

DISCUSSION PAPER

Islamic Finance: An Ethical Alternative to Conventional Finance?

ISLAMIC FINANCE: AN ETHICAL ALTERNATIVE TO CONVENTIONAL FINANCE?



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Whether the Islamic finance industry continues to escape the full force of current economic turmoil remains to be seen. What is clear is that the rapid growth in this area of finance and its ethical foundations make Islamic finance an increasingly serious alternative to conventional finance.

Islamic finance is one of the fastest-growing segments of today's banking industry. Formerly deemed a marginal industry by some, Islamic finance is now recognised as a vital and thriving market. While the size of Islamic finance and banking activities, estimated to range from \$500bn to \$1,000bn, is still a fraction of conventional banking, the impressive growth rates of 10–15% seen in recent years emphasise the potential market for such activities.

It is the fact that this growth is increasingly being seen outside the traditional markets of the Gulf Cooperation Council (GCC) countries and Malaysia which has meant that global market participants and policy makers are increasingly paying attention to its potential. Both New York and London have launched indices affiliated to their main Dow Jones and FTSE indices, to provide a benchmark for equity prices for investments in Islamic financial institutions. The UK Government has also played a major role in trying to make the City of London the global centre of Islamic finance by extending support wherever possible, including the abolition of double stamp duty on Islamic mortgages, and the recently announced plans to test the feasibility of issuing *Shari'ah*-compliant *sukuk* bonds. The 2007 Budget introduced new measures for *sukuk* bonds to be issued, held and traded on the UK financial market.

Indeed, the emergence and growth of *sukuk* instruments (commonly referred to as 'Islamic bonds') have revolutionised the *Shari'ah*-compliant debt securities sector. They have not only given momentum to the Islamic financial industry on a global scale, but have also provided opportunities for the development of secondary debt markets. After the German state of Saxony-Anhalt became the first non-Muslim issuer to enter the Islamic debt market in 2004, US and Japanese firms have also issued *sukuk* bonds. In the UK, the leveraged buy-out of Aston Martin from Ford (2006) was carried out using a *sukuk* instrument.

WHAT IS ISLAMIC FINANCE?

Islamic finance is any finance that is compliant with the principles of Islamic law (*Shari'ah*). In terms of finance, *Shari'ah* explains in detail the ethical concepts of money and capital, the relationship between risk and profit and the social responsibilities of financial institutions.

Interest (*riba*)

The most well-known aspect of an Islamic financial system is the prohibition of paying or receiving interest on capital. Essentially, any positive, fixed, predetermined rate tied to the maturity and the amount of principal, which is guaranteed irrespective of the performance of the investment, is considered *riba* and is so prohibited.

This prohibition is not to be confused with a rate of return or profit on capital, as the earnings and sharing of profit is very much encouraged within Islam. Moreover, profit, determined ex post, symbolises the creation of additional wealth through successful entrepreneurship, whereas interest, determined ex ante, is a cost that is accrued irrespective of the outcome of business operations, and may create wealth, even if there are business losses.

Risk and uncertainty (*gharar*)

Contractual risk is also forbidden. In general, this prohibits the selling of goods or services that the seller is not in a position to deliver or the making of a contract which is conditional on an unknown event. You cannot sell something you do not own. Also, the price and nature of the goods being transacted are defined in detail and agreed upon by both parties, thereby avoiding a sale that may represent a gamble (for example, conventional short sales or sales on margin are prohibited).

Although the prohibition of interest can indeed be viewed as the nucleus of Islamic doctrine relating to finance, there are a number of other supporting principles which provide guidance for an Islamic financial system:

- advocating risk sharing
- promotion of entrepreneurship
- discouraging speculative behaviour
- preservation of property rights.

These are evident through consideration of the Islamic financial system and conventional banking.

WHAT DIFFERENTIATES ISLAMIC FINANCE AND CONVENTIONAL FINANCE?

The evolution of Islamic banking and finance has come about from two main objectives, namely the elimination of interest-based (*riba*) finance and the development of low-risk products which would give confidence to regulators, shareholders and depositors alike. This latter aim was all the more necessary given the failure of some of the earlier Islamic banking models in Egypt, Pakistan and Malaysia in the 1950s.

One of the most notable features of the current Islamic finance market is the development of a comprehensive range of product offerings, with the industry now having almost like-for-like parity with conventional banking, whether it be investment banking, commercial banking or personal financial services.

Many of the primary products developed in Islamic banking were debt based in order to be more akin to the anatomy of conventional banking products. The use of these products, clearly similar to conventional instruments certainly appeased many of the stakeholders, including the financial services industry itself. However, those same resemblances did and continue to receive criticism from those wishing to see Islamic finance based on the core principles of *Shari'ah*.

Nonetheless there are quite distinct aspects of Islamic finance which differentiate it from conventional modes of finance. Describing the Islamic financial system simply as 'interest-free' does not do justice to the system. Its essence stretches to the promotion of entrepreneurship, preservation of property rights and the transparency of contractual obligations. These and the other pivotal and underlying principles are formed through a thorough consideration of *Shari'ah*.

The nature of capital as solely being a medium of exchange (ie no intrinsic value) is central to the prohibition of interest, and forms the central tenet of Islamic banking and finance. However other important principles include:

- the prohibition of contractual risk
- advocating sharing of risk and return
- asset-banked finance (as banks cannot rely on issuing against collateral alone).

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WHAT ARE THE MOST COMMONLY USED INSTRUMENTS OF ISLAMIC FINANCE?

Given the restrictions outlined above, modern-day scholars have developed principle modes of financing which can be applied to contemporary financial scenarios while adhering to Islamic principles. Some common financial instruments currently being utilised in Islamic finance in various forms are as follows.

For financing working capital and liquidity management

Murabaha: this is effectively cost-plus financing, as used for trade and asset finance, allowing deferred payment by customers. Rather than lending money as in conventional loan, the bank purchases the requested commodity (thereby taking in on risk) and sells it to the customer at the agreed mark-up price. In recent times *murabaha* contracts have been the instrument of choice for many financial products, be it trade and asset finance or the provision of working capital facilities.

Istisna'a: aimed at long-term construction projects, this along with *murabaha* products, is one of two types of finance which allows the sale of a commodity prior to it coming into existence. *Istisna'a* contracts are clearly aimed at long-term projects, and are frequently used to finance the construction of real estate developments and large assets such as ships.

For asset finance

Ijara: this is a quasi-debt instrument, essentially equivalent to leasing. Often used in the context of home purchasing, most aspects of an *ijara* are the same as those of conventional leasing, whereby the investor (lessor) purchases and leases the underlying asset to the prospective borrower (lessee) for a specified rent and term. *Ijara* are frequently used to finance the acquisition of real estate and equipment, although they have also been utilised to effect leveraged buy-outs in private equity transactions.

Diminishing *musharakah*: recent times have witnessed a shift in emphasis away from *ijara* towards diminishing *musharakah* (DM) as a mode of financing Islamic mortgages. Many of the major Islamic mortgage providers have either already switched to DM (HSBC Amanah uses DM) or are planning to do so imminently. DM is a hybrid financing technique involving both *ijara* and *musharakah*. It appeals to Islamic investors because it is based on the fundamental principle of sharing risk. The attraction for financiers is twofold, in that it can incorporate a variable rate of return and has a credit profile that would be acceptable to most conventional institutions.

Equity-like instruments

Musharakah: this is akin to a joint venture arrangement, through an equity participation contract. Ownership is distributed according to each partner's share in the financing, and profit and loss is shared by the partners. Such contracts are often used in connection with large-project finance and private equity funds. Despite it being a preferred option by many Islamic scholars, *musharakah* still

captures only a tiny portion of all Islamic finance, as there can be questions over the control of the assets.

Mudarabah: this is essentially an investment fund where one party provides the entire capital, and the other party provides the management (usually the bank, but can be the reverse). Profit sharing is agreed up-front, although the loss is borne by the provider of the funds alone.

Fixed income investment

Sukuk: this is an investment certificate (bond) that represents a proportionate interest in a well-defined pool of assets that yield income and capital returns. Usually set up through the conventional securitisation process, with a special purpose vehicle acquiring the assets, the returns from the assets are passed to *sukuk* holders (investors). To date popular asset classes have included real estate. This method has been a popular way for many governments to raise funds for infrastructure, and accounts for the largest portion of Islamic finance.

WHO REGULATES ISLAMIC FINANCE?

At the micro level, institutions that wish to offer *Shari'ah* compliant products have to have a *Shari'ah* Supervisory Board (SSB) (or at least a *Shari'ah* scholar). It is their responsibility to review and approve financial practices and products for compliance with Islamic principles.

However, just as *Shari'ah* itself is open to interpretation, so *Shari'ah* scholars often disagree as to what is *Shari'ah* compliant or not. Thus the laws that govern Islamic finance and the regulation of Islamic finance institutions continue to vary (mainly across jurisdictions).

At the macro level, given the markets where Islamic institutions initially developed, and the fact that the largest proportion of the market still remains in those jurisdictions, it is unsurprising that the major regulatory institutions are located in countries like Bahrain and Malaysia. The following are the most influential standard-setters regarding accounting for Islamic financial institutions.

Accounting and Auditing Organisation for Islamic Finance (AAOIFI)

AAOIFI was founded in Bahrain in 1990. Its standards (about 70 to date) are followed by a number of countries and institutions in the Gulf region, in particular.

Malaysia Accounting Standards Board (MASB)

MASB is the national standard setter for Malaysia and also produces Islamic accounting standards for Islamic institutions (since about 2001).

Islamic Financial Standards Board (IFSB)

IFSB, based in Malaysia, is more akin to the Basel Committee, and aims to promote the development of a prudent and transparent Islamic financial services industry. It also has a member on the International Accounting Standards Board's Standards Advisory Council.

HOW IS THE UK LEADING THE DEVELOPMENT OF ISLAMIC FINANCE?

Having initially relied on products created in traditional markets, the UK has in recent years used its long-standing reputation for innovation to develop products which are now being marketed in other countries such as the Middle East. The reasons for this are numerous but are headed by the UK financial services' proven skills base, with the large pool of legal, accounting and banking professionals leading the way in developing Islamic finance in the UK as well as around the world. The preference for English law in many Islamic finance transactions outside the UK is testament to that skills base.

We have earlier mentioned the various public policy and tax initiatives the UK Government has taken since the early 2000s. The relaxation of double stamp duty was a considerable relief, as property for instance purchased using Islamic finance would be bought and sold (legal title transferred) more than once. Thus stamp duty would otherwise be payable initially when the bank purchased the property and again when the legal title is transferred to the borrower upon repayment of the loan to the bank. Subsequent Finance Acts have contained further measures at equalising the tax position of other Islamic products with those of their conventional counterparts.

In the UK, the regulation of Islamic financial institutions falls within the remit of the Financial Services Authority (FSA). However, in contrast to other centres of Islamic banking such as Bahrain and Malaysia, which have separate authorisation and regulation for Islamic banks, the FSA regulates all financial institutions to the same standards. Thus while aiming to promote the UK as a 'global hub' for Islamic finance, the FSA's approach was clearly articulated by its then Chairman, Sir Howard Davies in 2003, as being one of 'no obstacles, but no special favours'.

This unique position that the FSA has to maintain means that when authorising an Islamic bank in the UK, careful consideration is required. While Islamic financial institutions fall within the same regulatory regime as conventional banks, some specific issues which the FSA have previously raised have included the regulatory definition of products and the role of the SSB. The significance of Shari'ah definitions in Islamic contracts is paramount, and it is therefore vital that institutions assess whether those products are within the bounds of regulated activities. With regards the role of SSBs there is particular concern around whether members should require FSA approval and, where members are on more than one board, how potential confidentiality issues are dealt with.

ENSURING FINANCIAL PROMOTIONS OF SHARI'AH COMPLIANT PRODUCTS ARE CLEAR, FAIR AND NOT MISLEADING.

In practice both the FSA and Islamic institutions themselves have been pragmatic, and issues over the definition of 'deposits', separating the responsibilities of SSBs and management have been resolved. This approach has already seen the establishment of six solely Islamic banks in the UK. These now operate alongside the increasing number of Islamic business lines ('Islamic windows') being operated by major international financial institutions such as HSBC, Deutsche Bank and Citibank.

While growth rates for Islamic finance are relatively high it still only constitutes a small proportion of the global financial services sector. For it to take a greater share and to expand in other jurisdictions, Islamic finance needs to focus on a number of key issues.

Product development

As some risk management tools are not available to Islamic firms, such as certain derivatives, other risk management methods need to be developed.

Standardisation

Differences of opinion from *Shari'ah* scholars on whether certain practices or products are *Shari'ah* compliant continue. A common set of standards and closer links between regulators and standard setters such as AAOIFI, the IFSB and the FSA are crucial.

Human capital

The nuances of Islamic jurisprudence and its assimilation with conventional banking requires a great deal of expertise. Investment in training and formal qualifications will be vital to attract and maintain the right level of professionals to allow the industry to develop.

As would be expected with a relatively recent phenomenon, there remain legitimate concerns over the mechanics and regulation of Islamic finance. However, as a Congressional Research Service report on Islamic finance in July 2008 notes: 'Some also view the integration of ethics and values into finance as a positive development, with many investors reportedly considering SCF (*Shari'ah*-compliant finance) to be more reliable than conventional financing, given the recent global credit crisis and fears of economic recession'.

ABOUT ACCA

ACCA (the Association of Chartered Certified Accountants) is the global body for professional accountants. We aim to offer business-relevant, first-choice qualifications to people of application, ability and ambition around the world who seek a rewarding career in accountancy, finance and management.

We support our 122,000 members and 325,000 students throughout their careers, providing services through a network of 80 offices and centres. Our global infrastructure means that exams and support are delivered – and reputation and influence developed – at a local level, directly benefiting stakeholders wherever they are based, or plan to move to, in pursuit of new career opportunities. Our focus is on professional values, ethics, and governance, and we deliver value-added services through our global accountancy partnerships, working closely with multinational and small entities to promote global standards and support.

We use our expertise and experience to work with governments, donor agencies and professional bodies to develop the global accountancy profession and to advance the public interest.

Our reputation is grounded in over 100 years of providing world-class accounting and finance qualifications. We champion opportunity, diversity and integrity, and our long traditions are complemented by modern thinking, backed by a diverse, global membership. By promoting our global standards, and supporting our members wherever they work, we aim to meet the current and future needs of international business.

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