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## **ISLAMIC FINANCE AND STRUCTURED COMMODITY FINANCE TECHNIQUES: WHERE THE TWAIN CAN MEET**

Study prepared by the UNCTAD secretariat

### **Executive summary**

Islamic finance has been growing in importance in recent decades. One of its major characteristics is that no interest rates can be charged — rather, the financier charges a mark-up, or shares in the borrower's profits. Several standard products have been developed to meet the financing needs of trade and projects. Some are based directly on structures described in the Quran, others are feats of financial engineering, combining various “permitted” financial instruments to arrive at a product that combines acceptable returns with acceptable risks.

Much of the first growth spurt of Islamic finance, in the 1970s, was based on the needs of commodity trade — in particular, to meet the strongly increased financing needs of oil-importing Islamic countries. The industry has diversified since, but commodity trade and project finance has not lost its importance.

At the same time, Islamic banks have had difficulty expanding their lending business as fast as their deposit base, largely because of limits in their risk management capacity. In effect, in international trade and project finance, Islamic financiers have commonly relied on bank credit limits: for example, in order to get a credit line, an importer needs to provide a guarantee from a local bank. International banks accept such local bank guarantees only up to a certain level. In conventional finance, various structured finance techniques have been developed to go around this constraint; such techniques can also be very suitable to Islamic finance.

This study discusses Islamic trade and project financing techniques, and draws parallels with conventional finance. It is hoped that the discussion will inspire conventional bankers to incorporate Islamic financing structures into their credit packages, and Islamic bankers to adopt some of the innovations of structured finance to expand their lending and investment possibilities.

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## Introduction

Since the 1980s, new financing techniques that are collectively known as “structured project and trade finance” (and exhaustively discussed in earlier UNCTAD papers) have become increasingly prevalent in financing transactions involving developing countries, as well as countries with economies in transition. This growth is linked to a growing understanding and better quantification of the risks of trade and project finance, and with the forthcoming Basel 2 agreement (the *New Basel Capital Adequacy Framework*) proactive structures to deal with risk and to maximize a financier’s risk carrying capacity will become even more important.

Many of the risk mitigation tools used in structured trade and project finance have strong similarities with various structures that have evolved in Islamic finance – in effect, both can have the same material effects, even though they differ in detail. The fact remains that the sophisticated Arab traders of Makkah did not at first see any discernible difference between the Islamic model and the one based on *riba*. Therefore, the reader seeking to understand this difference should expect that understanding the difference is a non-trivial process.<sup>1</sup> In order to facilitate the reading of this report and the understanding of the principles of Islamic finance, this report sometimes uses “shorthand” language; for example, it refers to “financing” and “loans”, even though strictly speaking, the core elements of Islamic finance consist (at least from a legal perspective) of sales and purchase transactions and equity investments.

The number of banks offering Islamic finance instruments has grown fast since the early 1970s and the market has now reached a size of more than US\$200 billion. This is partly because supply grew to meet the demand for Islamic finance, in part this growth is driven by the pressure of funds looking for “*halal*” (lawful or “clean”) investments. In other words, banks (or trading companies) that are able to propose Islamic finance to their clients can gain a competitive edge; and those that are able to tap into Islamic financing markets can obtain relatively low-cost capital. At the same time, banks involved in Islamic finance can learn from the structures and techniques developed by their structured finance peers and adapt them for their own purposes.

As banks are not allowed to charge interest, they have to make their income through fees<sup>2</sup> and other fixed commissions — which could be explicitly linked to the interest payments that a more traditional bank would charge. Similarly, depositors are not paid an interest on their savings, but a share in the profits of the operations that their money helps finance, or they are given discretionary “gifts”, prices or bonuses (monetary or non-monetary) by their bank.

Like traditional finance, Islamic finance can be applied to trade and to projects; and banks can use their own capital (including through syndications) or act like an investment bank and place a financing with Islamic (institutional) investors. This paper gives a brief overview of some major forms of Islamic forms of trade and project finance, as can be used in the commodity sector.

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<sup>1</sup> Mahmoud Amin El-Gamal (2000). *A Basic Guide to Contemporary Islamic Banking and Finance*, Rice University.

<sup>2</sup> This allows banks to undertake basic international payment operations such as the opening of letters of credit (L/Cs); a client appoints a bank as his agent, then deposits the full amount of the L/C with the bank, on the basis of which the bank can open the L/C. Through a similar mechanism (but not necessarily requiring the upfront deposit of the full sum involved), banks can provide letters of guarantee.

### Box 1. The principles of Islamic finance

In Islamic finance, the relation between financier and client is one between a seller and a buyer, or an agent and a principal, or an investor and an entrepreneur. It is not the lender-borrower relation of western banking.

Islamic finance should abide by the following rules:

- Any predetermined payment over and above the actual amount of the principal is prohibited. This includes indirect benefits — as one commentator has noted, "this prohibition applies to any advantage or benefits that the lender might secure out of the loan such as riding the borrower's mule, eating at his table, or even taking advantage of the shade of his wall."
- The lender must share in the profits or losses arising from the enterprise for which the money was lent.
- Making money from money is not acceptable. Making money is good only as long as it is made through productive activities. Money, as a productive factor, does not have a prior claim on production in the form of interest. It has an ex-post claim, as a reward for the risks taken by the financier.
- Unnecessary risk (*gharar*), gambling and ignorance (*jahl*) are prohibited. But "unavoidable risk", i.e. risk which is a normal part of any trade or investment activity, is acceptable. With respect to *jahl*, contracting parties should have perfect knowledge of the countervalues intended to be exchanged as a result of their transactions. For example, signing a contract with a farmer to buy all his future crop for price X creates a risk — it is unknown how much he will harvest. And this risk is not necessary: one could obtain the same economic result by signing a contract under which the farmer leases his land, and then works for a fixed salary.
- Financings should only support practices or products that are not forbidden or discouraged by Islam. This does not imply that one cannot finance ventures such as airline companies or hotel chains which serve alcohol to their clients. As long as these "illicit" activities only account for a small part (less than one third) of the venture's asset base and revenue, financing is still allowed (this is linked to a general rule that judgments need to be made on the basis of "the majority", and not "the minority"); but any profits that are made from such illicit activities need to be donated to charity.

Islamic finance is a versatile form of financing, with enough opportunities for banks and other financiers to compensate for the absence of interest rates. However, many Islamic financiers, intent on keeping their risks low, focus almost exclusively on the most basic "mark-up" forms of Islamic finance rather than the much more innovative "profit sharing" forms; and in practice, for international finance such banks often rely on bank-to-bank credit lines. Structured finance has given birth to many mechanisms to deal with risks where bank-to-bank credit lines are absent or insufficient, and in developed country capital markets securitization techniques have evolved to attract even conservative investors into new forms of finance. Linking Islamic financing with such structuring skills can, in a growing number of countries, help clinch deals. As discussed in Box 2, Islamic finance is very much open to innovation, with well-established procedures to introduce new techniques into mainstream financing practices.

### Box 2. Shari'a boards and innovations in Islamic finance

Islamic finance institutions generally have their own Shari'a boards consisting of one to three reputable Islamic scholars (“ulama”) with expertise in economics or finance. These boards review proposed transaction structures in detail, to determine whether they conform to Islamic precepts. If they conform, they issue a “fatwa” of approval. For those who accept the findings of these particular scholars (and note that the findings of a Shari'a board in, say, Malaysia, are not necessarily accepted in, say, the Middle East — for this reason, many international banks have several Shari'a boards), this suffices to accept the proposed transaction as “halal” (permitted).

The scholars base their decisions on:

- the Quran;
- the sunna of the Prophet Mohammed; these are the records of his decisions;
- the “human understanding” (“fiqh”) of the “divine law” that results from the Quran and the sunna.

The Shari'a boards are supposed to apply their own reasoning and to be creative. In Islam, outside of the narrow area of the core religious practices, what is not explicitly forbidden is allowed. Also, in deciding whether something is allowed or not, Islam does **not** use the rule of “economic equivalence” — in other words, if practice “A” is specifically disallowed, but the same economic effect can be reached by practice “B”, then what matters is whether this practice “B” has been specifically disallowed in the Quran, the sunna or the fiqh. Similarly, if “A” is not allowed, it is not against the precepts of Islam to reach the same result by combining permissible practices “B” and “C” ( $A=B+C$ ). One is also allowed to replicate the economic result of a non-allowed technique A by stripping a specific risk “D” away from a permissible practice ( $A=B-D$ ).

Given the importance of “fiqh”, interpretation plays a major role, and Islamic scholars may not always agree. In this respect, there are four major schools of Islamic law, which differ in the detail of their findings: Hanafi, which is generally considered the most liberal, although from a financier’s perspective, this may not always be the case; Hanbali, the predominant school of jurisprudence in Saudi Arabia, which is generally considered as the most conservative; Maliki, generally considered moderately liberal; and Shafi (which predominates in Malaysia), which is generally considered relatively conservative, but in finance can be rather liberal.

Most of the differences between these schools are in the fine detail — for example, whether in a *mudaraba*, the capital provider is allowed to make a partial first payment (Hanafi), or has to provide the full financing at once (as practiced in the other schools). According to the Hanafi and Hanbali schools, *mudaraba* can be restricted to a fixed term, after which it will be disbanded, while the Shafi and Maliki school do not allow for this. Or in the case of a *salam* (prepaid forward contract), the Hanafi school considers that in order for the *salam* to be valid, the underlying commodity must be available in the market at the time the contract is signed; according to the three other schools, it is only necessary that it should be available at the time of delivery. Hanafi and Shafi do not allow the sale of the usufruct of an asset, while Hanbali and Maliki, which consider usufruct as a property, do. Shafi allows debt re-sale, which is not allowed by Hanafi and Hanbali, and only under very strict conditions by the Maliki school.

## Chapter I

### COMMODITY TRADE FINANCE APPLICATIONS

Islam has named forms of finance (specifically mentioned in the Koran, and in effect mostly codifications of pre-Islamic financing forms), and new forms of financing, developed since (with most new forms developed over the past few decades).

The main forms of trade finance are *murabaha* contract (similar to a buyer's credit), *salam* (similar to a pre-financing), and certain uses of *istasna* which allows banks to provide pre-export finance for goods for which firm orders have been established. Table 1 below gives an overview of how Islamic financing instruments compare to conventional financing structures.

**Table 1. Simplified overview of the uses of Islamic financing instruments for trade and project financing purposes, and their "conventional finance" equivalents**

<b>Islamic financing form</b>	<b>Trade finance applications</b>	<b>Project finance applications</b>
<b>Murabaha</b>	Buyer's credit (incl. import finance), for consumer, intermediary and capital goods.	Mortgages; and deferred payment obligations can be used as the underlying for securitisations.
<b>Ijara</b>	-	Leasing
<b>Muqarada</b>	Buying "murabaha" trade paper.	Buying "Islamic" bonds, or "ijara paper".
<b>Mudaraba</b>	Little used for trade purposes.	Non-recourse project finance
<b>Musharaka</b>	Pre-export finance (including applications similar to back-to-back L/Cs), and financing of toll-processing	Equity investments
<b>Salam</b>	Campaign (production) credit; pre-export finance	-
<b>Istisna</b>	Packing credit; some forms of working capital finance	Limited recourse project finance, e.g., for pipelines, ships, plants machinery, independent power projects, etc,

#### A. Murabaha

The most commonly used Islamic financing form is *murabaha* (it accounts for more than half of all the financing provided by Islamic financing institutions). In principle, it is a straightforward buyer's credit, but it is often used for more complex structured financings, and can be the basis for securitisations (for example, to enable the financing of ships on the back of shipping fees to be paid under longer-term contracts).

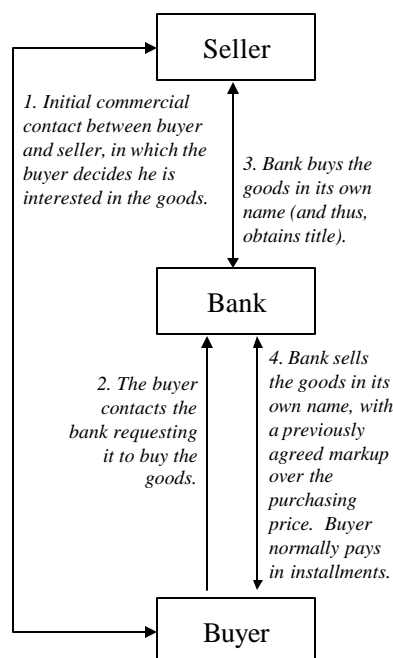
In the simplest form of a *murabaha* financing, the bank appoints the commercial buyer as its agent to negotiate and arrange the transaction with the seller. It makes prompt payment to the seller, and then transfers the goods to the commercial buyer specifying deferred payment (possibly in instalments); it may keep title to the goods until they have been fully paid. In the price paid by the buyer, the bank will add certain mark-ups on its own purchasing price. The mark-up is a function of the time between the moment that the bank buys the good and the

moment(s) the buyer pays the bank.<sup>3</sup> Although according to Islamic scholars, this is not an interest rate, most banks will actually determine the mark-up on the basis of the interest rates prevailing in international markets – after all, Islamic banks do not operate in a vacuum but have to compete with interest-charging banks, both to attract depositors and to attract borrowers.<sup>4</sup> In general, *murabaha* is used in conjunction with letters of credit (although the equivalent to "cash against documents" is also used) and normal documentary credit collections. In international financings, it is also common for a local bank to provide a standby letter of credit as guarantee.

Banks do not normally want to handle physical commodities (except if they want to do so as a vehicle for providing consumer loans), something for which they are not equipped and would, in all likelihood, not be very good at. So while banks wish to retain the title to the goods, they would normally wish the commercial parties to handle the actual physical transaction.

In reality, *murabaha* transactions therefore look more or less as in Figure 2 below (in the case of use of a Letter of Credit).

**Figure 1. Murabaha finance: the principle**



The sequence of events in a *murabaha* transaction would then be normally as follows:

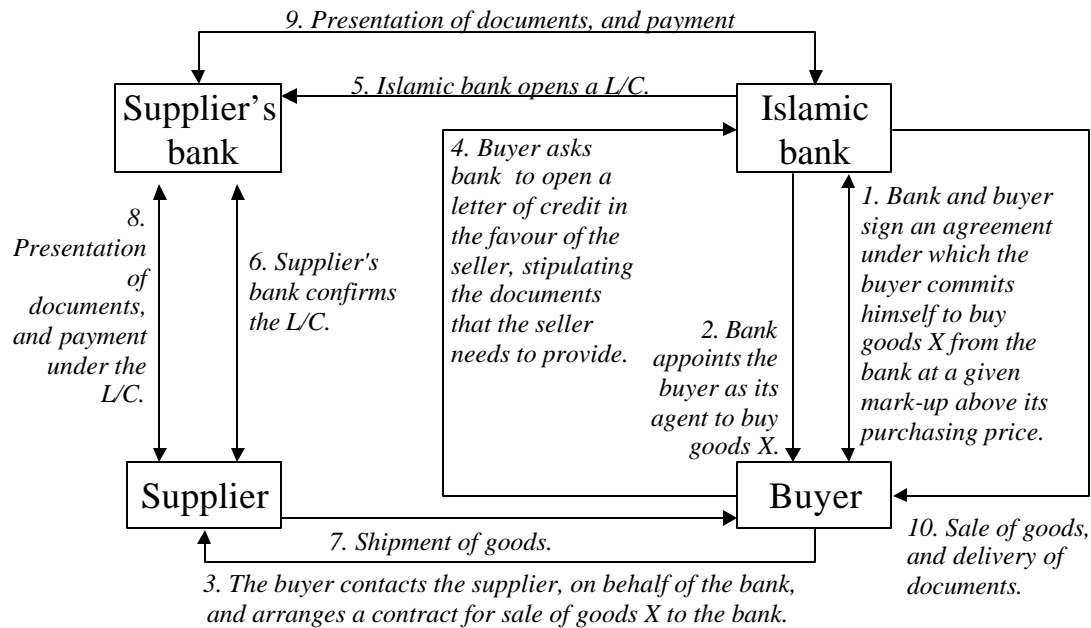
(1) After its initial approach by a buyer (who has already identified a supplier of the goods in which he is interested), the bank would normally appoint the ultimate buyer as their agent for purchase of the required goods (although there are exceptions; for example, banks in Sudan do not use such agency arrangements).

(2) At the same time the buyer would also execute an agreement with the bank binding himself to buy the requisite goods from the bank when delivered to him, at marked-up price on deferred payment basis. The buyer may pay a non-refundable premium (called *urboun*) to

<sup>3</sup> There may be a serious problem with payment delays in *murabaha*, because it is impossible to charge extra interest on late payments. To overcome this problem, Pakistani banks have resorted to what is called mark-down, in effect giving time-limited rebates as an incentive for early payments. Alternatively, an extra markup can be included for delays.

<sup>4</sup> Buyers often pay in instalments. These instalments are seen as having different proportions of reimbursement of principal and mark-up. This can be seen in practice if the system is used for longer-term finance of a fixed asset, e.g. a building. Say a client wants to buy a building. The bank buys it for him (say for \$500,000), and delivers it to the client who will pay him in, say, 15 yearly instalments of \$50,000 each. Say that the client wants to sell the building after five years, and prefers to pay off his bank debt. Evidently, he does not owe the bank \$500,000 — the bank will give him a rebate (*musafa*). But this rebate cannot be equal to what he paid already. To calculate how much he owes the bank, the bank will look at the pre-determined profit shares or mark-ups in his earlier payments. Naturally, most of his first payments consist of "mark-up" rather than payment of the principal.

**Figure 2. Murabaha trade finance in practice**



secure his “promise to buy” (in most cases, this is the buyer’s liability in case the deal is not finalized; other forms of guarantee payments also exist, though).

(3)/(4) The buyer, not the bank, would contact the supplier of the goods and enter into a sale contract with him on behalf of the bank.

(5) – (9) The supplier of goods would then arrange to transport the goods to the destination mentioned in the sale contract and send the documents, including invoices, carrier's note and other papers mentioned in the sale contract, either direct to the buyer who is acting as agent of the bank or, more likely, through his (supplier's) bank for payment. In the latter case, prior to shipment, the supplier would ask the buyer’s bank to open a letter of credit, through which he would be paid after delivery.

(10) The bank would then make an offer to the buyer to sell him the goods (of which it retains the documents, and thus, title) at the marked-up price. In its letter to the buyer, it clearly states the payment schedule. The amount of mark-up at the rate already agreed between the bank and the client would be calculated for the period from the date that the bank paid for the goods to the dates that the buyer pays. The bank also charges fees for its various services, including the L/C.

The seller could also decide not to use the L/C mechanism, but rather, sell on an “open account” or “cash against documents” (CAD) basis. In this case, when the goods (for “open account”) or documents of title (for CAD) are received by the buyer as agent of the bank, he sends a letter to the bank intimating the receipt thereof on behalf of the bank and offers to purchase the same at a ‘marked-up’ price. The bank accepts his offer and sells him the goods at the marked-up price. At the time of issuing each acceptance letter, the bank would issue pay order in favour of the seller of goods or make a payment to the buyer if he has already paid the amount himself to the seller and debit the buyer’s account with the marked-up price.

Figure 3 describes how the *murabaha* structure would typically be used in import finance, for example, to finance the purchase of raw materials. This transaction would be called a pre-import financing facility if arranged by a conventional bank. The underlying objectives are identical but the structure is different. The transaction works as follows:

(1) At the request of the customer and upon presentation of appropriate documentation (i.e. detailing the underlying asset, the supplier and bank details and the deferred payment date), import financing is arranged.

(2) The sale is made to the bank (as in export finance, the bank may appoint the final buyer as his agent to arrange the logistics). The supplier is paid directly. The bank then sells the goods to the customer/final buyer. Therefore, title passes via the bank to the customer.

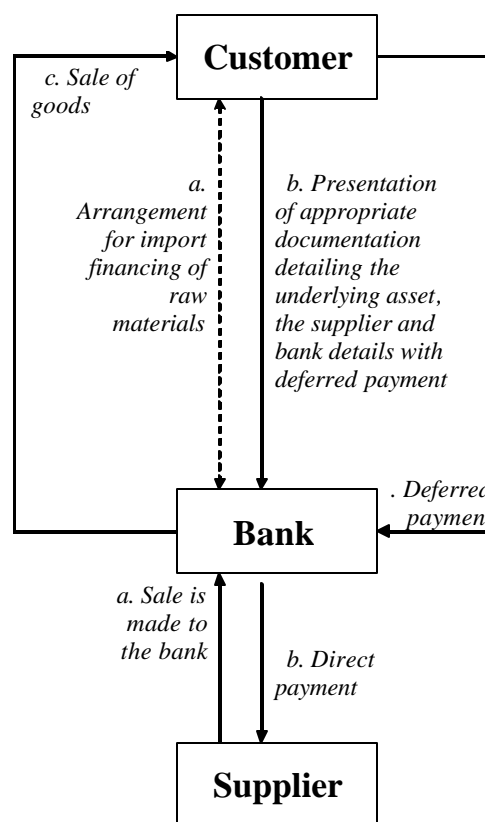
(3) Payment is then made by the deferred payment date as specified at the beginning of the transaction and within an agreed time period. This, usually, is made to match the customer's transaction cycle.

Commodity-backed *murabaha* structures have also been used to enable Shari'a-compliant consumer loans. Consumer loans in the western sense are not allowed in Islamic finance. The only loans allowed are charitable ones (*qard hasan*), where the lender is willing to take the risk that he will not be reimbursed. Nevertheless, there is strong demand from consumers for finance. For years, many bought, for example, a car under a *murabaha* scheme, with payments to be made in instalments, and then immediately sold the car for ready cash ? evidently at high transaction costs. In recent years, banks in Saudi Arabia and elsewhere have developed a more efficient Shari'a-compliant mechanism to replicate the western consumer loan.

Under this mechanism, the bank holds a small portfolio of physical commodities (often, but not necessarily, gold and silver — any fungible commodity is in principle suitable). These are sold to interested customers at deferred payment terms, and the customer then immediately appoints the bank as his agent for selling the commodities, which the bank then does. The client generally receives his funds within 24 hours. There are some further mechanisms to ensure Shari'a-compliance, but these complications have not halted the rapid growth of this new Islamic financing product.

Banks have to take some risk of losses on the assets in order for the *murabaha* to be valid (as in all forms of Islamic finance, a profit without a risk of loss is *haram*). But Sharia courts allow banks to restrict the possible extent of such losses, by putting a maximum value on

**Figure 3. A murabaha import financing**



possible damages, and limiting the possible sources and time period of loss through disclaimers. Banks should in particular manage the following risks:

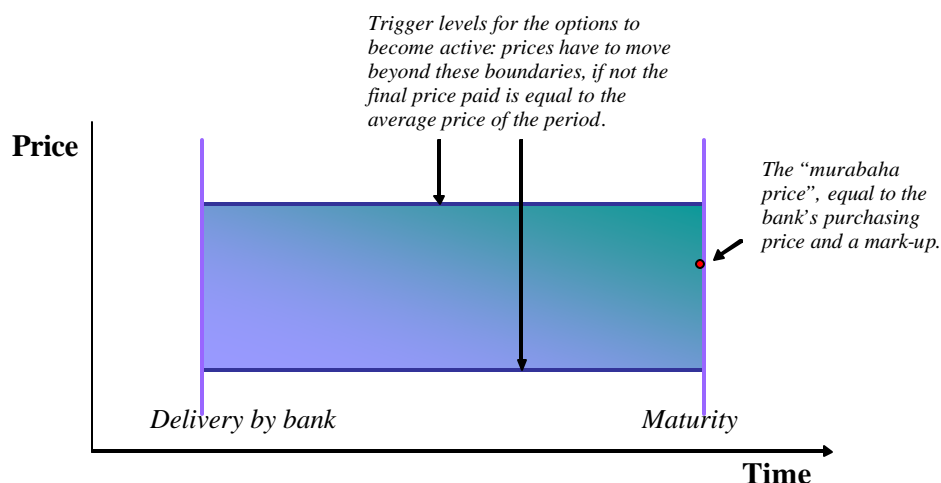
- Credit risk. When the client does not pay the successive instalments, the bank can declare a default and all instalments become due immediately; the *murabaha* contract will normally stipulate that in addition, the bank is entitled to damages. To make transactions more secure, banks may keep the title to the goods until they have been fully paid for. In international financings, it is also common for a local bank providing a standby letter of credit as a guarantee. Collateral management would be a very good alternative to standby letters of credit, but this technique is still under-utilized in Islamic finance.
- It is possible that the buyer complains that the mark-up is excessive. This could be a reason for a Shari'a court to declare the transaction void.

### Box 3. Building options into trade finance transactions: the *istijrar* structure

*Istijrar*, introduced in the late 1990s in Pakistan, can be considered as a more complex variant of *murabaha*. The difference is that whereas in *murabaha*, the bank's return is a simple percentage (markup), in *istijrar*, the bank's return depends on the prices of the goods during an agreed period between the delivery of the goods to the buyer and the maturity date of the *istijrar*.

The pricing formula is quite complex. The final price paid will be either the price that would have been paid had the contract been a simple *murabaha* (that is to say, the bank's purchasing price plus a markup), or the average of the daily prices from the moment of delivery until the moment of payment. Both bank and buyer have the possibility to fix the price (the bank has the equivalent of a put option, the buyer has a call option); in both cases they have the time until the maturity date of the *istijrar*.

The pricing mechanism is explained in more detail in the chart below:



*Istijrar* can be compared to the rather complex "knock-in" options used in some financial markets. In effect, both bank and buyer have the option to fix prices at a set level (the same for both of them, and equal to the price that the bank would have charged under a *murabaha* transaction), but this option only becomes active once prices have moved outside of certain agreed boundaries. If prices do not move outside of these boundaries before the buyer has to

make his payment (or if they do, but both buyer and seller decline — rather against economic principles — to exercise their option), then the price that the buyer pays is equal to the average price of the goods from the moment of delivery to the moment of payment.

- The buyer may reject the goods for non-conformity and leave the bank holding the goods. To avoid this risk, the bank has to assign the buyer as its agent in determining the conformity of the goods prior to acceptance. He is also allowed to take security from the buyer to ensure the latter will meet his obligation to buy the goods. A related risk is that the seller does not deliver the goods (see Box 4).

**Box 4. Managing the risk of non-delivery in a murabaha financing**

In a *murabaha* transaction, the bank buys goods from party A, and then delivers them to party B. There are several risks in this: the bank may buy A, but no goods are delivered; or the goods that are delivered are sub-standard. Party B could then refuse to pay to the bank, on the ground of non-delivery of the goods by the bank. To avoid this risk, the bank should use B as its agent in its dealings with party A. Then, if there is no delivery, or inappropriate delivery, this is the responsibility of B. And, both in Islamic and western law, B cannot refuse its obligations towards the bank for reasons that are due to its own deficient performance.

In a recent court case in the United Kingdom (*Islamic Investment Company of the Gulf [IICG] versus Symphony Gems*), the responsibility of the agent was clearly recognized. IICG had entered, in January 2000, in a *murabaha* financing agreement with Symphony Gems, under English law. IICG would provide a revolving purchase and sale facility to Symphony Gems to purchase precious stones. Symphony Gems was solely responsible for identifying the precious stones and the sellers, and on its request, IICG would buy them and on-sell for an agreed profit, with payments to be made in instalments.

In February 2000, Symphony Gems identified a Hong Kong seller, who would deliver 92,000 carats of precious stones. IICG paid, but the Hong Kong seller did not deliver. Symphony Gems then refused to pay. In court, the judge decided that it had arguable defence and had to pay. Among other things, he held that if there was no delivery, this was because Symphony Gems had not made the necessary arrangements.

- As the owner and seller of the commodities/goods, the bank is exposed to certain legal risks — third party risks caused by the commodities/goods (e.g. in the case of environmental pollution), and for productive assets, the risk that the buyer will claim that the product was not produced as required (and specified under the contract). The bank should include in the contract a disclaimer, to the extent possible; or at least, it should limit its own liability by the indemnities received from the seller.
- If there are warranties attached to the product, can these be assigned by the bank to the buyer?

## **B. Bai al Salam**

A second form of Islamic finance used in trade is *bai al salam*. *Salam* is in principle a simple pre-paid forward sale. It is used much for seasonal agricultural purchases, but can also be used to buy other commodities in cases where the seller needs working capital before he can deliver or even, produce (in the case of manufactured goods, packing credit and working capital can be provided under the title of *istisna*). In other words, it differs from the limited

recourse prepayments common in the West, made through trading companies, in that the bank, not the trader is making the prepayment.

Most often, this type of credit is used to finance the production of raw material (often seen in agriculture finance—seasonal agricultural purchases), where the advance payment made by the bank is used to buy, for example, the seeds, and repayment is made against the sale of the crop. It has also been used to finance cattle where the price paid is used for the purchase of calves (with repayment made against the sale of cows once they have been fattened and made ready for sale, all within a 120-day financing cycle). It can also be used to buy other goods in cases where the seller needs working capital to cover financial requirements before he can deliver (and this includes, for example, long-term power supply agreements — but a key condition is that it has to be for a fungible commodity). The pre-determined price is generally lower in that case than the spot price.

The *bai al salam* contract must conform to several conditions in order to be valid:

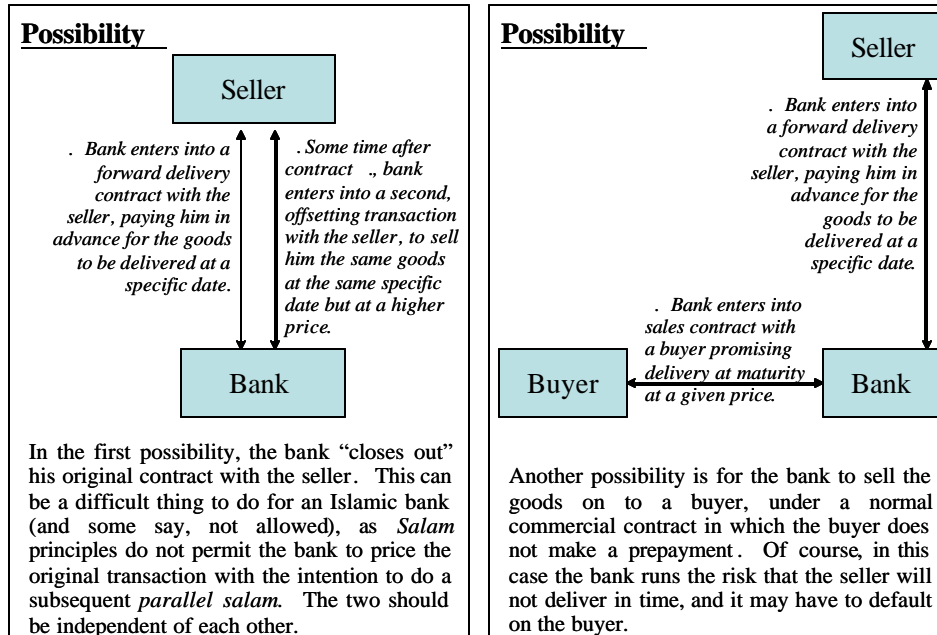
- The commodity should not yet exist when the finance is provided;
- The full purchase price is paid at or near to the moment that the contract is signed;
- The settlement price should be known in advance;
- The underlying asset is standardizable, easily quantifiable and of determinate quality;
- The contract cannot be for specific commodities, e.g., commodities identified as coming from a specific field;
- Quantity, quality, maturity date and place of delivery must be specified clearly in the contract;
- The underlying asset must be available and actively traded in the markets throughout the period of the contract, or at its maturity (different Shari'a boards have different opinions);
- The bank does not enjoy ownership of the goods until delivery has taken place;
- The buyer/bank is allowed to require security from the seller, in the form of a guarantee or mortgage. In case of a default in delivery, the borrower or his guarantor may be asked to deliver the same commodity by purchasing it from the market, or to reimburse the sum advanced to him.

As banks generally do not like to be involved in the actual handling of commodities, they generally close out their positions by entering into a *parallel salam*. The two main possibilities that they have are set out in Box 5.

## C. Musharaka

### Box 5. Parallel salam

*Salam* can be used for direct forward contracts between buyer and seller, but is often used by banks to provide pre-finance principally to small farmers and businesses. If used by banks, they generally would use two *parallel salam*, to avoid having to take possession of the commodity.



*Musharaka* is by some considered the purest form of Islamic finance. It is similar to a western style joint-venture. Profits or losses will be shared between the partners. At times, the activity more resembles venture capital: to compensate the high risks it is taking, the bank requires a relatively high share of the profits. This, of course, can discourage investors who can access non-Islamic financing sources (banks thus have an adverse selection problem).

The joint venture is an independent legal entity. It is allowed to issue shares for sale to the general public. The bank is allowed to sell its shares after some time. *Musharaka* financing is risky for financiers because they rely on the “partner” to manage the business properly. This can be attractive if the partner is a major enterprise; for example, in 1991, Sarawak Shell obtained M\$560 million (about US\$300 million) in *musharaka* finance for an oil drilling operation.

However, such partners can be difficult to find, and *musharaka* is therefore mostly used for very limited purposes, such as the procurement of goods and their onward sale, with or without processing (in the latter case, the bank would normally agree with his “partner” on a lump-sum cost for the processing, thereby reducing the risk of manipulation of the accounts). Figure 4 gives an example. Once an importer has opened a letter of credit, the exporter and its bank can form a *musharaka* to enable the goods to be collected, processed, prepared for exports, etc. The exporter undertakes to prepare the products strictly as specified under the L/C, and undertakes to indemnify the bank for any losses that may arise if he fails to do so. Once the payments under the letter of credit have been received the *musharaka* is extinguished.

If the proposed export is under a documentary collection, the financing will be undertaken on the basis that goods will be acquired and made ready for export under joint ownership of the bank and the exporter. The ultimate buyer will agree to buy the bank's share in these goods at an agreed price when the goods are ready for shipment.

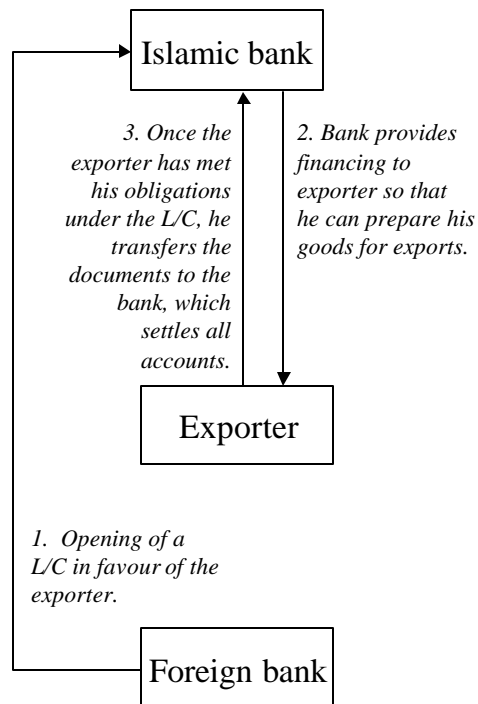
*Musharaka* can also be used for financing imports under a L/C, with deferred payment terms for the importer. The most common format would then be for an importer to approach a bank, which will then enter into a number of operations:

- (1) opening of a L/C in favour of the exporter.
- (2) appoint the importer as his agent for acquiring the goods. The importer is responsible for all negotiations.
- (3) bind the importer to buy the goods at an agreed price if they are not sold within 30 days after imports. During this period, the importer, as agent for the bank, can sell the goods onward.
- (4) enter into a *musharaka* agreement with the importer (specific to the import transaction), under which the net profit, after deduction of all expenses incurred on the import, will be shared between the bank and the importer in an agreed ratio.

In Pakistan, *musharaka* is the common mechanism for working capital finance, and then works as follows (see Figure 5):

- (1) Based on past experience and other available data, the company requiring the finance prepares a projection of the monthly rate of pre-tax profits taking into account the *musharaka* investment.
- (2) Based on this projected rate of profit, the projected annual profit that will arise on the *musharaka* investment (provisional profit) is calculated.

**Figure 4. Use of *musharaka* for pre-export finance**



(3) The company opens a bank account and authorizes the investor (financier) to debit from it at the end of each quarter an amount equal to the provisional profit for that period. The investor makes the investment. He can take security such as a mortgage, hypothecation or a pledge.

(4) At the end of the financial year, the profits are calculated. If an amount is due to the investor (financier) in excess of the provisional profit already debited from the bank account, the excess amount will be credited to a special reserve (participation reserve) which the company will create in its books. Likewise, if the amount debited from the bank account is in excess of investors' share of the audited profits, the excess will be debited to the participation reserve.

(5) Upon the termination of the contract, a final profit and loss account is prepared and at that time any amount in the participation reserve will be distributed among the two parties in the ratio provided in the contract.

If, during a financial year, losses exceed profits and the participation reserve is insufficient to make good such losses, the company may ask (during a certain period) the investor for a refund (in whole or in part) in respect of the amount it had debited from the bank account. If the investor's share of profit in any two of the preceding three years is less than the provisional rate of profit, the investor may convert not more than 20 per cent of its investment into ordinary shares based on the break-up value of the company.

Any breach of a covenant by the company which may jeopardize the interests of the investor is a breach of contract which entitles the investor to terminate the agreement. He can then claim the return of his share of the capital and of the provisional profit. If the company is unable to pay these amounts, liquidated damages equal to 20 per cent of the unpaid amount becomes due. If the investor suffers losses owing to the negligence or the mismanagement of company, it may liquidate the company.

#### **D. Istisna**

*Istisna* is similar to *salam*, in that it constitutes a simple pre-paid forward sale. The bank/buyer orders a specified quantity and quality of a manufactured good, deliverable at an agreed price. He may or may not pay the full purchase price in advance. However, while *salam* is for commodity trade, *istisna* applies to goods that need to be manufactured (made-to-order items). And while *salam* requires a full upfront payment, in *istisna*, payment can normally be made at various stages of the process. Moreover, the time for delivery of the product may not be fixed in advance.

In general, an *istisna* is a contract of acquisition of goods by specification or order where the price is paid in advance but goods are manufactured and delivered at a later date. It can be used for short or long-term arrangements. It is used for the acquisition of raw material; processing of raw material (including tolling); or for the marketing and selling of finished goods.

The general terms of an *istisna* contract are as follows:

- The nature and quality of the item to be delivered must be specified in the contract;
- The manufacturer must make the commitment to produce the item as described;
- The delivery date is not fixed. Instead, some flexibility is left with respect to the delivery period but a maximum time within which the good has to be delivered is

normally fixed. Should the manufacturer wish to deliver the product after this date, the buyer can refuse it — it is also possible to include a penalty clause for late delivery in the contract.

- The item is deliverable upon completion by the manufacturer;
- The contract is irrevocable after commencement of manufacture except where delivered goods do not meet the contracted terms (the contract only becomes binding once the manufacturer starts the manufacturing process; before that, it can be cancelled by both parties);
- Payment can be made in one lump sum or in instalments, and at any time up to or after the time of delivery;
- The manufacturer is responsible for sourcing of inputs to the production process;
- As long as the goods conforms to the previously agreed specifications, the bank/buyer does not have the right to reject it;
- The contract is satisfied when goods are delivered.

An *istisna* contract can be used, for example, for alumina or sugar tolling. It can also be used to finance high-tech industries such as aircraft, trains, shipping, where stage payment are required. An example of this kind of financing is when an order is placed for an aircraft and stage payments are made over a five-year period; in this case the bank pays the manufacturer part of the cost up front, followed by regular instalments at different stages of the manufacturing process.

Similarly, *istisna* can be used for activities such as financing housing construction by specialized operators. It can also be used in project financing. For example, a client may want to install machinery in his plant, but this machinery needs to be especially manufactured; the financier can then finance this manufacture through an *istisna* contract. This is further discussed in the next chapter.

It could also be used as a form of pre-export finance, with the bank buying all goods for which a firm export contract has been established. In Iran, a financing form similar to *istisna* called *salaf* is used to provide working capital to processors and manufacturers. The bank pre-purchases the goods that will be produced. The goods must be described in detail, and delivery must be made within a year or within one production cycle, whichever is shorter.

## Chapter II

### PROJECT FINANCE APPLICATIONS

While most project financings in Islamic countries, from West Africa to Malaysia, are still structured conventionally, the number of projects which are partly or fully financed through Islamic financing instruments is already significant, and increasing. For those who want to be involved in financing pipelines, ships, plants, machinery, independent power projects, etc., an understanding of the major techniques is useful. Apart from the Islamic joint venture (*musharaka*), most of these techniques resemble innovative western financing instruments. There is an Islamic equivalent of leasing, *ijara*; banks can act as equity partners in a *musharaka* arrangement; banks can provide “non-recourse” finance to an investor, receiving its principal and a share of the profits only if the investment project was successful – this is one of the applications of *mudaraba*; *istisna* can be used for project finance; and banks can arrange the issuance of bonds for project financing purposes, and place these bonds with Islamic investors (*muqarada*).

#### A. Ijara

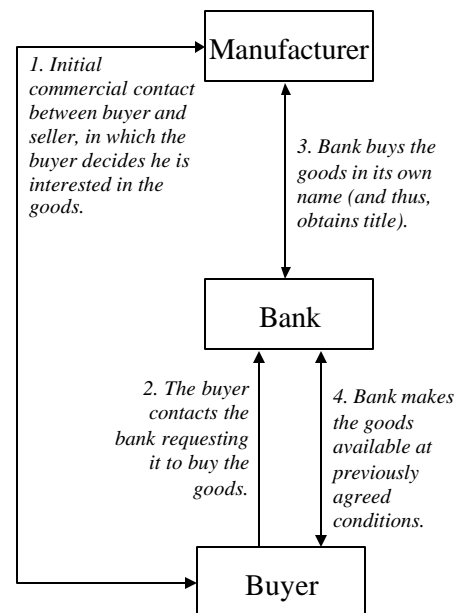
The most common form of Islamic project finance is *ijara*. This is virtually identical to leasing and hire-purchase arrangements, with the main difference that *ijara* cannot be used for financing consumer goods. Many "Islamic investment funds" principally invest in these leasing transactions. Figure 5 gives a schematic overview.

Their use by Islamic banks is limited by the fact that many Shari'a experts do not approve of it, and if they do provide *ijara* financing, it is limited to products that will be used productively (that is, consumer goods are excluded).

Contrary to other Islamic financing forms, *ijara* is actually providing for variable profit margins: the lease payment is made, say, every six months, and when the payment is made the profit margin for the following period is determined (generally on the basis of a reference such as six-month LIBOR, plus a fixed fee).

Apart from retaining ownership over the asset that is financed, the bank builds in additional security through the payment by the lessee of an amount to be mutually agreed upon by the parties as a security deposit. The lessor can use this in any manner it wishes in case of a rent default. To ensure timely payment, “liquidated damages” are included in the contract, specifying extra payments that need to be made for any day of delay.

Figure 5. An *ijara* transaction



In an *ijara* contract, a bank purchases goods on behalf of a client and leases them to the client for a rental fee, while maintaining ownership. The rental fee and the duration of the lease are agreed in advance. In one form, called *ijara wa iqtina*, the client purchases the goods from the bank at the end of the lease period for a predetermined price. This instrument has been frequently used for the financing of major assets such as aircraft.

The bank can issue “*ijara* bonds” for placement with Islamic investors, as a way to refinance itself. Alternatively, special Islamic funds can be set up to engage in *ijara* financing. Much of the recent growth in Islamic finance has been through the creation of such funds.

There are differences in the way that *ijara* operates from country to country. For example, more conservative Shari'a boards stipulate that management, insurance and maintenance is the responsibility of the lessor (the bank), unlike in conventional operating leases. This risks leaving the lessee with little incentive to properly manage and maintain the assets — to overcome this problem, strong undertakings are required in the lease contract.<sup>5</sup>

Banks can also combine Islamic financing instruments. This can be particularly useful for the financing of expensive assets: the construction part can be financed through an *istisna*, and once the asset/project is finished, the bank can lease it or sell it on deferred payment terms to the company that will operate it. This is similar to the back-to-back *istisna*, but with the important difference that the buyer can make his final payments after the asset has been constructed and delivered to him.

This combination was used, for example, in a 1998 deal for a \$77 million project financing for the Bakri Group to build two chemical tankers that were to be chartered by Saudi Basic Industries Corporation. The first tranche of the financing consisted of disbursements under an *istisna*, and this was replaced by an *ijara wa iqtina'a* on delivery of the tankers.

When engaging in an *ijara*, banks have to avoid certain possible problems:

- Risk of loss/destruction. Taking out property insurance may be difficult for Islamic banks (this depends on the specific interpretation of the relevant Shari'a court). Still, in order to classify as an *ijara*, the risks of loss or destruction have to stay with the bank, unless when caused by the lessee. If the bank can take out insurance, this should be paid (in advance) by the lessee. The risk of loss or destruction has to be carefully evaluated. It should also be noted that under “western” leases, the lessee has to continue paying even if the assets have been destroyed; under Islamic finance, this is not possible. As in Islamic finance, the lessee cannot be asked to continue paying under the lease if the property has been destroyed, or otherwise loses its economic value, ways to deal with such problems have to be built into the contract with the lessee. Normally, the way this is done is by requiring the lessee to purchase the leased property (with all obligations, liabilities and insurance policies attached to the property). The Shari'a principle is, however, that the purchase price should be the fair market value, and this value for a destroyed property is not very high. So in practice, this remains a very difficult issue to deal with.

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<sup>5</sup> The *ijara* contract requires detailed undertakings by the lessee that it will use the leased goods for normal business use, that it will ensure that the use of the goods will not vitiate the insurance policy, that it will not sub-lease or hire out the goods, that only properly trained personnel will use the goods, that the goods will be properly operated and maintained, and that it will return the goods at the end of the lease in good condition, fair wear and tear excepted.

- Timing of payments. Different from western leases, payment under the *ijara* can only start once the good (or at least, an economically useful part thereof) is effectively transferred to the lessee.
- Legal liability. Like is the case for a *murabaha*, as the owner and lessor of the goods, the bank is exposed to certain legal risks. The bank should include in the contract a disclaimer, to the extent possible; or at least, it should limit its own liability by the indemnities received from the seller. Also, in the *ijara* contract, the lessee should agree to indemnify the lessor for all costs, liabilities and obligations linked to the goods, whether or not due to its fault.

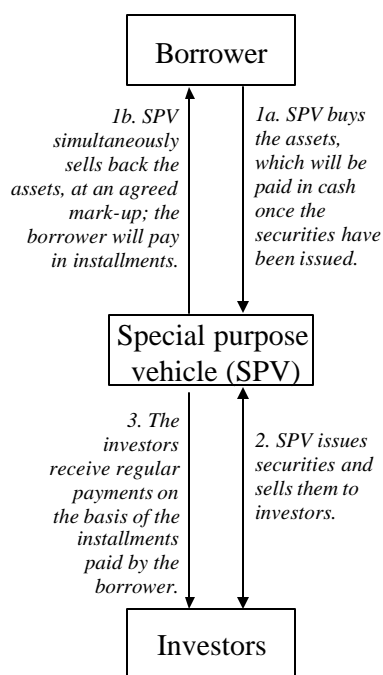
## B. Murabaha

Another fairly common form of project finance is the use of forward payment obligations under *murabaha* contracts to back a notes issue (see Figure 6).<sup>6</sup> This structure was used, for example, in a M\$ 125 million (US\$ 70 million) oil sector financing in Malaysia in 1990. The SPV sells securities, and the bond holders' purchase price for the securities go to the borrower (after deducting transaction costs and, normally, withholding a part as a liquidity facility). The borrower then pays in instalments, which are designed to fit with the payment obligations on the securities.

As the forward payments are fixed at the time that the notes are issued, the buyers know how much will be the annual pay-out on their investment. This structure has been used to finance airlines, airports, roads, railways, water supply works, and oil and gas infrastructure. It should be noted that this securitization structure can also be set up on the back of revolving trade paper — for example, to finance the working capital needs of an oil company or grain trading company.

More imaginative ways of *murabaha* structures to finance are also possible. For example, in 1998, a project for the expansion of a power plant and related transmission facilities (called the SCECO Power Project) was arranged for a Saudi Arabian electric utility company, Saudi Consolidated Electric Company (SCECO), using an Islamic joint venture combined with a *murabaha* structure. SCECO signed an engineering, procurement and construction contract (EPC contract) with a contractor. To arrange the financing, SCECO created a joint venture with three banks; this SPV was the owner of the SCECO Power Project.

**Figure 6. Use of *murabaha* for a securitization**



<sup>6</sup> The payment obligations under *murabaha* contracts (formalized as “*syahadah al-dayn*” or certificates of debt) can be traded on the secondary market, and they can also be used as the underlying for securitisations. It should be noted that neither of the two are considered legitimate by some Islamic scholars, notably in Arab countries.

The participation of the banks was not disclosed, which, under local law, meant that they only had limited liability (SCECO committed to indemnify the banks for any losses resulting from a disclosure). The EPC contract was assigned to the joint venture. SCECO acted as the technical manager of the joint venture, with full responsibility for all technical and unforeseen liabilities.

The banks made an initial share purchase in the joint venture to a value equal to that of the cost of the pre-existing development work. Then, during the two-year construction period, the banks bought further shares in the Special Purpose Vehicle, according to a pre-agreed scheduled and dependent on construction milestones being met. SCECO was responsible for certifying the completion of each milestone. It did so by delivery a milestone completion certificate to one of the three banks, which acted as the “administrative bank”. This bank then advised the other two banks, and all made pro rata contributions to the joint venture (in exchange for shares), in accordance with the initial percentage interest of each bank. After the project was completed, during a five-year repayment period the banks were to sell back these shares at a pre-agreed price (the bank’s investment plus a fixed or variable interest rate) to the power plant operator.<sup>7</sup> The sales price of the shares was determined on the basis of the amount invested by the bank, plus mark-ups. One of the banks provided fixed-rate financing, the other two provided variable-rate financing. The payment for the shares was under a *murabaha* arrangement, with the instalments determined in such a way that the goal of equal monthly instalments was reached.

### C. Mudaraba

*Mudaraba* is similar to non-recourse project finance. One party (the *rabb al-mal*, or sleeping partner) entrusts money to another (the *mudarib* or managing trustee). The *mudarib* is to use the funds in an agreed manner (e.g. to set up a factory), and then return to the *rabb al-mal* the principal and a pre-agreed share of the profits, over an agreed period of time. The *mudarib* is not allowed to guarantee either the capital or the profits (but the *mudarib* may be required to provide guarantees or financial sureties). The sleeping partners could be investors and the *mudarib* a bank or investment fund manager. Alternatively, the sleeping partner can be a bank and the *mudarib* the operator of the project.

*Mudaraba* is used for longer-term transactions of substantial size. They could be for a specific transaction or project, or for an ongoing business. The uses to which the funds provided by the *rabb al-mal* are put may be unrestricted, or restricted in terms of the commodities to be traded or the place of trade (two of the main schools of thought on Islamic finance also allow restrictions on the times of trade and on the persons that the working partner is allowed to trade with).

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<sup>7</sup> In effect, during the construction period, one of the banks withdrew from the transaction because of substantive disagreements between its own Shari'a board and the boards of the two other banks. But as the banks were allowed to trade the shares among themselves this did not create any serious problems for the transaction. See McMillen, Michael J.T. (2001), *Islamic Shari'ah-Compliant Project Finance: Collateral Security and Financing Structure Case Studies*, 24 Fordham Int'l L.J. 1184.

The distribution of profits must be on a proportional basis: the *mudarib* cannot be asked to commit himself to pay a certain minimum sum or a lump sum. Also, the sleeping partner stands to lose its principal if the project was a failure (without recourse to the *mudarib*), unless if the loss is a result of a misuse or a violation of the conditions of the contract on the part of the working partner, in which case the latter is liable.

The major problem of this form of financing is, of course, moral hazard: the investor/entrepreneur shares in the profits, but not in the losses. In case it is the “sleeping partner”, close monitoring by the bank over the actual use of the funds (that is, the investor’s operations) is normally necessary.

*Mudaraba* can also be used in a way similar to a closed-end investment fund. In this structure, investors contribute to the capital of an investment fund (managed by a specialized investment management company or a bank). This could be organized, for example, by the sale of “income notes” by the investment fund. The investment fund manager can be paid a fixed fee, or a performance-related fee.

#### **D. Istisna**

*Istisna* is often used for large, longer-term financings (e.g. infrastructure, electricity projects, transport equipment, pipelines). Naturally, the structure then can become quite complex. The buyer, or investor(s), would approach the bank, providing all relevant information, including details of the security offered (government, bank or parent company guarantees). If the bank agrees, buyer and seller have to deposit security bonds, and the buyer can order (as agent for the bank) the equipment.

The Islamic bank may pay the manufacturer an advance. The manufacturer has to provide a performance bond, as well as a guarantee to refund the progress payments made by the bank if he fails to make delivery, or if he delivers non-conforming goods. He also has to assign the insurance for the assets under construction to the bank. Then, for the regular payments on the work in progress, the bank would ask the manufacturer to open a letter of credit in favour of the supplier of the materials which the manufacturer is using, to control the actual use of its funds. Alternatively, the bank can reimburse the manufacturer for the expenses he already made. The buyer, through his own bank, would reimburse the Islamic bank, most likely in instalments. *Istisna* financing can be syndicated, it can contain financing tranches of different maturities and with different profit rates, and it can also be structured as a securitization.

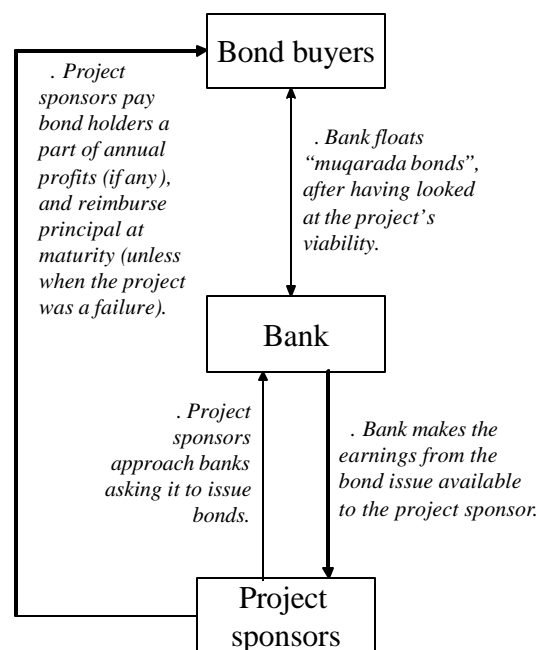
Banks often use back-to-back transactions:

- Under the first *istisna*, a customer agrees to purchase an asset from the Islamic bank upon completion. The purchaser can pay the bank in advance, at completion, or over time based on a set of pre-determined completion milestones.
- Under the second *istisna* (the “hire to produce” contract), the Islamic bank agrees to pay the manufacturer to build the asset in question. As an intermediary, the Islamic bank accepts the manufacturer's performance risk and the buyer's payment risk.
- Back-to-back with the *istisna* with the manufacturer (contractor), the bank could also use an *ijara* (lease) contract with the buyer, if he wishes the buyer to pay in instalments after delivery of the assets.

## E. Muqarada

*Muqarada* is generally used as a technique whereby a bank (called the *mudarib*) floats bonds for a specific project (e.g, the construction of a toll road or toll bridge), or for a general investment fund. The bond buyers share in the profits or, if they arise, losses of the project (as noted by a Jordanian bank which has issued several *muqarada* bonds, “in case of loss, holders of the bonds bear the loss whereas the Bank loses its efforts”). The investors have no say in the management of the project. The bank is not allowed to guarantee the principal nor the profits. On the other hand, where the financing is for a specific project, it is permissible for a third party (including the government) to promise to compensate the investors for any losses that they may sustain in the project, but this must be part of a separate arrangement and not part of the contract between the investor and the bank.

Figure 8. Typical *muqarada* structure



If a general investment fund is set up, funds are normally used for *murabaha* trade deals or in *ijara* financings.

*Muqarada* bonds are freely tradable ? they can be bought after issuance and liquidated at any time.

## F. Musharaka

As noted in the previous chapter, *musharaka* is mostly used for trade finance, even though its basic “venture capital” characteristic should make it very suitable for longer term financings. In effect, many of the conditions typically required by venture capitalists are fully compatible with Islamic financing principles.<sup>8</sup> However, when using a *musharaka* structure for longer term structures, there are several problems.

From the bank’s perspective:

- (1) Will clients give proper and true accounts of their business? Experience is that they can “cook the books” so that the venture appears to make no profit.
- (2) Many countries have weak accounting systems, and accountancy firms are not necessarily liable for poor practices.

<sup>8</sup> A detailed discussion on this is contained in Chapter 4 of Mohammed Obaidullah, *Islamic Financial Services*, King Abdul Aziz University, Jeddah, 2005.

- (3) It is often difficult to distinguish the transactions which are part of the *musharaka* from the general business of the investor.
- (4) Banks neither have the capability nor the required manpower to properly monitor *musharaka* operations.

From the investor's perspective:

- (1) Reporting requirements can become much more stringent (with a risk that banks have to share their records with tax authorities).
- (2) Banks may intervene too much in day-to-day operations
- (3) Will banks really share in any losses of a venture?
- (4) Is it really attractive to share a large part of profits with a bank?

Nevertheless, if a bank manages to arrange a longer-term *musharaka* for a large project, this can form the basis for a securitization. The certificates that are issued by the SPV then represent a pro rate ownership of the assets of the underlying project. They are fully negotiable after the project has started, and can be traded in the secondary market. A condition is that the *musharaka* should concern a real project, with illiquid physical assets (e.g., a power plant) — if its portfolio of liquid assets is more than 50 per cent of its worth (the Hanafi school allows a higher percentage), sale of the certificates is not permitted as it would be debt trading.

It is also worth noting that in its historic context, *musharaka* finance was primarily seen as a form of agricultural finance. Various types of *musharaka* specifically refer to agriculture.<sup>9</sup> One form, for example, spells out different forms of partnerships in farming – with land and other production factors (including expertise) coming from one party, labour from the other; or land and labour provided by one party, all the other production factors by the other; or even, three parties coming together in a farming enterprise. Another form, known as “diminishing *musharaka*”, starts with the bank financing a package of physical inputs for an agricultural firm; the bank's share of the profit is stipulated, but it is progressively reduced over time until the farmer fully owns the inputs that were financed. This scheme has been used to finance agricultural machinery and equipment. This indicates that the *musharaka* form of finance is eminently suited to contract farming arrangements, which are growing in importance in developing countries.

## **G. Investment auctioning**

A less common instrument is "investment auctioning". In this mechanism, financiers form a consortium which formulates an industrial project, in as detailed a manner as possible. Thereafter, it announces the project with the assurance to make available the needed plant and machinery of specific description and call for bids from prospective investors for the purchase of the machinery. The project is then awarded to the highest bidder considered capable of efficient implementation and running of the project, provided the bid meets the consortium's minimum.

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<sup>9</sup> See Mahmoud A. Gulaid, *Financing Agriculture through Islamic Modes And Instruments: Practical Scenarios And Applicability*, Islamic Research and Training Institute Research Note No. 34, Islamic Development Bank, Jeddah, 1995.

The consortium then makes the plant and machinery of the agreed specification available to the successful bidder in accordance with the agreed time schedule, which the bidder is obliged to accept. The amount of the bid accepted would be repayable in instalments over the agreed period. The liability of the investor whose bid is accepted by the consortium is independent of whether he earns a profit or incurs a loss.

## Conclusion

In Islamic finance, banks need to earn their profit not simply because they make money available, but because they take a production or trade-related risk. In principle, this orients Islamic bankers more towards venture capital, project finance and structured finance than their colleagues in other banks. However, in practice, Islamic banks often have difficulties to build up the skills base necessary to evaluate financing proposals in the necessary detail (and, in many countries, lack the supporting commercial framework, such as national rating services), and therefore tend to concentrate on relatively low-risk transactions which, for most non-Islamic observers, look remarkably like interest-bearing loans under a different name. This may, however, change when more experience is built up.

While there is still much scope for innovation, it would seem that Islamic finance runs into its largest problems (as concerns commodity financing) in the following areas:

(a) How to provide general working capital finance and bridge finance. For example, bridge financing, to fill a temporary liquidity gap, would seem difficult to justify. Also, general working capital finance is in most cases rather difficult because one cannot easily identify the single productive activity that is being financed; and thus, one cannot determine what profits have been made through use of the financing (attempts to overcome this obstacle by defining some “normal rate of return on capital”, which is then deemed to be the profitability of the activity financed, appear somewhat artificial, although this has been accepted in Pakistan’s Islamic financing system).

(b) How to develop an equivalent to the “easy” collateralized finance of the conventional banking sector. One problem of Islamic financing is that the simple presence of sufficient collateral (real estate, or commodities stored in the warehouse) is not sufficient for a loan ? instead, an extensive evaluation of the borrower’s business is required. This can slow down financing decisions, and disqualify borrowers without much of a track record, stifling economic growth. In effect, most banks in Islamic countries only deal with (take credit exposure to) “known names”.

(c) How to give the flexibility of variable interest rates. Except for *ijara*, loans are on a basis equivalent to fixed interest rates. It is not clear whether borrowers can swap out of such a position, but if not, fixed interest rates (in an environment where most companies have the possibility to actively influence the rates they are paying) may seem at times somewhat unattractive; and would definitely discourage longer-term borrowing at times of high interest rates.

(d) How to attract long-term deposits. Until the introduction of land-backed *sukuk* bonds (floating-rate Global Islamic Trust Certificates by the Malaysian government in 2001, Islamic banks also had difficulty lending to government entities (and as a consequence, in placing their short-term cash surplus); after all, the productive uses are difficult to evaluate.<sup>10</sup> In Iran, the government solved this by decreeing that the fixed rates of return paid to banks for the funds they lend to the government are not an interest rate. Islamic banks also have some

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<sup>10</sup> In Malaysia’s *sukuk*, this problem was overcome by the government’s assignment of the benefits of part of its land holdings to a Special Purpose Vehicle. It then signed lease arrangements for this land under which it would make regular lease payments to the SPV. Backed by this future revenue stream, the SPV issued *sukuk* bonds. The structure has since been replicated by several other entities, including for a bond issue by a large Malaysian plantation company.

problems with their depositors, who often prefer short-term deposits rather than the longer-term ones that a bank would like to use for investment in venture-capital type efforts.

In particular the problems with respect to collateral are very familiar to conventional bankers active in developing countries' commodity sectors, and the techniques that they have developed to deal with the inherent risks of providing credits in these countries may well be relevant to Islamic banks too. The pressure on Islamic banks to make money through taking risks on productive activities should drive them to be oriented towards venture capital, project finance and structured finance. The area is young and much still needs to be learned.

From the point of view of a conventional banker, Islamic finance can provide valuable new products and solutions — not to mention access to a large new deposit base as well as investors' public. It is a versatile tool. As its fast development over the past two decades has shown, it can deliver solutions to difficult trade or investment finance proposals. Many of these solutions are similar to “western” structured and project finance, and in certain cases, Islamic finance is able to deliver these solutions at a lower cost. Bankers active in Islamic countries can benefit by having a basic knowledge of the tools described in this paper.

## Annex

### Glossary of basic Islamic finance terms

- **Bai Muajjal** = a deferred payment sale.
- **Bai al Salam** = pre-paid purchase, similar to a pre-paid forward contract.
- **Fiqh** = jurisprudence — the jurists' understanding of Shari'a.
- **Fiqh al-mu'amalat** = Islamic commercial jurisprudence.
- **Gharar** = undue uncertainty or ambiguity in a contract, which will render it void.
- **Halal** = lawful.
- **Haram** = unlawful.
- **Ijarah** (also called Aitab) = leasing.
- **Istijrar** = variant of mudaraba, giving some pricing flexibility to buyer and seller.
- **Istisna'a** = a contract of sale of specified goods to be manufactured, with an obligation on the manufacturer to deliver them upon completion.
- **Jahl** = ignorance ? for example, entering into contracts with clauses that are unduly favourable to one of the parties renders them void.
- **Mudaraba** = profit-sharing (for trade financing).
- **Mudarib** = entrepreneur-borrower. Typically, mudaribs are banks which manage investors' funds. Also used to indicate the arranger of a syndicated financing.
- **Muqarada** = bond financing.
- **Muqasah** = rebate.
- **Murabaha** = cost-plus or mark-up financing.
- **Musharaka** = equity participation. Profits or losses are distributed according to capital contribution, but after taking into account administrative and management costs.
- **Rabbul-mal** = owner of capital (e.g., the investor in a mudaraba contract).
- **Riba** = unjustified increase (interest). Some have argued that the real meaning is "usury", and "normal" interest rates should therefore be acceptable under Islamic law, but this is not the majority opinion.
- **Shari'a** = Islamic law, as well as moral obligations, duties and considerations.
- **Sukuk** = Investment certificates or participation securities.
- **Takaful** = A Shari'a-compliant form of insurance.
- **Urboun** = "Earnest money" — a non-refundable premium paid by the buyer in a murabaha deal if at some time during the transaction, he decides not to take delivery (somewhat comparable to a put option).