Modern Islamic Finance: An Introductory Overview

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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
Introduction
Background – Foundation Elements
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
Camels and Petrochemicals
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)
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
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
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 (*sharikāt, mudāraba*)
- Manufacture or construction contracts (‘*istiṣnā*’)
- Agency (*wakālah*)
- Others
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.
The Dow Jones *Fatwā*: Permissible Impurity Cleansing and Purification
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
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?
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.
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.
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%
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
Current Markets
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
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
    - 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
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
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
Predominant 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
Understanding to Purchase
Lease (Ijāra)
Understanding to Sell
Managing Contractor Agreement
Occupational Tenant Leases
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).
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.
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.
Sukuk al-Mushāraka
(Diminising Mushāraka)
Funding

Holders

Sukuk

Proceeds

Mushāraka Agreement

Murābaha Agreement

Issuer

Project Company

Mushāraka

Hissas

I-1

I-2

I-n

PC-1

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Sukuk
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
Issuances Generally

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%)

# Issuances by Industry Sector

## Table 1

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

Issuances by Sharī'ah Structure and Year

Issuances by Tenor and Dollar Volume

Conclusion - Musings
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.
- 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”
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
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
THANK YOU
Attributions

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

Faiences Murales - du Tekyeh des Derwiches
(SVIIe.siecle),
New York Public Library
Attributions

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

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

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
Attributions

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

Bowl, Iran, 9th-10th century,
Los Angeles County Museum of Art
Attributions

Bowl, Iraq, ninth century,
Los Angeles County Museum of Art

Bowl, Iraq, ninth century
Los Angeles County Museum of Art
Tile, saz leaves, Ottoman Turkey or Syria, first half of the 16th century, private collection

Tile, Grater Iran, 15th century, Los Angeles County Museum of Art
Attributions

Tile, border panel, plum blossoms and hyacinths, Damascus, Syria, late 16th century, private collection