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Islamic Debt as the Global Propeller

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Islamic debt is the real missing link in the Islamic finance industry, as at present the global regulatory legal framework has designed debt to be interest-based.

Differing regulatory and tax regimes, diverse legal frameworks and disparate banking rules all influence effective communication between Islamic financial centers and market players on how to manage the business. Complying with Shariah is the easy part of the industry; sorting out the intricacies of undertaking the Shariah compliant nature of Islamic debt is a more interesting challenge. As a result, Islamic debt transactions are not as cost-effective as they should be in many jurisdictions. Institutions in Malaysia and the Middle East have been trying to bridge this gap, and 2006 saw the largest number of Islamic debt transactions brought to the market thus far.

Some of the activity that has been seen in the market includes Malaysia's tax neutrality announcement in 2004, which has proven how critical the tax issue is to the development of the industry. After this announcement, the market share of Islamic debt securities shot up to more than 70% of Malaysia's total corporate bonds issuance. Singapore, a budding Islamic finance jurisdiction, also announced some tax neutrality when the country entered the industry. Many other jurisdictions have made similar proactive moves, including the UK, the US state of New York and Queensland in Australia. Tax neutrality allows Islamic banking products or debt securities to be treated in the same manner as their conventional counterparts. No extra tax or stamp duties will be imposed. Equity instrument contracts, whether conventional or Islamic, are similar. As a result, the development of Islamic equity is a lot simpler.

The success of the Islamic debt market will have a direct impact on the developmental success of the Islamic finance industry. Thus all Islamic finance players, including Islamic bankers, Shariah advisors or Shariah committee members, regulators and other key industry players must pay extra attention to issues other than Shariah, particularly tax, legal and regulatory frameworks, which will become a tipping point to the development of Islamic finance industry globally.

Background

A successful financial market requires all industry components to be present – debt market, equity market, banking industry, non-banking sectors (e.g. trusts, waqf, etc...), baitulmal and zakat. Some people argue that Islamic finance is all about equity instruments, not about debt instruments. Nevertheless, the same people will also agree that activities such as

Murabahah sale (where the price is paid in the future) and Ijarah (where the purchase undertaking is in the future) are also Shariah compliant financial instruments. The Islamic finance industry will never be relevant and significant to the national economic agenda of a particular jurisdiction until all components of the industry are developed.

This article attempts to address the complexities in dealing with the challenging status of Islamic debt to be developed as a key component of a nation's Islamic finance industry and the financial market as a whole, operating on a par with, and being as convenient as, the conventional debt market. In this article, for the purpose of clarity, Islamic debt is defined to include all banking products, as well as Islamic fixed-income securities products.

Islamic debt?

"Debt" has always been interpreted to be loans with riba (interest), which makes any discussion on Islamic debt sound very odd indeed. All finance students and bankers have been trained in debt transactions based on riba.

Conventional debt is a financial obligation arising from borrowed monies that a customer takes from a financier/investor, while Islamic debt is a financial obligation arising from a plethora of trade relationships entered into between a financier/investor and a customer/issuer. Many Shariah principles can be used for this trade relationship, such as Murabahah (installment sale), Bai Bithaman Ajil (deferred payment sale), Ijarah (lease/hire), Mudarabah (partnership), Musharakah (joint venture), Inah (buy and sell transactions), Salam (forward sale), Istisnah (sale by order), etc... A loan can also take place under the Shariah principle of Qard – the only loan permissible under Shariah because it is interest free.

Why is the Islamic debt market important?

To determine how important the Islamic debt market is to the well-being and growth of the Islamic financial market, we must look at the composition of a successful and sound financial market. The debt securities market in developed countries such as the US or the UK is mature and is widely used as a means of fundraising. In the US, 72% of its fundraising is done via the debt capital market, which is worth about US\$23.84 trillion, as compared to bank loans of US\$9.34 trillion in 2005.

For emerging market countries, particularly Asia (excluding Japan) there was a 27% market share in 2005, which increased from 24% in 2004. On the other hand, in the

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Middle East, supposedly the home of Islamic banking, there was a mere 7% of total fundraising in the form of debt in 2005. Banking assets still dominate the Asian and Middle Eastern markets. In order to have a sound financial market, both these markets need to develop their debt capital market including their Islamic debt capital market.

Issuers will be more likely to tap the debt capital market to raise funding for projects and assets acquisition. Investors needs are becoming more sophisticated and they are demanding more debt securities products.

A debt transaction is not necessarily a loan transaction!

An Islamic debt transaction may be entered into to meet various requirements, arising from personal, business or societal needs. When someone plans to buy a home, a need to own a house is identified. A mature Islamic financial market should be able to facilitate this need effectively by providing an Islamic debt facility from an Islamic bank by way of a loan or by way of trade. Whether it is an equity participation or an interest-free loan or a trade, the Islamic bank's only purpose for undertaking the transaction is to facilitate the home buyer's needs. A debt transaction is not tantamount to an interest-bearing loan.

Islamic debt is critical to business and economy

Project finance, corporate finance and asset finance are all key business needs, and an Islamic banking practitioner must understand these key needs and understand how to optimally meet them. The optimum level objective plays a significant role in appreciating and understanding the applicability of Islamic debt transactions for a project or an investment. Below is an illustration:

Here, project finance is being contemplated. What would be the optimum financing model as far as debt to equity

requires? First of all, the key consideration is meeting and matching the needs and objectives of equity investors and the needs and objectives of debt investors. Generally, equity investors are driven by return on equity (ROE). Certainty of ROE will be subject to performance of the project at residual level as it ranks junior to debt investors. At the same level of project Internal Rate of Return (IRR), ROE will be able to earn different return levels depending on composition of debt. At the same level of project IRR, the higher the debt level, the higher ROE is expected and vice versa. Any upside return on the project will go straight to equity investors. Thus, equity investors would be looking forward to have the lowest equity contribution to a project and have the highest portion possible on debt financing part.

Three cases below demonstrate the above scenarios:

Case A

Project Cost	100
Debt	90
Equity	10
Profit before Debt cost	15
Debt cost (i.e. ijarah rate - 10%)	9
Net Profit after Debt Cost	15-9 = 6

Based on the above, ROE to equity investors is 60% (based on 6/10)

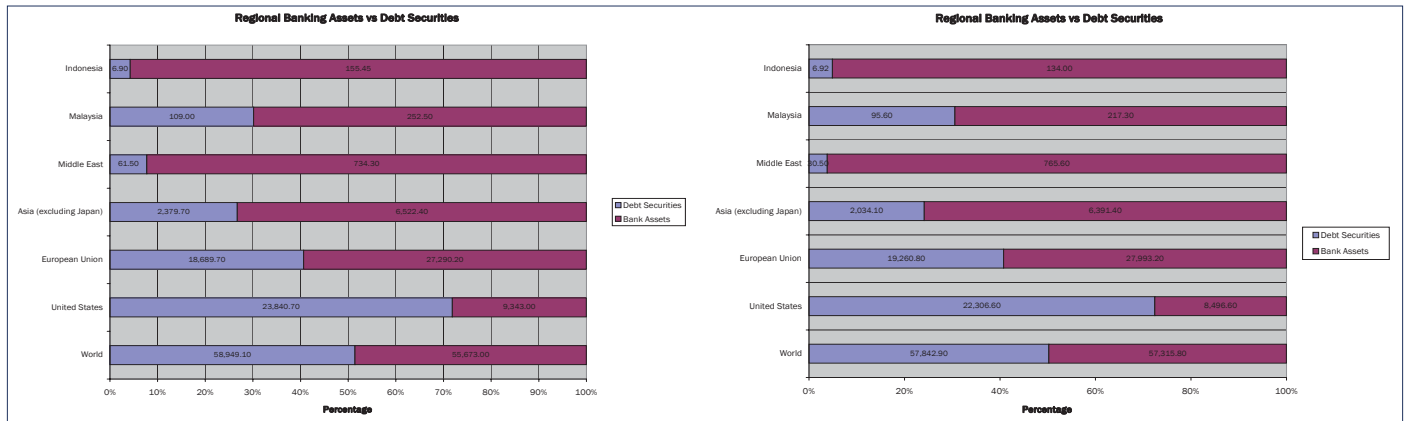
Case B

Project Cost	100
Debt	50
Equity	50
Profit before Debt cost	15
Debt cost (i.e. ijarah rate - 10%)	5
Net Profit after Debt Cost	15-5 = 10

Based on the above, ROE to equity investors is 20% (based on 10/50)

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Diagram 1: Regional debt securities vs bank assets



Source: International Monetary Fund, Bank Negara Malaysia, Bank Indonesia, & Bursa Efek Surabaya

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Case B

Project Cost	100
Debt	50
Equity	50
Profit before Debt cost	15
Debt cost (i.e. ijarah rate - 2%)	5
Net Profit after Debt Cost	15-1 = 14

Based on the above, ROE to equity investors is 28% (based on 14/50)

Based on the above 3 cases, Case A will be the most attractive return to equity investors. Despite the fact that Case C has a lower Debt Cost i.e. 2% compared to 10% in A and B, C does not give the best ROE because of the low debt composition. Structuring a capital structure for a project will be based on the market condition of the debt market at one particular time. Assuming the above is the market condition the project promoter is facing, option A will be selected easily.

From the above scenario, if an effective Islamic debt market is absent many Islamic equity investors will not achieve an optimum ROE. The only way for them to achieve an optimum ROE is to opt for the project to be financed via Riba based financing, which will cause these Islamic investors to do something haram. If an Islamic debt market is effectively developed, business activities can be facilitated optimally.

Shariah flexibility

Shariah contract choices are available for any type of debt transactions and reaffirm that Shariah is the easiest thing to deal with in the industry. Islamic banking practitioners across the globe deal with many different banking products but utilize only one Shariah principle, such as Ijarah. Ijarah can be used for hire purchase, for term financing and for leasing products. These three banking products, although using a similar Shariah principle, are treated differently in accounting treatments and risk-weighted capital ratios. A term financing can also be undertaken in the form of Murabahah, Bai Bithaman Ajil, Salam, Inah, Mudarabah and Musharakah. The accounting treatment and risk-weighted capital ratio in this case would still be the same as term financing using Ijarah, as the product is a term financing.

Term financing could be also structured as a floating rate financing. The same Ijarah term financing can also be done as fixed rate financing. Typically, a term financing under the principle of Murabahah, Bai Bithaman Ajil, Inah or Salam would be done as a fixed rate debt transaction but with some Shariah compliant techniques. These principles could also accommodate floating rate financing features, even though this would be slightly more tedious operationally. A Musharakah and Mudarabah can also be used for debt

transactions as long as the identified underlying productive activity provides either a variable or fixed cash flow.

As can be seen from the above, Shariah is very flexible in addressing financial needs as long as riba is avoided. If we cannot apply Mudarabah, we could apply Murabahah or Bai Bithaman Ajil. If we cannot apply Musharakah because of the underlying nature of the financing requirement, we can always apply other Shariah compliant contracts such as Ijarah. For example, the acquisition of leaseable assets could be best structured in the form of Ijarah, but if a lease cannot be done due to the legal framework in the jurisdiction in question, then a Murabahah or Inah principle can be used.

Inah, Tawarruq and Commodity Murabahah

When we discuss Islamic debt transactions, we cannot avoid dealing with the hullabaloo of Inah transactions in several of the major Islamic financial markets including Malaysia. The alternatives to Inah are the Tawarruq and Commodity Murabahah which was developed and popularized in the GCC amongst the Islamic financial institutions there.

Though Commodity Murabahah has received wide Shariah endorsement in the GCC and in the western financial market, Tawarruq has not been fully accepted by some GCC Shariah advisors or Shariah committees as they would argue that Tawarruq is a sister of Inah. Commodity Murabahah as it is practiced in the GCC and western financial markets has not been approved in Malaysia, Indonesia and several other markets. Tawarruq is fully accepted in markets that accept Inah. If one accepts Inah, then one would definitely accept Tawarruq and vice versa.

The pertinent question is does everyone in the Islamic financial markets share similar meanings, understanding and usage of these three terminologies? To illustrate, below are the relevant meanings and usages:

Inah or Einah: Refers to a sale and a buy-back arrangement from the same party. Purchase Agreement Price is paid spot and Sale Agreement Price will be paid in the future by way of installments or one lump sum.

Example:

Ali wants to transfer his home financing from Bank A to Islamic Bank B. Since he owns the home, he will sell to Islamic Bank B at a price equivalent to redemption amount of Bank A. Islamic Bank B will subsequently sell the home to Ali at a price (including Islamic Bank B profit) to be paid by equal installments over the next 20 years.

Some Islamic home financings in Malaysia have been implemented under the Inah concept but most would carry Bai'

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Bithaman Ajil label. But not all Bai' Bithaman Ajil is necessarily Inah. During the 1990s, Bank Islam Malaysia offered Islamic home financings that included developers in the whole legal documentation process. After a sale & purchase agreement had been executed by an Islamic home financing client, the Bank would enter into a novation agreement with the developer. Then, the Bai' Bithaman Ajil agreement would be entered between the bank and the client. Other than home financings, South-East Asian Islamic financial institutions also practice Inah for other Islamic financing segments including business banking and corporate banking clients.

Tawarrukh: Always refers to "Tawarrukh Al-Munazzam", which means Tawarrukh with pre-arrangement. Legal documentation reflects the full flow of funds including the ultimate utilization. As such the control to ensure that the fund raised is utilized for Shariah-compliant purposes can be identified upfront.

Example:

Islamic Bank C plans to provide term financing-i to a corporate client. Islamic Bank C will take an undertaking or the pre-arrangement with the corporate client and purchase a commodity from a commodity vendor. The commodity will be subsequently sold to the corporate client with the price to be paid in the future through installments or one future lump sum. Immediately, the corporate client will sell the commodity back to the same vendor or another vendor at spot/cash price. But the whole arrangement is made upfront. By the closing of the transaction, the corporate client receives cash for business expansion or to fund operating expenses.

However, some GCC Islamic banks or Shariah advisors do not accept this type of contract or legal documentation that reflects the full monetization process of the commodity.

Commodity Murabahah: This concept is always referred to as "Tawarrukh bi ghaira Munazzam" which means Tawarrukh without pre-arrangement. This concept is used for Islamic treasury placements and Islamic deposit products with Islamic banks or conventional banks. It is better known as Commodity Murabahah not Tawarruq to differentiate from "Tawarrukh Al-Munazzam".

Example:

Islamic Bank D wants to place short term money i.e. US\$1 billion for a right return. Islamic Bank D enters into Commodity Murabahah arrangement with either an Islamic Bank E or XYZ Conventional Bank. Say Islamic Bank D decides to place with Islamic Bank E. Typically Islamic Bank E would need to match the liability it obtained from Islamic Bank D with the right Islamic assets. Islamic Bank E has 2 options whether to use the liability to finance its own Islamic assets or to make an interbank placement or investment in the form of Commodity Murabahah in XYZ Conventional Bank or any other Islamic

Bank or conventional bank. Assuming that Islamic Bank E decides to place the same funds it received from Islamic Bank D on a back to back arrangement with XYZ Conventional Bank because the Islamic assets for Islamic Bank E is limited and they are pressured to provide the right return to Islamic Bank D. XYZ Conventional Bank, in its ordinary course of business, invests in interest-bearing loans or Riba instruments. Since the identification of purpose is not required under Commodity Murabahah documentation in some parts of the world, this type of transactions flourishes there.

It has always been argued that since the commodity Murabahah documentation only reflects at the commodity trading level without identifying issues as to what the funds will invest in or how it will be reflected in the conventional banks' balance sheet, certain Shariah boards outside of Malaysia have approved. Below is the illustration.

Balance Sheet of XYZ Conventional Bank

Assets	Liabilities
Riba Instruments US\$1 billion	Commodity Murabahah Deposits US\$1 billion

At the documentation level, the above relationship might not be identified. However, at balance sheet level, the issue of financing riba instruments by Islamic deposits can easily be established.

Under Malaysia's Islamic Banking Act 1983 and under the excellent and able supervisions of the Central Bank and the Securities Commission, the above arrangement whereby the funds goes to XYZ Conventional Bank and be utilized in riba based transactions has never been allowed and will never be allowed. The Act states clearly that all Islamic banking and finance transactions must not contradict Shariah and it clearly states riba is prohibited directly or indirectly. It must be noted that Inah, Tawarruq and Commodity Murabahah can be done and are being done in Malaysia subject to the Act.

At the end, we may conclude that Tawarruq and Inah is in the same family. The Tawarruq can involve 3, 4 or even 100 contracting parties and it will still continue to be akin to Inah. Unfortunately, both do not seem to be practiced widely in the Middle East particularly the GCC as the market has used Commodity Murabahah for the last 40 years to facilitate practically all their Islamic banking and finance activities. The main beneficiaries of this product are the conventional financial institutions as it facilitates riba based financial transactions using Islamic funds. One of the main reasons why the GCC markets still see a lackluster secondary market for its nascent Islamic debt market is attributed to the existence of Commodity Murabahah in that market as it is currently practiced.

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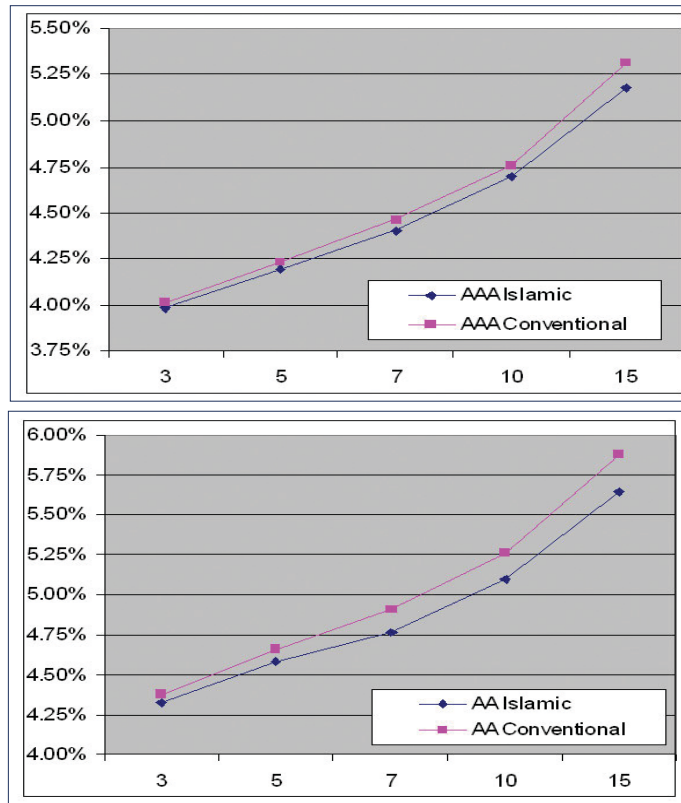
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The compelling need for Islamic debt

The faster the Islamic debt segment develops, the faster the whole Islamic finance industry will grow – in terms of domestic markets and at a global level.

One only has to look at the development of Islamic debt securities in Malaysia to obtain an insight into how compelling the need for this market is. Traditional Islamic banking products might not be able to reflect the commercial benefits directly to investors and fundraisers or issuers alike. However, Islamic debt securities (or to use the more popular label, Islamic private debt securities) have provided portfolio investors as well as fundraisers with better deals. As a result, both sides would make Islamic debt securities issuance the most cost-effective and the most profitable proposition. This dimension is reflected in the following chart of historical record.

Diagram 2: Yield to issuers



The Malaysian market has been able to achieve the above impact due to its properly regulated Shariah management. We have not seen comparable development in the US dollar market or in the GCC markets as yet. In Malaysia, which is driven by the Islamic Banking Act 1983, Islamic banks or windows will not place funds with conventional banks either in the form of Mudarabah or in the name of commodity Murabahah. As such, Islamic funds are fully circulated in the Islamic financial system and thus create a real demand for Islamic fixed income securities, especially in the secondary

market. This rule has allowed issuers and investors to benefit, while by default developing the Islamic debt securities market and ultimately the whole Islamic finance industry.

Diagram 3: Illustrates the return of Islamic papers vs. conventional papers

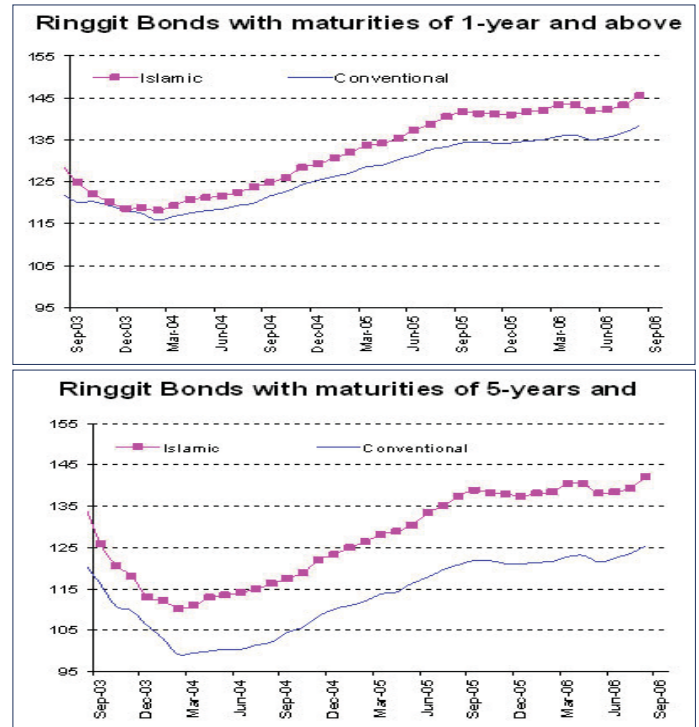
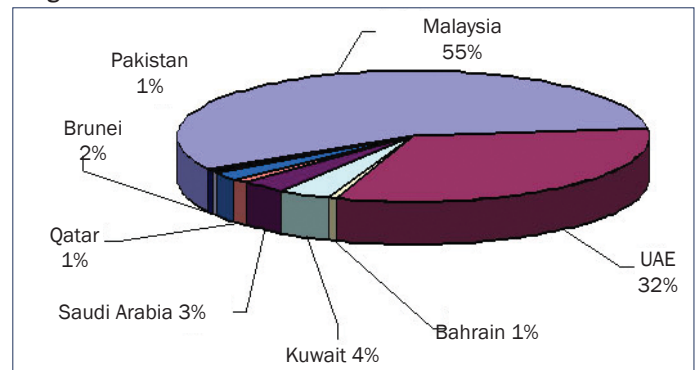


Diagram 4: Global Sukuk issued



Conclusion

Islamic debt instruments, whether in the form of banking products or securities products, must be looked at as the ultimate propeller to develop the Islamic finance industry globally. Recognizing and addressing the challenges faced by Islamic debt implementation will create a new platform for growth.



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