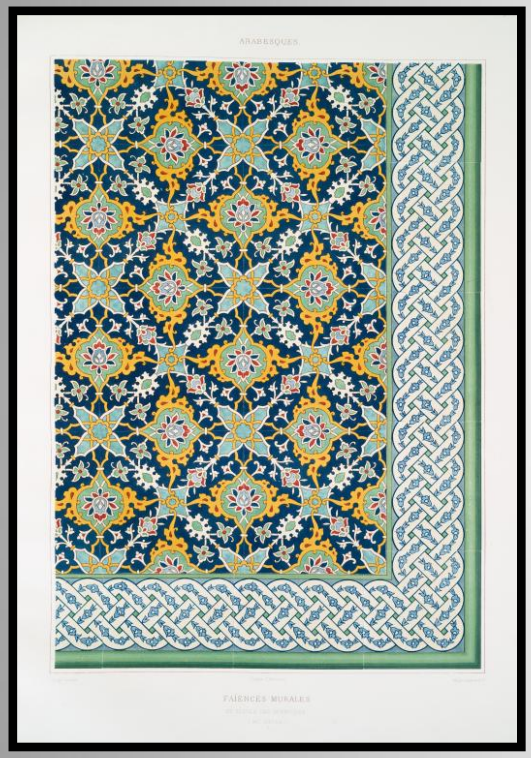

The Dow Jones *Fatwā*: Permissible Impurity Cleansing and Purification

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Permissible Impurity

- Prior to 1998, any violation of *Sharī`ah*, however slight, rendered the transaction impermissible
- E.g.: could not invest in an equity security because virtually every company has interest income or interest expense
- Dow Jones Islamic Indexes *fatwā* of 1998 – monumental:
  - Institutionalization of a degree of "permissible impurity"
  - Institutionalization of cleansing and purification (small amounts of impermissible interest income could be cleansed or purified by donation to charity)
  - Dow Jones equity investment tests

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Equity Investment Tests

- The determination of whether an equity investment can be made in compliance with the *Sharī`ah* involves two levels of tests (with two tests at the first level):
  - Level 1: First: Is the instrument itself prohibited?
  - Level 1: Second: Is the entity in which the equity investment is to be made in a permissible business?
  - Level 2: Does such entity have impermissible *ribā* elements?

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Equity Investment Tests

- The first test at the first level tests focus on the instrument in which investment is being made
- Certain types of instruments have traditionally been prohibited:
  - Fixed income instruments
  - Preferred shares
  - Convertible notes
  - Similar instruments
- Reason for prohibition: predetermined rate of return with a guarantee of principal

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Equity Investment Tests

- The second test at the first level focuses on the business affairs and activities (the industry) of the entity in which the equity investment is to be made
- Equity investments may not be made if the entity's "core" business is:
  - Production or distribution of pork for human consumption
  - Production or distribution of alcohol for human consumption
  - Production of tobacco for human consumption - ?
  - Interest-based financing
  - Gambling
  - Prostitution and pornography
  - Defense and weapons – ?
  - Entertainment - ?
- The application of the permissible business test in multifaceted modern transactions

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Equity Investment Tests

- Financial tests:
  - Total accounts receivable / market capitalizations ≤ 33% (originally 45%)
  - Total debt (short-term and long-term) / market capitalization ≤ 33%
  - Total cash plus marketable securities / market capitalization ≤ 33%

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Permissible Impurity

- The important point, however, is that:
  - some degree of variance or impurity was determined to be acceptable
  - continuing application of these principles in a broad range of areas is
- Also institutionalized “cleansing” and “purification” concepts
- A monumental *fatwā* allowed the development of Islamic finance
- Finding the balance point between *Sharī`ah* doctrinal purity, the realities of global markets, and what is necessary to allow Islamic finance to develop and grow

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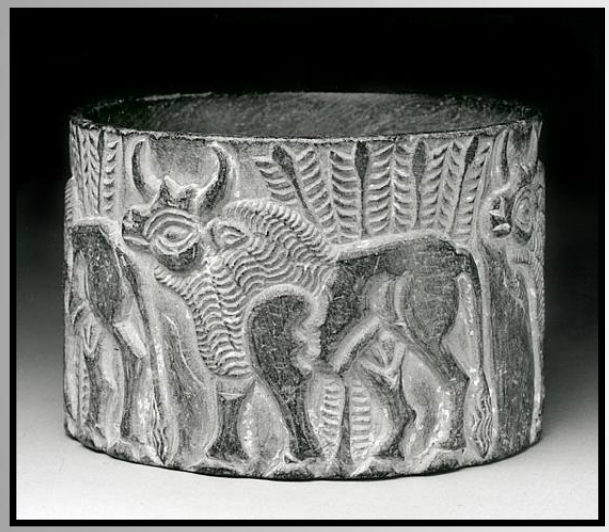

Current Markets

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Market Status

- Infant markets
- Modern Islamic finance is 1996 and thereafter
  - first US structures were in 2000 and virtually all investments are made through offshore funds
  - Europe 2003 and thereafter
  - Middle East beginning in late 1990s, large acceleration in 2005
  - Africa 2000
  - Malaysia, Indonesia mid-to-late 1990s

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Market Status

- Real estate – primary investment category
  - Residential – 1999 to 2002 – structure developed and this category of investments avoids prohibited business issues
  - Commercial – 2000 onward
    - First in US in 1999, Europe in 2003. Middle East 2005, Asia 2006-2007
    - Single tenants in initial transactions; multiple tenants as permissible impurity doctrines were/are given more fulsome development
  - Prohibited business issues and permissible impurity issues pertaining to tenants

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Market Status

- Private Equity: 1999 in US; some European activity from 2005; Middle Eastern activity from 2005
- Equity Markets – Dow Jones (1999) and thereafter
- Hedge fund concepts – short sales and options trading (2003 but not yet implemented)
- Index tracking funds
- Exchange traded funds
- Bankruptcy and distressed debt funds
- Derivatives – essentially none, but ISDA and Malaysian initiatives

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Market Status

- Virtually no short-term investment instruments
- No commercial paper
- No derivatives
- US and European banks and investment banks are recent entries to the field; commercial banks first, and in real estate finance
- No secondary markets – Islamic Financial Services Board capital markets initiative focusing on asset securitization *sukuk* and secondary markets

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Predominant Structures

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First *Sharī`ah*- Compliant Structures

- Assumption: US and European banks needed to finance real estate transactions in, first, the US and, later, Europe
- These banks would only make conventional interest-based loans
  - Familiarity
  - Credit and underwriting
  - Regulatory and tax
  - Other reasons
- Bifurcated structures making use of both *Sharī`ah* structures and conventional structures in an overall transaction that is determined to be *Sharī`ah*-compliant by the *Sharī`ah* scholars
- The first structures made use of the *ijāra* (lease)
- Those structures remain predominant throughout the world – adjusted for each jurisdiction

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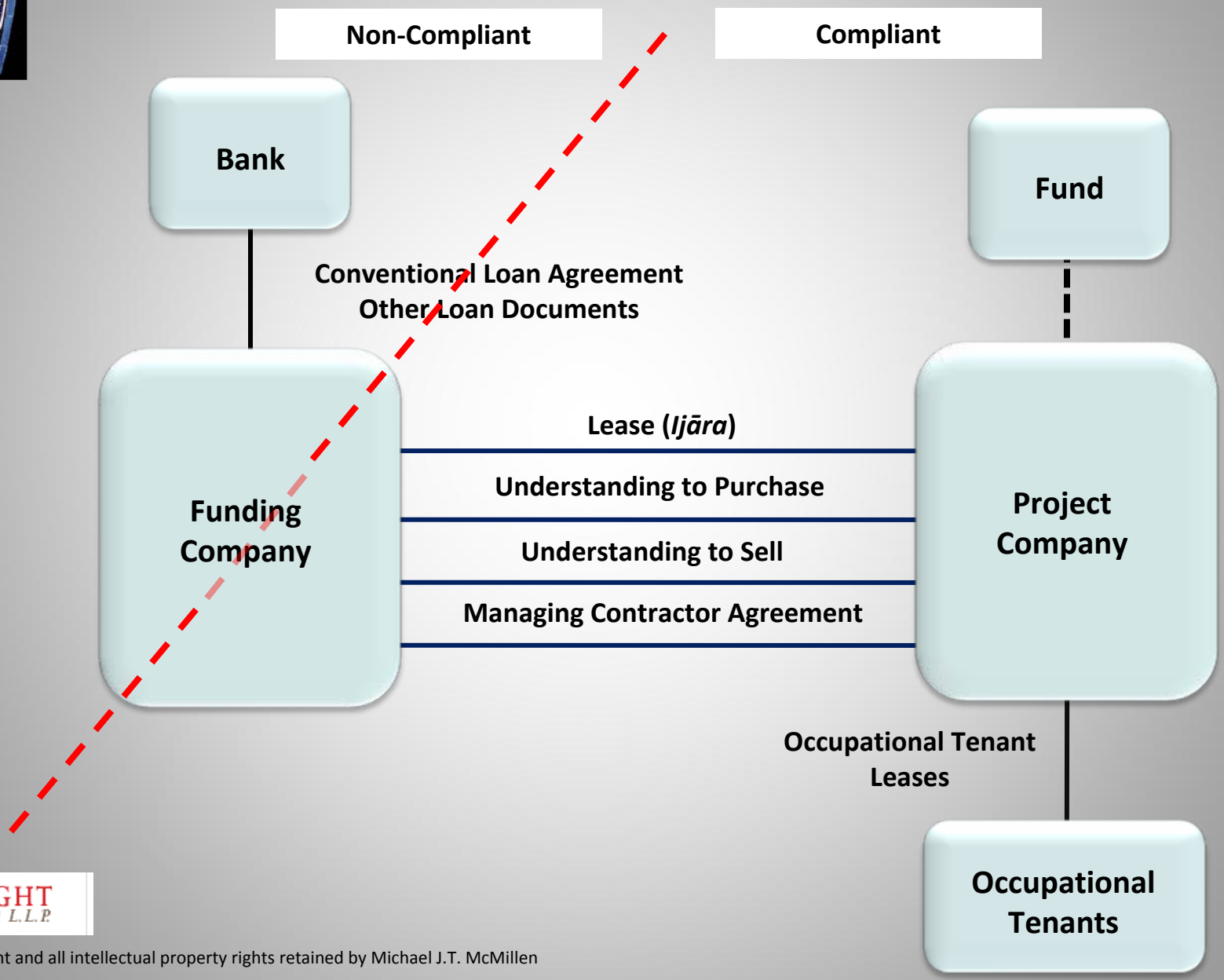
Bifurcated Structure



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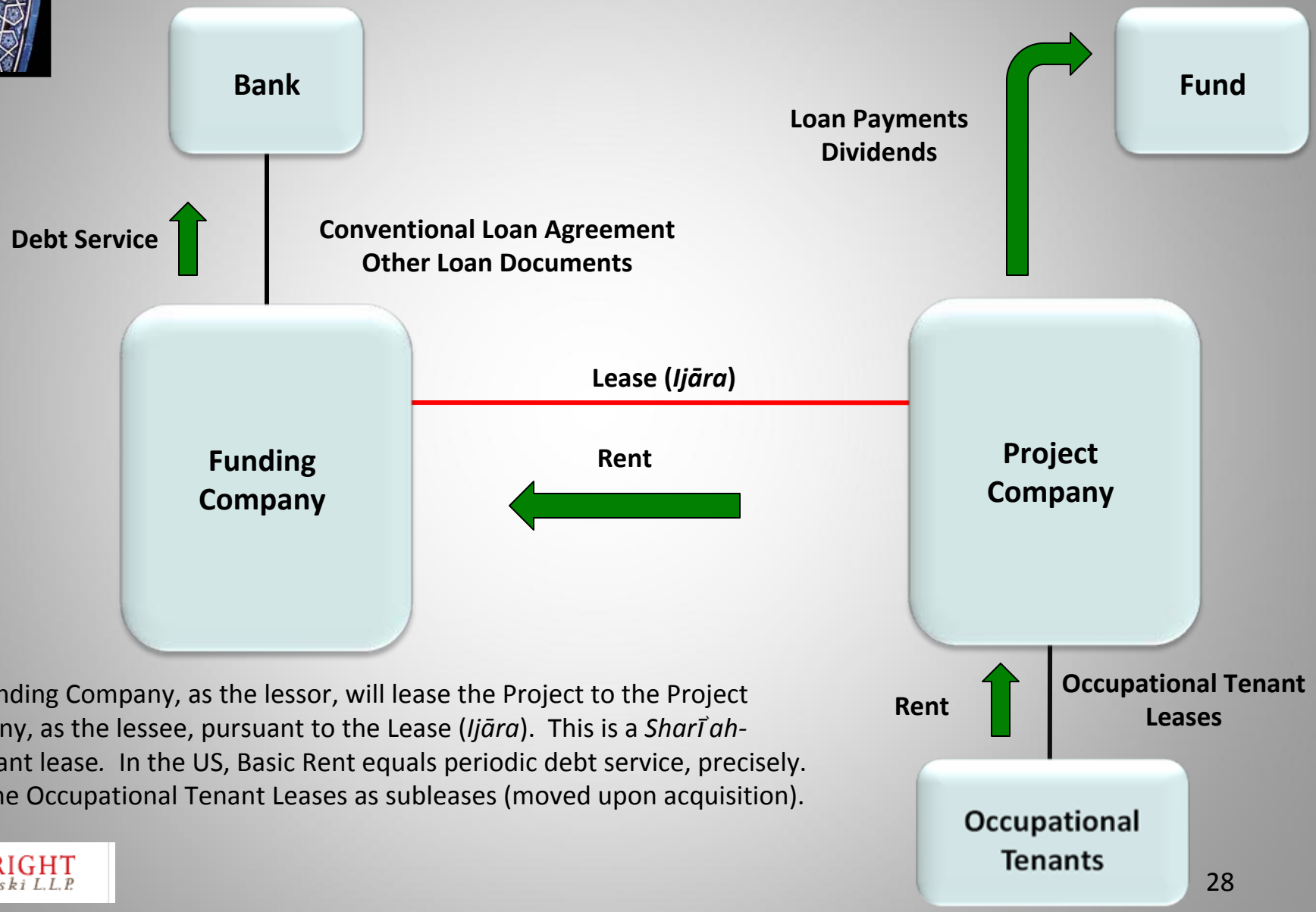
Lease (*Ijāra*)



The Funding Company, as the lessor, will lease the Project to the Project Company, as the lessee, pursuant to the Lease (*Ijāra*). This is a *Sharī'ah*-compliant lease. In the US, Basic Rent equals periodic debt service, precisely. Note the Occupational Tenant Leases as subleases (moved upon acquisition).

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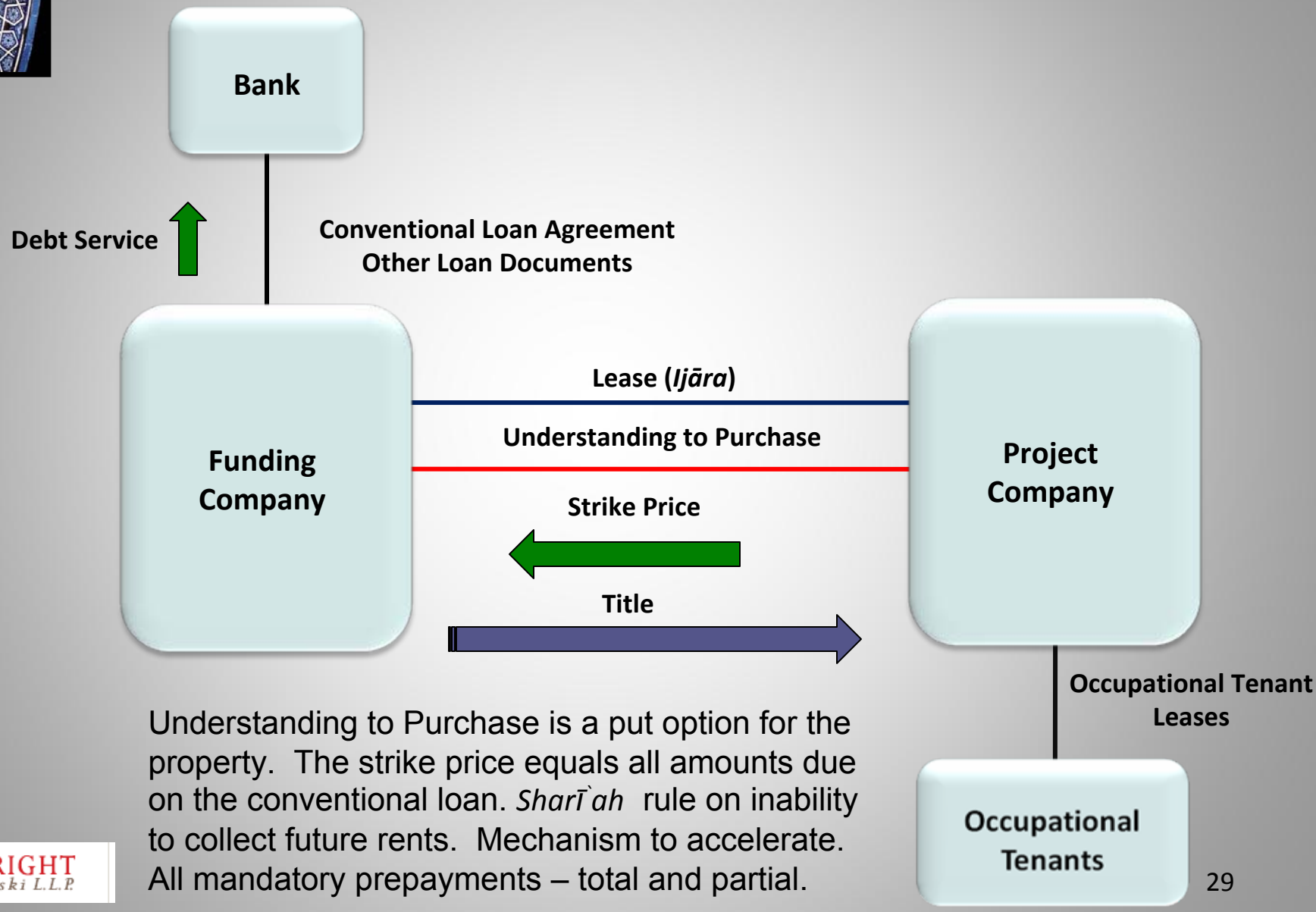
Understanding to Purchase



Understanding to Purchase is a put option for the property. The strike price equals all amounts due on the conventional loan. *Sharī`ah* rule on inability to collect future rents. Mechanism to accelerate. All mandatory prepayments – total and partial.

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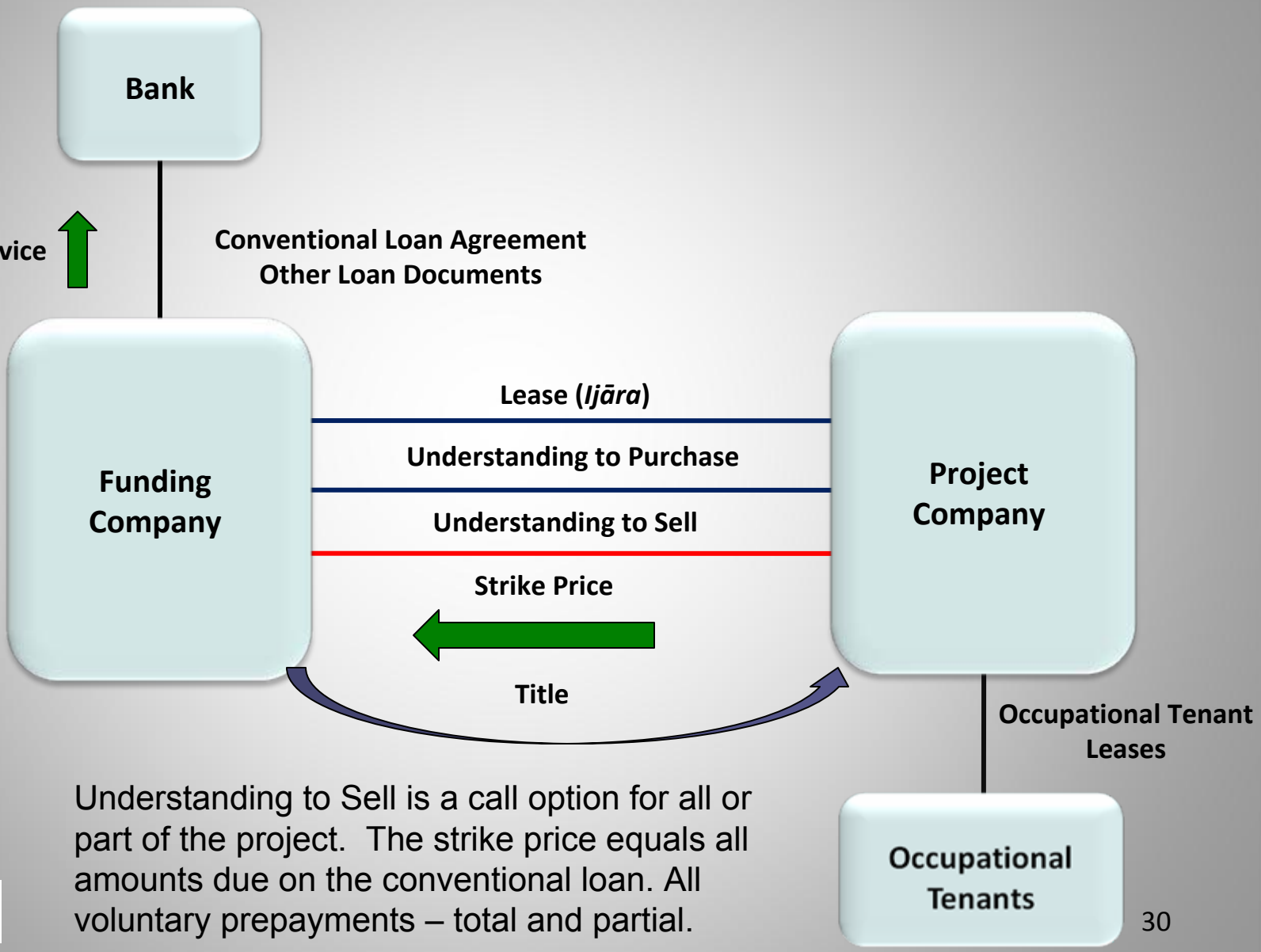
Understanding to Sell



Understanding to Sell is a call option for all or part of the project. The strike price equals all amounts due on the conventional loan. All voluntary prepayments – total and partial.

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Sukuk al-Mushāraka
(Diminising *Mushāraka*)

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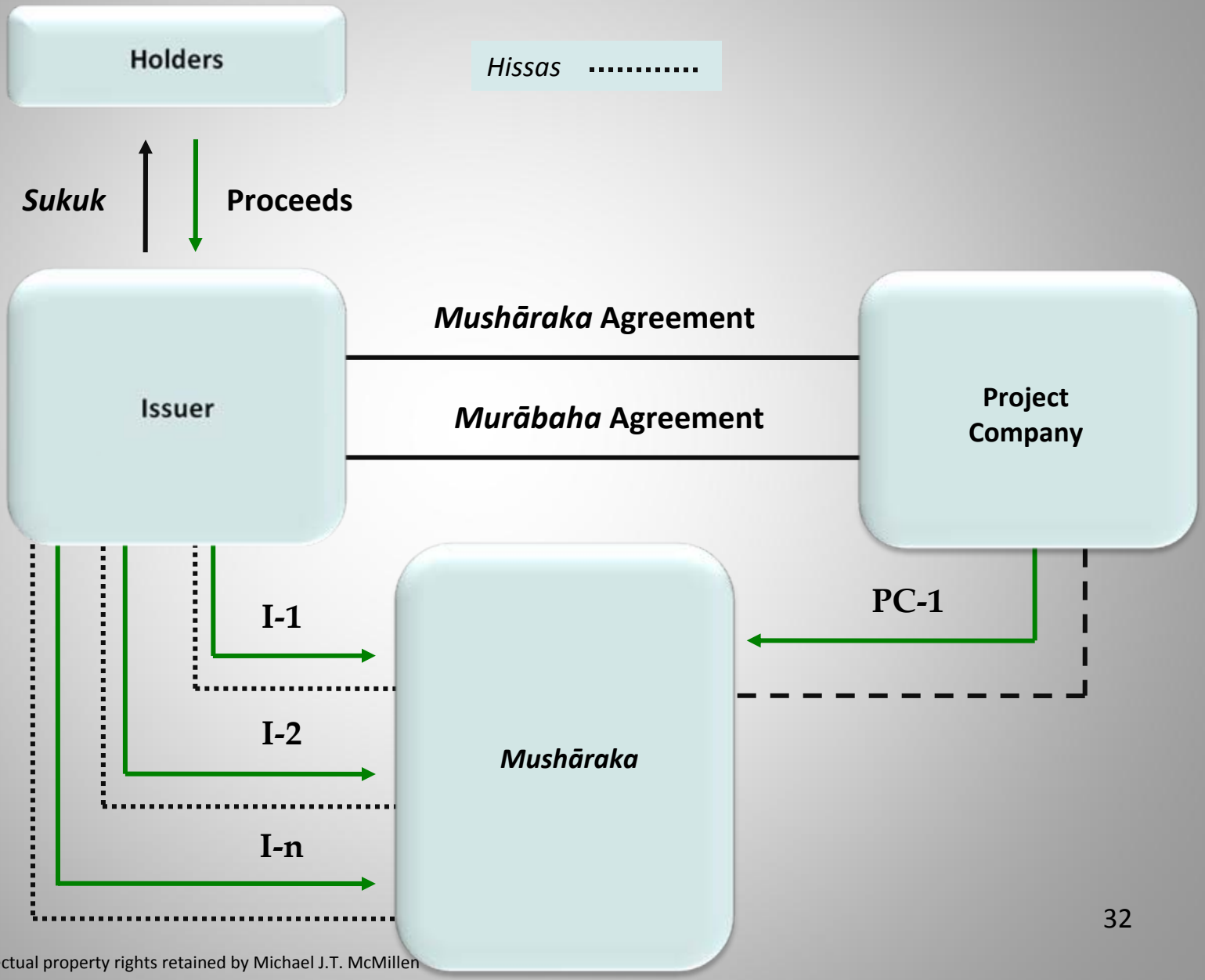
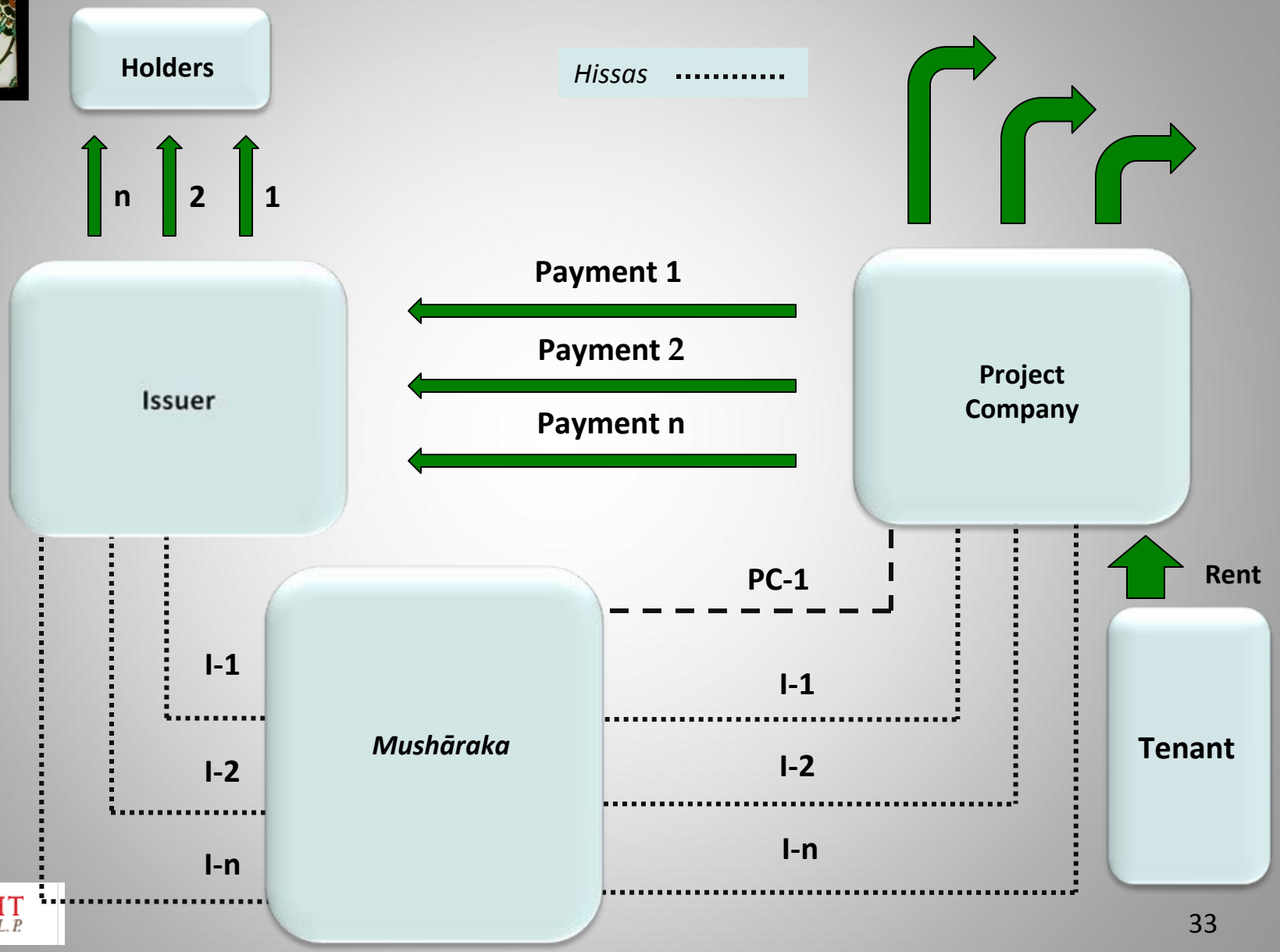
Funding



Payments



Sukuk

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Market Status - *Sukuk*

- Growth since 2003 – one of the fastest growing areas
- One of the first instruments to access the debt side of the capital markets
- *Sukuk* are of two types:
  - "Bond" structures – not Western "bonds" but "whole business securitizations
  - Asset securitization structures
- Most transactions to date:
  - bond structures
  - sovereign credits
  - corporate issuances are increasing
  - one or two asset securitization *sukuk*
- IFSB capital markets initiative: the *sukuk* as a backbone of the Islamic capital markets (common law trusts; securities and capital markets laws; bankruptcy) – enforceability issues

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Issuances Generally

Source: Michael J.T. McMillen and John A. Crawford, *Sukuk in the First Decade: By The Numbers*, Dow Jones Islamic Indexes Newsletter, Issue 3, 2008.

Total Issuances: US$ 87,955.22 million
Total Offerings: 596

Sovereign Issuances: 35%
Corporate Issuances: 65%

Malaysia
- Issuances: 267 (44.80%)
- Total Volume: US$ 37,696.72 million (42.86%)

Bahrain
- Issuances: 150 (25.17%)
- Total Volume: US$ 6,149.78 million (7.00%)

UAE
- Issuances: 34 (5.70%)
- Total Volume: US$ 26,977.48 million (30.67%)

Total Number: Malaysia + Bahrain: 69.97%
Total Volume: Malaysia + UAE: 73.53%

Compare: Gambia: 36 (6.04%) and US$ 11.49 million (0.0%)

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Issuances by Industry Sector

Table 1					
Industry	Volume (US$ millions)	% Total Volume	Offerings	% Total Offerings	Average Issuance (US$ - millions)
Financial Services	21,712.92	24.7%	69	11.6%	314.68
Real Estate	19,368.73	22.0%	67	11.2%	289.09
Transport	12,004.63	13.6%	40	6.7%	300.12
Power & Utilities	9,054.77	10.3%	22	3.7%	411.58
Oil & Gas	6,338.12	7.2%	20	3.4%	316.91
Government	7,340.65	8.3%	197	33.1%	37.26
Construction	4,254.04	4.8%	34	5.7%	125.12
Services	2,088.67	2.4%	7	1.2%	298.38
Telecoms & IT	1,836.32	2.1%	28	4.7%	65.58
Industrial Manufacturing	1,090.30	1.2%	21	3.5%	51.92
Conglomerates	1,014.88	1.2%	7	1.2%	144.98
Agriculture & Food	767.55	0.9%	52	8.7%	14.76
Consumer Goods	347.64	0.4%	11	1.8%	31.60
Mining & Metals	306.65	0.3%	4	0.7%	76.66
Basic Materials	169.10	0.2%	7	1.2%	24.16
Healthcare	128.08	0.1%	3	0.5%	42.69
Automotive	127.51	0.1%	6	1.0%	21.25
Travel & Tourism	4.69	0.0%	1	0.2%	4.69
Total	87,955.25	100	596	100	

Source: Michael J.T. McMillen and John A. Crawford, *Sukuk in the First Decade: By The Numbers*, Dow Jones Islamic Indexes Newsletter, Issue 3, 2008.

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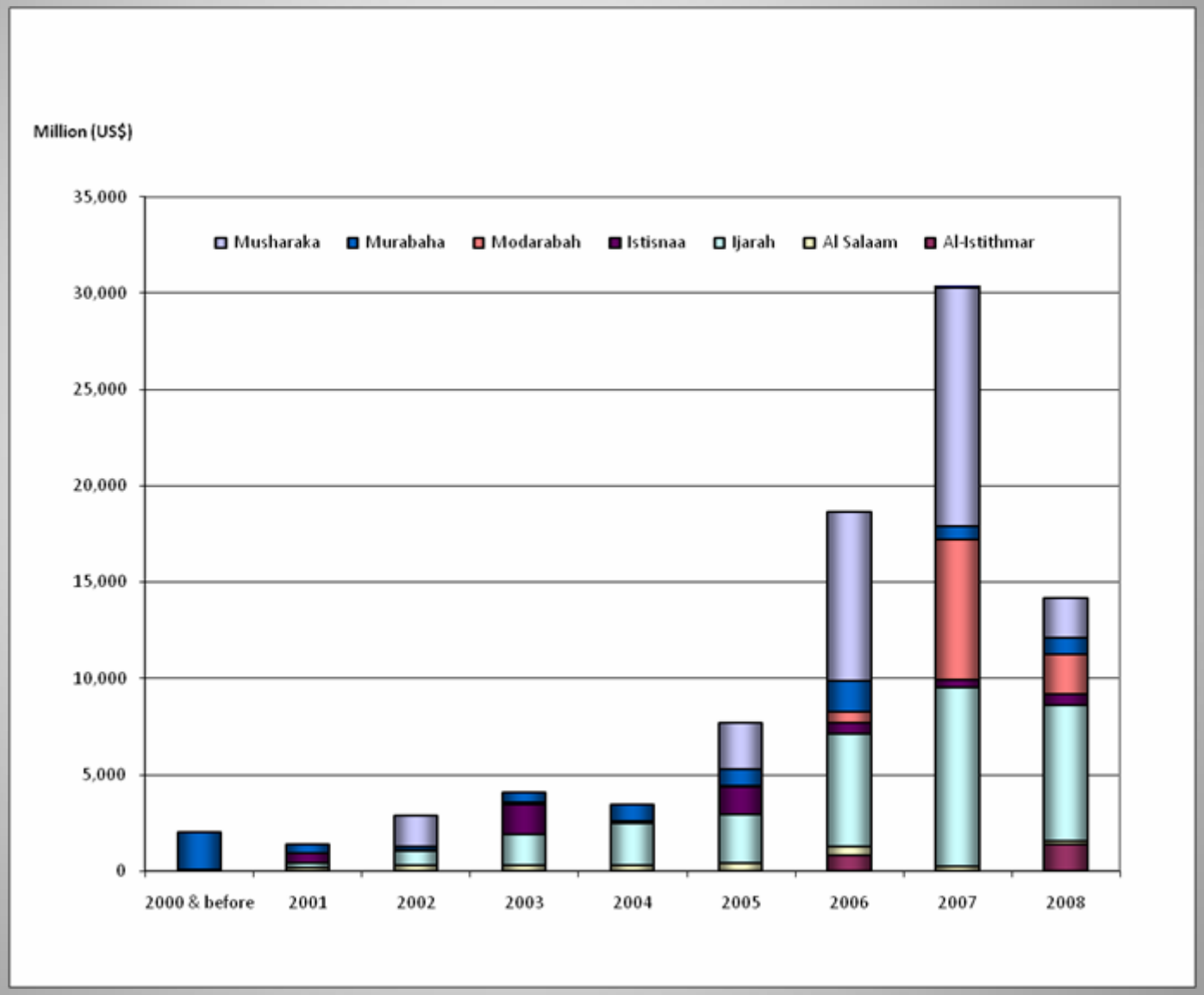
Issuances by *Sharī`ah* Structure and Year



Source: Michael J.T. McMillen and John A. Crawford, *Sukuk in the First Decade: By The Numbers*, Dow Jones Islamic Indexes Newsletter, Issue 3, 2008.

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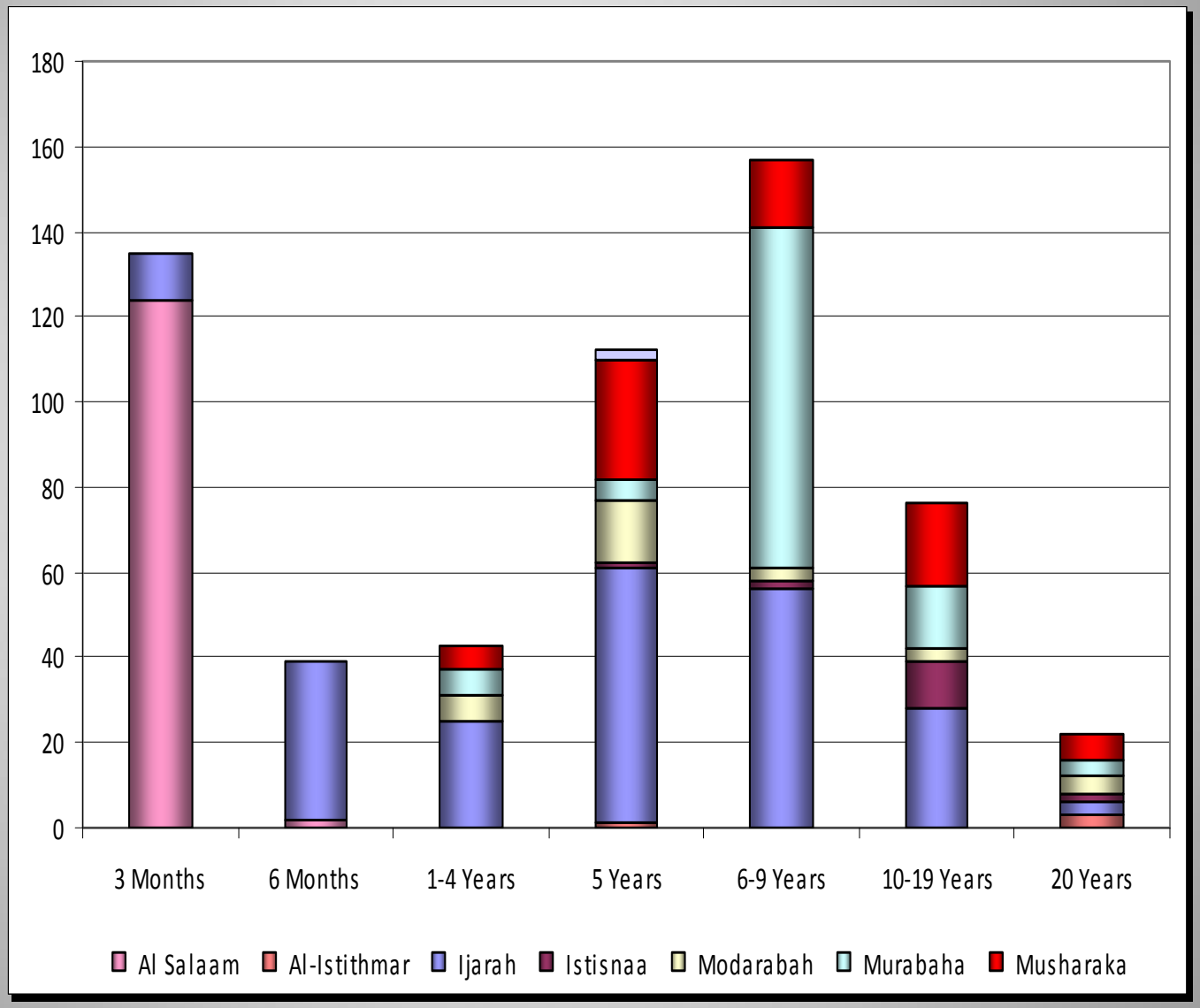
Issuances by Tenor and Dollar Volume



Source: Michael J.T. McMillen and John A. Crawford, *Sukuk in the First Decade: By The Numbers*, Dow Jones Islamic Indexes Newsletter, Issue 3, 2008.

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Conclusion - Musings

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Overview

- It Is business, both practical and principled
  - Rapid growth rate in the areas of:
    - greatest population growth
    - the greatest urbanization rates, and
    - some significant financial resources
- You will encounter these financial practices and transactions – really, you will, it is just a matter of time

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Overview

- It Is In The Context Of A Developed Jurisprudential and Legal Framework
  - There is significant certainty and predictability, although more difficult to appreciate unless you take the initiative to learn about it
  - Legal reform efforts, both within the existing system and via “financial centers”

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Overview

- It is structured finance, both ancient and modern
  - The essential principles and rules are ancient, from the *Shari'ah* vantage
  - Development in the context of modern global financial practices is accelerating, particularly as there are more cross-border multi-jurisdictional transactions
  - The modern structures are familiar to Western participants (consider the *ijara* as compared with the leveraged lease)
- There are more similarities than differences

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Overview

- It is a competitive edge
  - Access to new capital pools
  - Access to more markets
  - Access to new financing concepts and ideas
- It is culturally enriching
- It requires mutual cooperation and mutual understanding
- It engenders good will among people
- It is culturally enriching

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QATAR AIRWAYS القطرية

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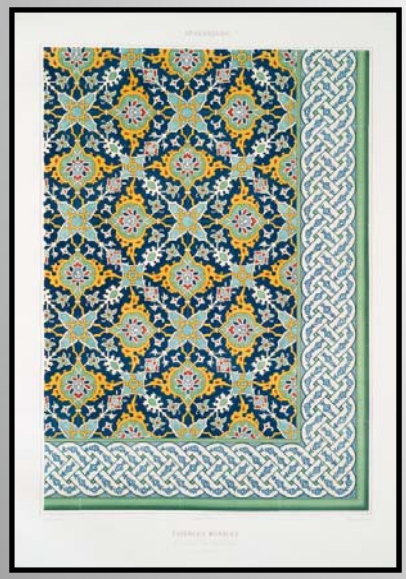
Panel for a Spandrel, Isfahan, Iran, 17th century
Los Angeles County Museum of Art



Faiences Murales - du Tekyeh des Derwiches (SVIIe.siecle),
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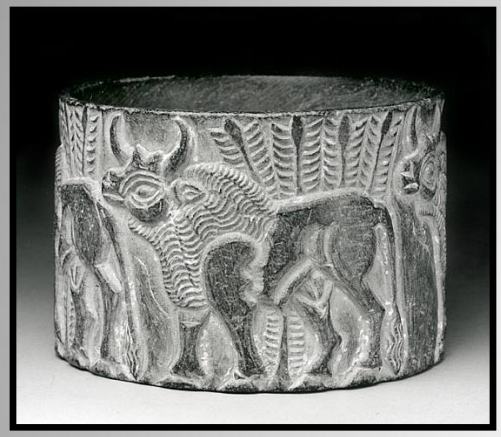

Cup, chlorite, 3000 – 2000 BCE
Sumerian Gulf and South Iran

Flask, Eastern Mediterranean, 11th century,
Los Angeles County Museum of Art

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Bowl, Iraq, Abbasid, 9th century
Metropolitan Museum of Art of the City of New York

Dish with artichokes and tulips, Iznik, Turkey,
circa 1550-55,
Los Angeles County Museum of Art

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Bowl, Egypt, 12th century,
Los Angeles County Museum of Art

Bowl, Iran, 9th-10th century,
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Bowl, Iraq, ninth century,
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Bowl, Iraq, ninth century
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Tile, saz leaves, Ottoman Turkey or Syria, first half of the 16th century, private collection

Tile, Grater Iran, 15th century,
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Tile, border panel, plum blossums and hyacinths, Damascus, Syria, late 16th century, private collection

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