

Overview of Islamic Financial investments¹

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Introduction

It has been noticed that the global financial crisis that erupted in September 2008 had a lesser impact on the economies of Middle East countries and Islamic financial institutions and banks. Islamic finance has captured the attention of the academia, practitioners and industry players for the last few years. Islamic finance has emerged since the birth of Islam 1,400 years ago. Unlike conventional finance that is bound primarily by the market place, Islamic finance finds its legitimacy and guidance from *Sharia*. This article will outline the general framework for structuring and developing Islamic financial techniques. The author will highlight the advantages and disadvantages of the Islamic financial investments by comparing it to the conventional banking to see if lessons can be learned from such a comparison and come up with a solution, if any that can be beneficial to the users of both systems.

Islamic finance – What is it?

Islamic finance is based on profit and risk sharing partnership. The core principle underlying *Sharia* law is promotion of social responsibility and economic justice as mandated by the Divine Law. It prohibits *riba* (usury)

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and *gharar* (uncertainty or speculation). The characteristics of Islamic financial investment are the requirement for the existence of physical tangible assets as a basis for undertaking a business transaction. The investment should be made for the purpose of manufacturing and production of specific goods and services. Unlike conventional banking money is not a factor of production. Money cannot be used to make money. *Sharia*-compliant investment must exhibit elements of ownership and control in the management of the underlying investment. Therefore, Islamic finance principles do not recognise derivatives (options, currency swaps), forward contracts and short-selling (except for *Istisna* and *Salam*).

Sources of *Sharia* law

The primary sources of *Sharia* are:

- a) the Quran, the Holy Book for Muslims
- b) the Sunnah, the utterances, deeds, and tacit approvals of the Prophet Muhammad (pbuh) which are reported as *Hadith*,
- c) *ijtihad* which comes in the form of *ijma*, which is the consensus or unanimous agreement of all Islamic jurists of an age,
- d) *qiyas* is obtained through the legal and philosophical method of analogy, whereby a divine law revealed for a particular situation is applied to another where some common feature exists in both situations.

The interpretation and application of the *Sharia* law varies depending on the geographic region. This lack of international consensus is one of the key challenges facing the developing market. There are four different *Sunni* schools of thought in Islam, namely the *Hanafis*, *Malikis*, *Shafi'is*

and *Hanbalis*. There is a fifth school of thought the *Twelver Jafari* which is practiced mainly in the *shia* Iran. Although these schools do not disagree on basic concepts, principles and methodologies, they do, however, differ on certain specific rules, but none of their differing views can be declared wrong.

Prohibited investments

Sharia law prohibits investments in certain products which are known as *haram* activities. These are conventional banking, insurance, gambling (*ghimar*), alcohol, pork, adult entertainment and arms and weapon (not all school of thoughts prohibit investment in weaponry production). Therefore, as long as the activities of the trader do not fall within the above mentioned prohibited categories of investment they are considered as *halal*.

Types of investments

There are two main types of investments:

- a) profit/risk sharing partnership contracts such as musharaka and mudaraba, and
- b) predictable/fixed return structure such as murabaha, ijara, istisna, salam and sukuk.

Musharaka

Musharaka is similar to a partnership or a joint venture. The musharaka partners will share the profit according to the ratios agreed in the original contract but losses must be shared in proportion to their initial

investment. Both contracting parties provide the needed skill and capital for the transaction. Partner's liabilities are unlimited. In a financing context, the profit-sharing arrangement is usually structured so that the financier receives his initial investment plus a return based on a benchmark, such as LIBOR (London Inter Bank Offered Rate), plus a margin. The customer will typically be appointed as the manager of the musharaka, with responsibility for investing the musharaka funds and managing the musharaka assets. The customer may charge a fee for this but it will generally be nominal.

Mudaraba

Mudaraba which is a subset of musharaka is more suited to private equity investments. One party contributes capital fund and the counterparty provides skills and expertise. In effect the relationship is based on a trust. The investor pays 100% of capital and relies on the mudarib for profit share payments. Profit share is determined according to the ratio specified in the original contract. The losses are attributed to the investor as he is the sole provider of all capital to the project. However, in event of loss the manager does not receive compensation for his efforts. Partnership model require close working relationship between the investor and fund manager which is why the method is favoured by the Islamic scholars.

Murabaha

Murabaha is a technique often used to provide trade finance and also increasingly used to provide acquisition finance for leveraged buy-outs, such as the 2007 US\$ 1.2 billion buy-out of Aston Martin by a Kuwaiti-led consortium. The predictable return structures do not require

significant monitoring by bank to ensure that they receive profit share which is why it is more favoured by the banks. Murabaha transaction is “deferred payment sale” or an instalment credit sale and is mostly used for the purchase of goods for immediate delivery on deferred payment terms. An apparent feature of murabaha is that, the seller discloses the actual costs incurred and asks for a set amount of profits which can be demanded as a lump sum or as percentages of the costs. The bank is entitled to the profit as it takes title, even for a very short time, and assumes a risk. This profit is usually defined in reference to an interest rate index such as LIBOR.

Ijara

An ijara transaction is the Islamic equivalent of a lease and is defined as a bilateral contract allowing for the transfer of the usufruct, which basically means that one party (lessor) allows another (lessee) to use his assets against the payment of a rental fee. In a simple financing ijara, as in murabaha, the financier buys an asset from a supplier. However, rather than selling it to the customer, the financier then leases it to the customer. The customer makes regular rental payments to the financier while the asset is in use. The rent represents an agreed profit, typically calculated using a benchmark, such as LIBOR, plus a margin.

Salam

Salam (short term production finance) is a purchase contract in which the payment is made now against the future delivery of an asset. Salam is a technique similar to murabaha that can be used to provide working capital. The key difference to murabaha is that the financier pays in full

for the specified asset in advance, for supply on a pre-agreed future date. Usually, the financier will receive a discount for advance payment, typically calculated by reference to a benchmark, such as LIBOR, plus a margin. There are two exemptions that are normally applicable to salam contract; a) at the time of contracting the asset does not have to be in existence, and b) seller does not need to have ownership. It is most suitable for financing of agriculture or small construction and manufacturing projects.

Istisna

Like salam contract, istisna contract (long term production finance) is a purchase contract for future delivery of an asset and is exempt from the same two conditions concerning the asset; ownership and existence. The key practical difference to salam is that, instead of buying a finished asset at the outset, the financier pays an amount to fund the manufacture, development, assembly, packaging or construction of an asset to an agreed specification, and acquires that asset on completion, when it will typically sell the asset to the customer or lease it back to the developer under an ijara.

Sukuk

Sukuk are Islamic equivalent of a bond. Sukuk are normally linked to an underlying tangible asset. The ownership of an underlying asset is transferred to the holder of sukuk certificates together with all ownership and benefits and risk. This gives the sukuk characteristics of both equity and bond. This distinguishes them from both conventional bonds (which represent debt obligations of the issuer) and conventional equities (which

represent ownership interests in the issuer itself). The basic principle is that an ownership share in the underlying asset entitles the sakk holder to a proportionate share of the returns generated by the asset. The overall economic effect is similar to a conventional bond. Islamic bond is still in its infancy outside of Malaysia. Sukuk is not widely traded because there are shortages of instruments but the markets are expected to expand to \$15 Billion.

Governance structure of Islamic finance

Sharia supervisory board (SSB) are responsible to make sure that the investment product devised by the banks complies with the principles of *Sharia* law. There is also the Islamic Financial Services Board (IFSB) established in Malaysia to advice on the management of financial institutions. Accounting and Auditing Organisation of for Islamic Financial Institutions (AAOIF) based in Bahrain is responsible for development of accounting, auditing of the *Sharia* standards. The AAOIF standards are largely based on the international financial reporting standards (IFRS). International Islamic Financial Markets (IIFM) established in Bahrain with the support of banks of Bahrain, Brunei, Indonesia, Sudan and Islamic Development Bank (IDB) are involved in the establishment, development, self-regulation and promotion of an Islamic capital and money market. The Islamic Development Bank (IDB) established in 1975 and based in Jeddah organises with member countries to fund projects and works closely with the World Bank.

Advantages of Islamic financial investment

The underlying principle behind Islamic finance is the distribution of wealth by regulating (soft regulation) the free activities of the market for the collective benefit of the society. Islam believes in free trade and creation of wealth and true private ownership as the means of production.

The advantages of Islamic finance are summarised as;

- a) no speculative trading,
- b) reduced uncertainty,
- c) no excessive leverage,
- d) no excessive profiteering (reasonable mark-ups)
- e) ensuring equal bargaining power of the parties.

The establishment of an Islamic money market fund in the UK has attracted greater flow of capital from investors in the Middle East and other Muslim countries.

Disadvantages of Islamic financial investment

Investment in *Sharia*-compliant products does not mean that the investor is insulated from commercial risks. In fact there may be more risk associated with Islamic methods of financing as with conventional banking. The disadvantages of *sharia*-compliant instruments can be summarised as follow;

- a) there are limited enabling legislation,
- b) restrictions on foreign ownership of assets and enterprises,
- c) limited enabling infrastructure like Special Purpose Vehicle (SPV) and trust are being permitted and methods for setting these up or allowing them to cross borders.
- d) no global consensus on *Sharia*. There is no international consensus on *Sharia* interpretations, especially in relation to innovative products

- e) no standard *Sharia* model, drafting documents for the Islamic finance market are tailor-made for individual transactions, leading to much higher transaction costs than conventional finance alternatives.

Islamic financial products are devised by market players and financial institutions who are not qualified in the Islamic jurisprudence as opposed to Islamic scholars who are expert in *Sharia* principles. Even though banks employ Islamic scholars to oversee and approve transactions to make sure that they comply with the *Sharia* standards, the prudent investor must beware of the associated risks. There also limited methods for Islamic banks to minimise their risks as hedging is prohibited and they are subject to liquidity, credit, settlement, leverage, operational and business risk.

Enforcement of *Sharia* law in the English Courts

Investors should bear in mind the structure and devising of Islamic funds that are offered in the London Stock Exchange (LSE) are subject to Financial Services and Markets Act 2000 and supervision of the Financial Services Authority (FSA) which is the regulatory body. Islam recognises the concept of freedom of contract therefore the parties can choose *Sharia* principles as the governing law of the contract. They can also choose the jurisdiction of the courts of a designated country as the forum for resolving disputes between the contracting parties. However, the application of Islamic principles by the selected forum depends on the laws of the country in which the enforcement is sought. Generally, the UK courts apply the governing law which is the law of a contracting state under the Rome Convention. So in case the disputing parties choose

Islamic law as the governing law of the contract, as a general rule the English courts will not apply the *Sharia* as it is not a law of country. (*Beximco Pharmaceuticals Ltd v Shamil Bank of Bahrain, EC [2004] EWCA Civ 19*).

Conclusion

In summary *Sharia*-compliant investment are based on the equal sharing of risk and reward undertaken for the purpose of production and manufacturing which should be free from interest (usury), uncertainty, and the prohibited activities (*haram*). This means that investors have limited options for investments as compared with conventional banking transactions and the costs for undertaking such transactions are higher given the amount of time required to comply with the formalities. Furthermore, there are different interpretations of the *Sharia* standards depending on the applicable school of thought as adopted by the financial institution. As to the enforcement it is important to choose a law of a particular country such as the English law as the governing law of the contract to avoid uncertainty. In conclusion, the innovation of the bankers in devising such financial instruments has unleashed the vast amount of wealth which otherwise would be hidden under the pillow. The search for identifying new methods of formulations of Islamic instruments should continue as there are many challenges ahead, in particular in areas of legislative framework, investor protection, transparency, securitisation and enforcement.