



## Der Blick in die islamische Welt

Islamic Finance in a nutshell

### Strong fundamentals of Islamic Finance

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Despite the financial crisis, the fundamentals of the Islamic Finance sector have remained strong. Today, it is estimated that Islamic Finance represents a rather small but growing segment of the global finance industry of 1% to 2% of the worldwide financial assets. However, the appetite for Shariah compliant investments is increasing. What is this sector about? What are these products? And is there a role for Luxembourg in this sector?

Islamic Finance is a subtle mix of Shariah (Islamic Law) and finance, whose aim is to address the desire of Muslims to invest their funds in line with the principles of their faith. The main differences between Islamic Finance and conventional finance consist in the restrictions that investors should observe in order to conciliate their belief with their utility, and the use of Shariah compliant agreements to achieve this goal.

Shariah refers to Islamic Law, based on the Qur'an, the Sunnah (the sayings and actions of the Prophet Mohammed (PBOH)), and Ijtihad (the result of individual or collective effort or collective juridical analysis). It is very important to understand that Shariah does neither have a static nor a uniform set of interpretations, as different Islamic schools exist, Islamic scholars have differing opinions on a number of subjects, and the interpretations can be subject to change or completion. Though there are initiatives to harmonize certain interpretations, Shariah compliance still largely depends on the Shariah board's position.

#### What are the main restrictions?

An Islamic bank or institution will indeed appoint such board consisting of Shariah scholars, which need to approve the investment products as Shariah compliant, and to



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Raymond Krawczykowski, author of this study

monitor the institution's ongoing Shariah compliance.

Riba: this concept refers to the general prohibition of interest in return for the lender's waiting on his money, and the prohibition of excess compensation without consideration. Capital in Islamic Finance does have a cost, but this cost is based on profit and loss sharing arrangements or negotiated prices for sale and lease transactions. The restriction of Riba e.g. implies that investments in shares of conventional banks are prohibited, as are investments in highly geared companies in general.

Gharar: the prohibition of ambiguity or uncertainty. For example, buying a car the price of which is to be specified in the future is not allowed based on Gharar. Based on Gharar, investments in derivatives are also generally prohibited.

Haram: the prohibition on investment in

certain products and industries such as gambling, alcohol, pork, pornography and weapons. To provide a taste of the main products and investments, a few common examples:

#### Islamic bank accounts

Islamic banks cannot offer conventional interest bearing accounts or products. What can be offered are, for example:

\* Amanah accounts, close to current accounts, whereby the bank is safekeeping the money without remuneration for the client. According to certain scholars, the bank may offer a non-contractual gift if the client agrees that the bank may invest the deposit.



## Der Blick in die islamische Welt

\* Investment accounts, which can be restricted (asset allocation is contractually determined) or unrestricted (bank may place the money in any Shariah compliant product). The underlying agreement between the bank and the client is a Mudaraba agreement; a partnership agreement whereby one or more parties provide capital (the Rab al Mal; in this case, the client) and another party does not provide capital but has the role of investment manager (the Mudarib; in this case, the bank) in exchange for a share of the profits. Under a Mudaraba, the Rab al Mal share in the profits and are exposed to the losses; the Mudarib shares in the profits and is only exposed to losses up to his time and efforts, unless in case of negligence.

The funds deposited on investment accounts are not guaranteed as to their capital and there is no fixed return. In practice, it is considered by the regulator in certain countries that banks are under "some kind of obligation" to maintain the capital and pay out a steady return (e.g. Qatar), or that failure to do so would be considered as bad banking practices (e.g. Bahrain). In certain countries unrestricted investment accounts are not permitted by the supervisor (e.g. Saudi Arabia).

\* account receivables/total assets less than 45 per cent.

A number of Islamic indexes was already created, such as the Dow Jones Islamic Market Index and FTSE Global Islamic Index. These are extremely useful but one should bear in mind that they apply financial screens which are not necessarily the same as the ones mentioned above.

Islamic financing agreements

Financing can obviously not be provided through conventional interest bearing products, but is provided based on a range of specific Shariah compliant agreements, such as Murabaha (a kind of instalment credit sale, with mark-up), diminishing Musharaka (a declining balance partnership), Ijara (lease), Istisna' (forward sale of manufactured goods or constructed property) and Salam (forward sale of commodities).

Without going into technical details, an example can illustrate the principles:

\* Murabaha to the purchase order: applied to the banking sector, a client wishing to finance the purchase of e.g. 50 tons of coffee beans will communicate the specification of the goods to the Islamic Bank, and make a binding promise to the bank to purchase these goods. The bank will then, in practice through an agent, buy the good at spot from a supplier, against immediate payment of the supplier. The bank enters into a Murabaha agreement with the client against a price at spot plus a margin. The coffee beans can be delivered directly to the client, and he will pay back the bank in instalments. The cost of the capital, based on all features of the transaction, is the margin of the bank.

Islamic investment certificates - Sukuk: Often called Islamic bonds, Sukuk are in reality investment certificates. Contrary to bondholders, Sukuk holders indeed participate in the ownership of the issuer. Sukuk represent an ownership right of the underlying assets. Sukuk holders do not only participate in the profits of the underlying, but are also exposed to the losses. The mechanics for setting up and issuing Sukuk are quite similar to securitization. There are various types of Sukuk, depending on the underlying contract: Mudaraba Sukuk, Musharaka Sukuk, Salam Sukuk, Ijara Sukuk, Istisna' Sukuk, which all can be quoted (except Salam Sukuk).

To be continued page 35

#### Investments in qualifying shares

- Screening: In order to screen suitable equity investments, a double screen is applied:

\* an industry screen, whereby certain sectors are per se excluded: conventional banking and insurance, alcohol and pork producers, distributors and stores, defense and munitions, gambling (casino's, lottery, bookmakers), and adult entertainment. Particular attention is paid to companies which may derive a substantial part of their turnover from selling alcohol or pork meat (e.g. hotels, restaurants, airlines, supermarkets).

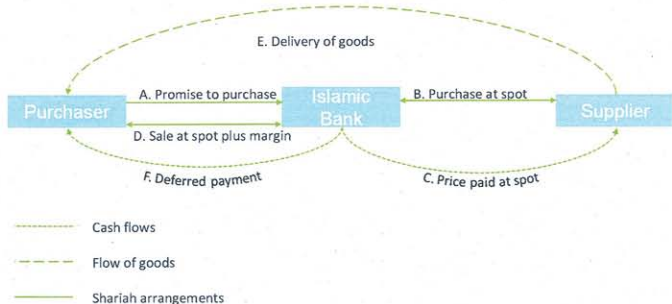
\* a financial screen: the majority of Islamic scholars currently accepts that investments in equities which passed the first test can be made if the following ratios are respected:

- \* total debt/capitalization less than 33 per cent;
- \* interest income/total revenues less than five per cent;

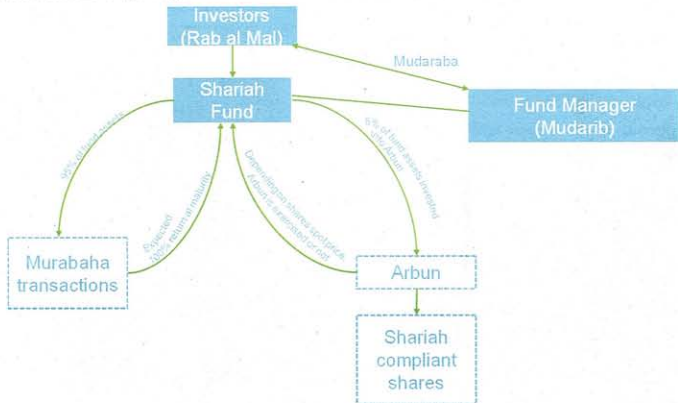


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**Schedule 1: Example of Murabaha to the purchase order**



**Schedule 2: Capital protected investment fund**



**Der Blick in die islamische Welt**

**End of page 33**

Luxembourg was one of the pioneers regarding quotation of Sukuk and new issues of Sukuk are regularly quoted on the Luxembourg stock exchange. Islamic investment funds

The Shariah investment fund sector is developing rapidly, with Mudaraba agreements as most widespread agreements for structuring Shariah compliant funds. Investors provide capital (without being involved as an active partner of the operating business), and a mudarib has the role of fund manager. Profits or losses must be shared between the investors and the mudarib according to a predefined formula.

Shariah compliant investment funds can invest in a wide range of sectors such as transferable securities, real estate, private equity, infrastructure, but the investments must obviously be Shariah permissible.

It is not impossible to structure capital-protected investment funds, but these would typically:

\* Invest most of the funds into fixed-term Murabaha (cost-plus sales) transactions.

The invested amount plus realized margin on the Murabaha ensures that the fund is in practice able to return the capital, but with no formal guarantee;

\* Invest the remaining funds into Arbun, a down-payment on a basket of Shariah compliant shares, which are delivered on a forward date for a pre-determined consideration. Arbun is more or less similar to options, but contrary to options, the down payment must be part of the total purchase price (it is not a premium). It is this component that may provide the extra return of the fund if Arbun is exercised and underlying shares are sold with a profit. If the purchase is not carried out, the down payment is lost for the investor.

**Luxembourg's opportunities**

It is clear that Luxembourg has a role to play in the Islamic Finance sector in particular as an important gateway to Europe for

inbound investments, and as one of the primary fund locations in the world. In addition to the technical expertise of Luxembourg local service providers and adaptability of the legal and tax framework to complex Shariah compliant arrangements, Luxembourg has a number of investment vehicles to host these transactions. SIF and SICAR are obvious vehicles to accommodate acquisitions and holding of Shariah compliant assets.

But unregulated entities such as so-called Soparti offer tremendous flexibility as well. Hence, Middle Eastern based Shariah funds may also successfully use Luxembourg as an intermediate holding country for structuring their investments in a tax efficient way. Finally, we should praise the exceptional efforts of the Luxembourg legislator who entered into an impressive number of double taxation agreements with Middle Eastern countries / countries with an important Muslim population (e.g. Morocco, Tunisia, Indonesia, Malaysia; pending treaties with Bahrain, Kuwait, Lebanon, Pakistan, Qatar, Syria, UAE).



Austausch der Urkunden zum Doppelbesteuerungsabkommen zwischen Luxemburg und Bahrain

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