ISLAMIC FINANCE: ALTERNATIVES TO THE WESTERN MODEL

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Islamic banking has come a long way since 1960, when the first modern Islamic bank was launched in Egypt. That experiment came to an end in 1967, mainly for political reasons, but it had an important impact on the further development of Islamic finance. In 1971, an interest-free financial institution was again launched in Egypt, primarily to develop a social security system.[1] In 1998, Islamic banking operations are established in about 100 countries with an estimated U.S.$160 billion in assets.[2] With this industry growing 10 percent to 15 percent per year, 1998 assets would be estimated at about U.S.$181 billion. Although some observers caution that the Islamic financial industry cannot sustain such spectacular growth, the entrance of major international players in the field indicates the opposite.

The essence of Islamic banking—the trade in physical, productive assets and the sharing of risks in the development of projects—is its great strength and a benefit to the average investor who need not worry that illusory profits will be wiped out by currency fluctuations or the decline in value of option or futures contract. Islamic instruments, based on the concept of securitizing productive, legitimate assets, offer a unique avenue for investment. Yet for the same reasons, Islamic banking may be hampered in its growth, since options, futures and forward contracts, popular in the global financial marketplace, all are prohibited by Islamic strictures.

WHAT IS ISLAMIC BANKING?

Islam, according to believers, is a social system imparted by Allah (God) to mankind. Allah is the creator and ultimate owner of the universe, and thus man and his institutions (financial or otherwise) have a vice-regent

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role to play in the world. Religious laws in Islam govern all aspects of life. Unlike Western finance which is governed by "man-made" laws, Islamic banking and finance are governed by the divine law, the *shari'a,* as revealed in the Qu'ran (the Muslim sacred text) and the Sunnah, i.e., the actions of the Prophet Mohammed. The *shari'a* (literally "the way") is an interpretation of the written text of the Qu'ran and the Hadith (written reports about Mohammed's actions and sayings) and is interpreted by scholars called the *ulama*. The *shari'a* scholars study, research, interpret and derive specific rules from the written texts of the Qu'ran and Sunnah. These rules govern all aspects of human life, including prayer, family life, community relationships, ownership, inheritance, buying and selling, political life, state behavior, international relations, commerce and economics. Practitioners of Islamic finance pursue business, trade and financial transactions in accordance with the shari'a.

Institutions offering Islamic finance must comply with *shari'a* rulings, called *fatwas*. Banks and other financial institutions usually have a *shari'a* board (or *shari'a* advisory committee) that reviews transactions, instruments and financial structures and provides oversight to ensure compliance with Islamic laws. The practitioners of Islamic finance must follow four basics rules to develop, innovate and offer Islamic financial products: 1) avoid interest or unlawful gain, called "*riba*;" 2) avoid excessive risk taking, called "*gharar*;" 3) recognize that money is not a commodity; 4) recognize that money has no time value, that is to say, money doesn't change in value as time passes.

Some scholars argue that there is a time value for money in Islam since, like conventional banks, Islamic banks charge a higher profit for long-term, versus short-term financing. Islam allows seeking a higher return for a higher risk. For example, assume Sami has two identical cars for sale. Rachid agrees to buy one car (an asset) from Sami for U.S.$500 (U.S.$400 original cost plus U.S.$100 profit) and pay Sami the total amount immediately. Sami also agrees to sell the second *identical* car to Amir for say U.S.$550 (U.S.$400 original cost plus U.S.$150 profit) where Amir agrees to pay him the full amount in two equal installments in one year. First, Sami can sell the two identical cars to Rachid and Amir for any price he chooses. Second, Sami could charge a higher profit from Amir, as he will receive the payment for the entire amount over a period over one year. Sami can do this since, compared to Rachid, he is taking a higher risk on Amir for the repayment over one year. One may argue that the higher amount is charged because the payments will be made over a period of time. The subtle difference is that the higher profit charge is not linked to the time period but because he is taking a higher risk over that period of time.

CHART 1

CONVENTIONAL FINANCE	ISLAMIC FINANCE
•For example, Anne wants to buy a car for U.S.$10,000. She will go to the bank and request a loan for U.S.$10,000.The bank may agree to give a ten month loan provided Anne pays say U.S.$50 per month (for simplicity assume a fixed charge) in addiion to the principal amount of say U.S.$1,000 each month. In summary, the bank is charging U.S.$50 each month for providing the U.S.$10,000.	•Considering the same example, suppose Anne seeks funding through an Islamic mode of finance, a *murabaha* instrument. In this case, the bank initially will make Anne its agent. She will buy the car on behalf of the bank for U.S.$10,000. The bank then sells this car to Anne for a total price of U.S.$10,500. Although the end result in both cases is the same, i.e. U.S.$10,500, the approach is totally different.
•The above is a lending transaction.	•The above is a sale transaction.
•In the case of conventional financing, what the bank is doing is charging money for making the loan.This is interest.	•In the case of Islamic financing, the transaction is a trade, whereby the bank initially buys the asset and then sells the asset to the client for a profit.
•Under "no-default" circumstances, the cashflow would be identical to that of an Islamic financial transaction.	•Under "no-default" circumstances, the cashflow would be identical to that of a conventional financial transaction.
•The systems also diverge in the case of default. In conventional finance, the interest will continue to compound until all principal and interest is paid.	•In case of default in the Islamic system, the amount of U.S.$10,500 does not change. Why? Because under Islamic financing, the transaction was actually a sale where the selling price of the asset is fixed at the time of the agreement. Thus, if the customer defaults, she only is liable to pay U.S.$10,500.

Islamic Versus Conventional Finance

Some may argue that "profit" in Islamic finance is just another name for interest. In reality, Islamic finance uses a completely different approach than does conventional finance. The following comparison may assist the reader in developing an understanding of the differences between the two systems.

Western Bank Participation in Islamic Banking

In 1996 Citicorp[3] set up CitiIslamic Investment Bank in Bahrain. Today, financial institutions like ABNAmro, American Express, ANZ Grindlays Bank, Chase Manhattan, Deutsche Bank, Nomura Securities and Union Bank of Switzerland all have in-house Islamic units. Hong Kong Shanghai Banking Corporation also is preparing to enter the market. The Islamic banks themselves are continuing to aggressively develop the market. These banks include institutions like the Dar Al-Mal Al-Islami Trust,[4] Islamic De-

Table 1

INVESTMENT REQUIREMENTS FOR INFRASTRUCTURE IN ASIA IN U.S. BILLIONS FOR THE DECADE 1995-2004

Country	Power	Telecom	Transport	Sanitation	Total
China	200	141	302	101	744
Indonesia	54	25	62	20	161
Korea	101	32	132	4	269
Malaysia	17	6	22	4	50
Philippines	19	7	18	4	48
Thailand	49	29	57	10	145
Other	25	18	14	4	61
Asia	465	258	607	145	1,476

Notes: U.S.$ billion in 1994 prices. Original table excludes data for Hong Kong, Singapore and Taiwan.
Source: The World Bank

velopment Bank, Al-Rajhi Banking & Investment Corporation, Al-Baraka Group and Kuwait Finance House.

Even Western regulators are sanctioning Islamic instruments. Last year, Citibank asked the Federal Reserve Bank of New York to approve an unusual trade finance deal that charged no interest and was governed by Islamic principles. The New York Fed promptly gave its approval, a testament to the growing role of Islamic banking in mainstream global finance.[5]

Use of Islamic Financing Instruments

High levels of government spending continue to create favorable financing opportunities for both Islamic and conventional banks. For example, despite the current financial and economic turmoil in Asia, the World Bank estimates that the major countries in the region still require infrastructure expenditures amounting to U.S.$1.48 trillion for the period 1995 to 2004 (Table 1).[6] The funds are primarily required for telecommunication, power and infrastructure development.

Although long-term financing is achieved mostly through conventional instruments, both governments and the private sector are aware of the existing advantages of Islamic finance. They are turning to Islamic finance, not because it is cheaper, but because of the growing number of Islamic investors. The Islamic equity and debt (bond) market in Malaysia is a clear example of this trend. Between 1992 and 1998, Islamic debt instruments in Malaysia have grown in volume from RM25 million (U.S.$6.75 million) to RM8.8 billion (U.S.$2.38 billion).[7] Islamic bonds account for almost 56 percent of total debt instruments in the Malaysian debt capital market. The country is targeting 5 percent of its banking system to provide Islamic banking products by the year 2000. The following is a detailed example of one company's use of Islamic financing.

The KFCH Islamic Bonds

In August 1996, Kentucky Fried Chicken Holdings Malaysia Berhad (KFCH),[8] became the first nonfinancial Malaysian company to undertake the issuance of an Islamic Bond. KFCH, a publicly listed company, issued RM150 million (U.S.$60.2 million)[9] in Islamic debt securities (IDS) with 37.35 million warrants to the primary subscriber, Arab Malaysian Merchant Bank Berhad (AMMBB).

The two-tiered securities issued were based on securitization of the *ba'i bithaman ajil*[10] structure, or deferred payment financing, extended to KFCH in the form of IDS under the acronym "BaIDS," together with warrants. Although not accepted by conservative *shari'a* boards,[11] these instruments were approved by the Malaysia central bank's *shari'a* advisory board and are traded in the market under the concept of *ba'i al dayn.*[12] The structure is as follows:

>•AMMBB purchased the RM126.68 million (U.S.$50.84 million) in assets that KFCH required and simultaneously sold the assets to KFCH through a *ba'i bithaman ajil* arrangement at a price that included a 5 percent profit margin.
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>•The total amount, i.e., the selling price, was then securitized through KFCH's issuance of BaIDS in the form of primary and secondary notes (two tiered securities). The value of the primary notes represents RM126.7 million plus a portion of the profit margin, while the face value of the secondary notes represents the balance of the profit. The BaIDS were issued along with warrants. The securities are redeemable and issued on an unsecured basis, while the warrants can be detached and traded independently of BaIDS.
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>•Under the BaIDS structure, the secondary notes have a very low coupon, while the final amount, represented by the primary note of the BaIDS, is similar to deep discount zero coupon bonds. This structure has the advantage of ensuring an attractive yield to investors.
>
>•The warrants were offered for sale to KFCH shareholders on a renounceable basis at a price to be determined in the future at the rate of one warrant for every five ordinary shares held after a certain date. Exercise price of the warrants will be determined prior to the price fixing date, based on the premium above the five weighted average market prices of KFCH shares. The premium would not exceed 5 percent of the weighted average market price of KFCH shares traded during the said period.

In a conventional bond structure, the coupons attached to the bonds represent the interest portion. The value of the coupons determines the yield and secondary trading of the bonds. The flexibility pertinent to financing under *ba'i bithaman ajil* is in the repayment structure. Repayments can be in the form of a lump sum bullet payment or in either prorated or graduated amounts. In the case of KFCH, the schedule of repayment was on the basis of a graduated scale. Under this structure, AMMBB could detach the warrants from the BaIDS and place them (through an approved brokerage house) with approved institutions, individual investors, insurance companies, statutory bodies or pension funds. The brokerage house would negotiate the price with the investor.

Malaysia also is the first Islamic country to launch Islamic benchmark bonds. These instruments are a series of zero coupon bonds, issued by the monetary authority with differing maturities of three five, seven and 10 years. The initial tranche of RM 794.4 million (U.S.$214.7 million)[13]—with a face value of RM1 billion, a maturity of three years and an average internal rate of return of 7.8 percent—was issued in September 1997 by Khazanah Nasional Berhad (the investment arm of the Malaysian government). This benchmark bond was oversubscribed 1.262 times.[14] The second tranche of RM 748 million (U.S.$202.2 million)—with a face value of RM1 billion, maturity of three years and an average IRR of 9.87 percent—was launched in March 1998. The instruments are based on the asset-backed *murabaha* (cost plus markup) concept.[15]

Islamic Benchmark Bonds

The structuring of the bonds is as follows. Initially, Khazanah acts as an agent of the private debt securities (PDS) investor. As agent, Khazanah buys a pool of assets and investments and then sells these investments to the investor at an agreed up-front lump-sum cash payment comprising both cost and profit elements. Khazanah then legally promises to purchase this pool of investments at an agreed time in the future (e.g., three years) at a fixed purchase price. At this time the investor appoints Khazanah as its trustee and manager to oversee the pool of investments. During the tenure, any income arising from the investment accrues as management fees to Khazanah, as trustee.

As documentary evidence of the arrangement, Khazanah (i.e., the trustee and manager) issues the Islamic benchmark bond to the investor. The investor may hold the instrument until maturity or choose to sell the benchmark bonds in the secondary market. To avoid reinvestment risk from the investor's perspective and interference with the benchmark yield curve, Khazanah does not have the right for an early redemption of the benchmark bonds. If the investor wants to exit early from the benchmark bond, he can do so by disposing of the bonds.

TABLE 2

ISLAMIC WORLD SAVING AND INVESTMENT

	Country Investment as share of GDP	Government Spending as share of GDP	Bank Savings as share of GDP	Income per capita (PPP[17]) in U.S.$
Algeria	33	17	49	5,330
Bahrain	28	21	60	12,070
Bangladesh	14	14	6	1,350
Egypt	18	14	32	3,610
Indonesia	29	10	52	3,690
Iran	23	12	35	4,650
Jordan	26	24	76	4,290
Kuwait	11	38	57	24,500
Malaysia	39	13	84	8,610
Morocco	21	16	14	3,440
Pakistan	20	13	16	2,210
Saudi Arabia	24	31	17	7,240
Tunisia	24	16	12	4,960
Turkey	22	16	6	4,610

Source: World Bank 1996

NATURE OF PROJECT FINANCE

Islamic finance also continues to grow in the area of project finance. According to some studies, it is projected that by the year 2010, Arab countries will require approximately U.S.$650 billion in project finance and leasing.[16] Table 2 below shows investment and government spending as a percentage of total gross domestic product (GDP) for several Islamic countries in the Middle East and Asia.

Project finance is essentially non-resource based and is used to develop large infrastructure projects. In project finance, lenders assume risk primarily by relying for repayment on the successful completion of projects and the subsequent expected cash flows. Interestingly, there are striking similarities between project finance and certain kinds of Islamic financing structures.[18] The nature and concept of project finance is the sharing of risk by lenders and borrowers alike; this is also the fundamental principle of Islamic finance. Under Islamic finance, the financier (lender, partner or investor) cannot receive a monetary benefit (i.e., interest in conventional arrangements) if there is no sharing of risk on his/her part.

One of the main selling points of Islamic finance (at least in theory) is that in determining risk, it is concerned primarily with the viability of the project and the profitability of operations, not the size of collateral, as is the case in conventional financing.

Like conventional project financiers, Islamic banks focus on what are considered to be the "essential ingredients for successful project finance."[19] These include: reputable sponsors, appropriate joint venture partners, adequate equity contributions (indicating commitment of the sponsors), professional feasibility studies, planning, tested technology, a market for the product or service, experienced contractors or operators and, finally, lender confidence that all pertinent financial and production information from project managers will be accurate and available on a timely basis. In project finance, majority funding is mostly required for instruments of long duration.

CURRENT FORMS OF ISLAMIC FINANCING

MURABAHA (COST PLUS FINANCING) Although used as a mode of finance, a *murabaha* is actually a sale contract. In the case of financial institutions, this contract between the bank and the client usually serves as a short-term funding facility. In a *murabaha*, the bank first buys the asset, then sells it to the client at a price which includes the bank's profit. The selling price is fixed at the time the facility is funded. The client repays the amount in installments over an agreed period of time. The key difference between conventional lending and *murabaha* is that if the client defaults, the selling price of the contract cannot be changed, i.e., the client is only liable to pay the agreed sale price of the asset (whereas in conventional finance if the client defaults he remains responsible for interest payments due on the principal and interest until the loan is paid off). Although this type of funding mostly is used for tenures of short duration, i.e., one or two years, some banks have provided the *murabaha* facility for up to five years. In May 1998, the Islamic Development Bank, provided U.S.$20.25 million in short-term *murabaha* financing for the Hamm power plant in Algeria. Funds will be used for the expansion, upgrading and installation of new gas turbine generators.

IJARA (LEASE FINANCING) Lease financing, called "*ijara*," "*kira*" or "*iktara*," is often used by financial institutions to provide funding for plant and machinery purchases. Under this contract, the bank agrees to purchase the equipment and lease it to the client for a rental fee. The duration of the lease and the rent for the entire term is fixed at the time of agreement signing. The bank as lessor has ownership of the assets.

Banks are primarily involved in providing the *ijara wa iqtina* (lease/hire purchase) facility which allows the lessee to purchase the asset at the end of the lease period. The price of the equipment in this case is included in the rent and is paid to the lessor (bank) over an agreed period of time. The primary difference between *ijara* and a conventional lease is that with the former: 1) a lease/hire begins the day the asset is delivered to the client (not the date the contract is signed as with the latter), 2) the lessee is not liable for the full rent if the asset is destroyed (the bank takes out insurance on the asset and factors in the cost of insurance at the time the rent is fixed), and 3) the purchase at the end of the contract cannot be made binding.[20] Presently Islamic banks are providing the *ijara* facility for tenures of three, five and seven years. In 1997, Faysal Islamic Bank of Bahrain provided a five year, U.S.$50 million *ijara* facility to the Oil & Gas Development Corporation of Pakistan (OGDC).[21] The facility was used to purchase oil pipeline equipment for a gas field development project. Chase Manhattan Bank provided a letter of credit for this facility.

ISTISNA (COMMISSIONED MANUFACTURING) The *istisna* contract is primarily used for assets which are constructed or manufactured. Progress payments are made to the developer/contractor as the job is completed. Under *istisna*, the price may be paid in advance (*ba'i al-salam*) or on a deferred basis (*ba'i bithaman ajil*).

BA'I BITHAMAN AJIL (DEFERRED PAYMENT) The *ba'i bithaman ajil* refers to the sale of goods on a deferred payment basis. Under this method the bank initially purchases the contract to buy the assets, equipment or goods as requested by the client and subsequently sells them to the client at an agreed-upon price. The bank's selling price includes its profit margin. The bank makes progressive payments to the supplier as the asset is purchased or manufactured. The client, on the other hand, can repay in lump sum or make installment payments over an agreed-upon period. *Ba'i bithaman ajil* is similar to a *murabaha* contract as it also is a credit sale. Recently, the Islamic Investment Company of the Gulf (IICG) provided a U.S.$35 million *istisna* facility with deferred payments *(ba'i bithaman ajil)*

TABLE 3 ISLAMIC PROJECT FINANCE 1996 TO 1998

FINANCIAL INSTITUTION	INSTRUMENT*	U.S.$ MILLIONS	CLIENT	PURPOSE
ISLAMIC DEVELOPMENT BANK	Ij, M	26	SULTANATE OF OMAN	RAYSUT PORT DEVELOPMENT
CITIBANK INT'L PLC	M	28	DOGUS GROUP	PURCHASE OF CONTRUCTION EQUIPMENT
ISLAMIC DEVELOPMENT BANK	Ij	30	ALEXANDRIA NATIONAL IRON & STEEL CO.	EXPANSION OF MANUFACTURING FACILITY
ISLAMIC DEVELOPMENT BANK	M	33	JORDAN PHOS-PHATE MINES CO.	ESHIDIYA PHOSPHATE MINES DEVELOPMENT
ISLAMIC INVESTMENT COMPANY OF THE GULF	Is	35	TURKISH GOVERNMENT	ISMIR RING ROAD AND AUDIN MOTORWAY PROJECT
ISLAMIC DEVELOPMENT BANK	M	44	ISLAMIC REPUBLIC OF IRAN	EQUIPMENT, LOCOMOTIVES AND PARTS FOR SUGAR PLANT
ARAB MALAYSIAN MERCHANT BANK BERHAD	Mu	48	SIERRAVIEW SDN BERHAD	LAND AQUISITION AND INFRASTRUCTURE FOR INDUSTRIAL CITY
AL RAJHI BANKING AND INVESTMENT CORP	M	49	SAUDI PUBLIC TRANSPORT	IMPORT OF BUSES FROM SWEDEN
SAUDI BRITISH BANK	Ms	72	UNITED INSTALLMENT CO.- ABDUL LATIF JAMEEL GROUP	SALE OF TOYOTA CARS TO INDIVIDUAL CLIENTS
ARAB MALAYSIAN MARCHANT BANK BERHAD	Is	79	LEBUHRAYA SHAPADU SDN SHD	NORTH KLANG STRAITS BYPASS PROJECT
KUWAIT FINANCE HOUSE & CITIBANK MALAYSIA (LABUAN) LTD.	M	100	MALAYSIA AIRLINE SYSTEM BHD	IMPORT OF JET FUEL AND SPARE PARTS
AL RAJHI BANKING AND INVESTMENT CORP.	Ij, Is	200	SAUDI CONSOLIDATED ELECTRICITY	QASSIM POWER PLANT EXPANSION
GULF INTERNATIONAL BANK	Ij	250	UNITED ARAB SHIPPING	PURCHASE OF CONTAINER SHIPS
KHAZANAH NASIONAL BERHAD**	Ib	417	INVESTORS IN MALAYSIAN ISLAMIC DEBT MARKET	ISLAMIC BENCHMARK BONDS, CREATING A YIELD CURVE FOR LOCAL DEBT MARKET
BANK ISLAM MALAYSIA BERHAD	Is	884	INTERNATIONAL AIRPORT BERHAD	CONSTRUCTION OF AIRPORT

NOTE: amounts indicated are equivalents in U.S. millions of dollars and have been rounded off.
* M = *murabaha*, Ij = *ijara*, Is = *istisna*, Mu = *mudaraba*, Ms = *musharika*, Ib = Islamic bond, O = other
** Investment banking arm of the Malaysian government; the funds indicated are cumulative for the two tranches.

to the Turkish government for the construction of Izmir Ring Road and the Audin Motorway Project. The facility was coordinated by ABN Amro Bank, Turkey.

MUDARABA (TRUST FINANCING) A growing number of Muslim investors (many of whom initially had little understanding of what Islamic finance involves or were skeptical,) are becoming involved in Islamic finance. For them, the structure of the *mudaraba* contract provides an opportunity to participate in large projects, sharing in both the risks and profits. A *mudaraba* is an agreement between two parties: an investor and an agent. Under the *mudaraba*, investors provide capital for the project and the agent invests the funds according to the investors' instructions. Profits from the investment are shared between the two at a predetermined ratio. Any accrued losses are borne by the investor. The investor provides the capital, trusting the agent for his/her expertise and experience in the particular field.

Islamic Development Bank, Saudi Arabia, has recently launched a U.S.$1.5 billion infrastructure fund that is based on the *mudaraba* concept. Also, WorldTel, a London-based private sector telecommunication project-development company, launched a U.S.$500 million fund for investment in the telecommunications sector in 51 Muslim countries.[22] The *mudaraba* funds are a vehicle for banks to raise funding for projects that are considered too large or risky for a single bank.

These Islamic funds also are being launched to cater to the growing demand of Muslim investors interested in investing in listed securities on the various stock exchanges. Between 1995 and 1998, 16 Islamic equity funds (based on the *mudaraba* concept) have been launched, compared to just four launched between 1986 and 1994.[23] Reputable traditional banks continue to offer Islamic investment products through their in-house Islamic banking units, while some institutions have joined hands with large Islamic institutions to offer multi-investment funds based on the *mudaraba* concept. For example, American Express Bank and Faisal Finance Switzerland launched a multi-investment Islamic fund for the Muslim investor.

Depending on the individual risk appetite, the fund allows investors to invest in trade finance deals (based on *murabaha* principals), the purchase and sale of acceptable commodities, emerging market securities and global equities. Besides the flexibility and choice of investment, these funds provide assurance to the Muslim investor that the portfolio components are in compliance with Islamic *shari'a* principals.

In May 1998, the Al-Tawfeek Company (an investment arm of Al-Baraka Banking Group) launched the "Al-Nukhba" Asian equity fund with Nomura Investment Banking, Middle East. The fund is targeting an issued capital of U.S.$50 million to U.S.$100 million. Prior to investment, the securities are vetted to ensure compliance with the policies established by the *shari'a* board of the Al-Baraka Investment and Development Company. The Al-Baraka *shari'a* board approves investment in companies whose interest-based debt is less than 33 percent and whose interest income does not exceed 10 percent. Investment is forbidden in companies that are engaged in activities such as gambling or the production of alcohol or pork. Despite the turmoil in Asia, Al-Nukhba will invest only in the listed equities of seven Asian countries, including Japan, Malaysia, Indonesia, the Philippines, Thailand, Hong Kong and Singapore.

In countries like Singapore, where Muslims comprise 14 percent of the population, the Overseas Chinese Banking Corporation (OCBC) has become the first bank to offer special accounts that conform to Islamic law. The new service offers interest free checking and savings accounts. The returns on the investment are based on a *mudaraba* concept and are apportioned between the bank and the investor at a predetermined ratio.

MUSHARIKA (PARTNERSHIP FINANCE) "*Musharika*" or "*sharika*," meaning partnership, is an Islamic mode of finance in which capital is provided by two or more parties for project development. Banks can participate in equity along with the project sponsors. The profits are shared among the parties on the basis of their participation or on a pre-agreed ratio and the losses are shared on the basis of equity participation. The difference between *musharika* and *mudaraba* is that in *musharika*, all involved parties provide capital to share in the profit or loss of the project. In *mudaraba*, one party provides the capital and the other acts as an agent to invest it. The agent in a *mudaraba* does not share in the losses.

Equity finance is considered the backbone of Islamic finance. Yet, in the last two decades, debt finance, i.e., short-term *murabaha*, has been the most popular mode of financing for Islamic banks. With the growing demand for long-term financing, some Islamic banks are beginning to get involved in providing *musharika* financing for projects. In 1997, the Saudi British Bank provided a U.S.$72 million *musharika* facility to the Abdul Lateef Jameel Group, Saudi Arabia, which provided financing to individual clients for the purchase of Toyota cars. The *musharika* is essentially unsecured funding and exposes banks to a higher risk than that faced through *murabaha* or *ijara*, where the funding is secured by the asset. However, the risk in the *musharika* can be mitigated by choosing an appropriate security structure.

Islamic Finance, A Growing Sector

Critics argue that Islamic banks use the same rates such as the London Interbank Offer Rate (LIBOR), to determine their profit that commercial banks use. However, Islamic banks do not have their own benchmarks to establish profitability and, as such, have to use the conventional benchmark rates. With the growing demand for Islamic finance, Islamic countries are beginning to develop instruments like Malaysian Islamic Benchmark bonds that will allow Islamic banks to have their own benchmark. For example, the Central Bank of Iran is in the process of approving government instruments that are securities backed by government assets. The profits from the performance of these assets will be shared with the investors on a pre-agreed ratio.

Because Islamic finance prohibits the sale of commodities before they are delivered to the buyer, conventional instruments such as options, futures and forward contracts are not available to Islamic institutions. It may be argued that the prohibition of such instruments may hamper the growth of Islamic finance. On the other hand, the presence of a physical, legitimate and productive asset in a financial transaction is a great strength of Islamic finance. It prevents the illusion of profitability, which may be wiped out by currency fluctuations or the decline in value of options or futures. Islamic instruments, based on the securitization of productive legitimate assets, offer a great avenue for investment and will perhaps be the greatest strength in the growth of Islamic finance.

In a nutshell, Islamic finance is based on the trade of productive assets, the sharing of risks in the development of projects, the promotion of entrepreneurship and the provision of social benefits to those who are often exploited by lenders. The continuing growth of Islamic finance as an alternate system to conventional finance breeds competition that will benefit borrowers. As well, this growing financial sector offers an additional avenue for raising funds from Muslim investors by allowing consumers and financiers to choose financial instruments that are compatible with their business needs, social values and religious beliefs. ■

Notes

[1] Volker Nienhaus, "Islamic Economics, Finance and Banking: Theory and Practice," *Journal of Islamic Banking and Finance* 3, no. 2 (1986): 36-54.
[2] "Sobering Reality of Global Growth," *New Horizons* 74 (April 1998): 2.
[3] This is the first conventional bank in the world to set up a separate Islamic investment bank.

[4] This is the largest Islamic trust in the world with 26 institutions including banks, investment banks and insurance companies.
[5] "Sobering Reality of Global Growth," *New Horizon* 74(April 1998): 2.
[6] The World Bank, "The Emerging Asian Bond Market" (June 1995).
[7] This figure is estimated by Malaysian Rating Corp. Bhd. (MARC). Estimates of Abrar Discount Bhd indicate 1998 figure of RM10.8 billion (U.S.$2.91 billion). April 1998 conversion rate of U.S.$1.00 = RM3.70 is used to indicate figures in equivalent U.S. dollars.
[8] Kentucky Fried Chicken is the largest fast food conglomerate in Southeast Asia.
[9] The equivalent amount in U.S. dollars is based on the parity of the Malaysian Ringgat (RM) to the U.S. dollar at the time of the bond issue.
[10] See the explanation of the *ba'i bithaman ajil* contract in the following pages.
[11] *Shari'a* boards in Arab countries are known to be conservative in comparison to the *shari'a* advisory in Malaysia which is known to be more liberal.
[12] One of the Islamic sale contracts is a called *ba'i al dayn*. *Dayn* refers to a generic commodity such as a bag of rice. The opposite of *dayn* is *ayn*, which means a specific object such as "my house."
[13] See conversion rate in footnote 9.
[14] "A Yield Curve for Local Debt Market," *Islamic Banker* (April 1998):9-11.
[15] See subsequent description of Islamic instruments.
[16] "Third Executive Development Program," *New Horizon* 76 (June 1998): 4.
[17] PPP stands for purchasing power parity.
[18] See *mudaraba* and *musharika* discussed in the following pages.
[19] Gohar Bilal, "Islamic Project Finance," Islamic Project Finance and Leasing Conference, London (March 1998).
[20] The purchase cannot be a mandatory condition as part of the *ijara* agreement (if it were, a sale contract would be preferable). What the banks can and usually do is to promise to give the goods to the lessee provided the terms of the lease have been met. Also, the banks can promise to sell the assets at the end of the lease for a nominal sum. The lessee cannot be penalized for not purchasing the equipment if there is negligence on the part of the lessor.
[21] OGDC is the largest oil and gas exploration company in Pakistan.
[22] The International Investment Group, Kuwait, (IIG) together with WorldTel, is promoting the fund, which was expected to close by Autumn 1998.
[23] "Islamic Incubation Fund," *New Horizon* (May 1998): 3.