



NON-CONVENTIONAL FUNDING: ISLAMIC BONDS OR SUKUK – Part 1

I) Growth of Islamic Finance

Islamic finance has become increasingly significant since the mid-1970s and has made its presence felt, both in the eastern and western worlds. The growth in national and personal wealth in the Middle East over the past 25 years has coincided with a resurgence in the influence of Islamic beliefs in various parts of the world. This has created a strong demand for a financial system which enables Muslims to make use of their wealth in a manner consistent with their beliefs.

Market dynamism has been felt in both the traditional Islamic finance centres and a number of other markets.

Sukuk – the Islamic finance world's equivalent of a traditional bond – has taken the Islamic finance industry by storm over the recent years, with most of the origination in Malaysia and the Gulf Co-operation Council countries.

Although Sri Lanka is yet to witness any sukuk issuances, there is a growing interest in these instruments to tap the liquidity of the Muslim community in Sri Lanka. Presently, Islamic institutions and community have limited investment vehicles that are in accordance with Islamic principles. This together with the tight liquidity in the conventional finance market has fuelled interest in Islamic Finance. However, in order to support the growth of this alternative instrument, regulatory, accounting, legal and tax issues need to be resolved.

In Malaysia's case, the Islamic finance market has grown from strength to strength and is one of the fastest-growing capital pools, rapidly being drawn into the mainstream financial system. The Malaysian Sukuk market, in particular, has successfully evolved out of its infancy. The viability of Islamic finance is no longer an issue; the success of

the domestic Islamic bond market - within a relatively short period - is a firm testament to investors' widespread acceptance of Islamic financing principles in that country.

II) Principles of Islamic Finance

The cornerstone of Islamic finance is that funding is not provided for monetary returns. Rather, Islamic finance is based on contracts of exchange. Under such contracts, assets or services will be exchanged for money, or for other assets. These give rise to sale and purchase contracts or leasing contracts.

Among the fundamental components of Islamic finance is the *Shariah* board. *Shariah* simply refers to Islamic law and *Shariah* boards are councils that are made up of Islamic scholars who ensure that all the activities of a company are in accordance with *Shariah*. Although *Shariah* interpretations may vary from one board to another, the differences are very minimal. The challenges can be mitigated by creating an apex *Shariah* council so that there is uniform practice in the industry. In Malaysia, Islamic securities are based on principles and concepts that are approved by the Securities Commission of Malaysia's *Shariah* Advisory Council.

III) Types of Islamic Contracts

The foregoing are structures that have been observed in the Malaysian context. RAM Ratings Lanka notes that these are not prescriptive structures as each market will have its own preference with regard to the underlying Islamic structure; over time, these can and do change.

1) Murabahah

A contract referring to the sale and purchase transaction for the financing of an asset, whereby the cost and profit margin (mark-up) are made known and agreed upon by all parties involved. The settlement for the purchase can either be on a deferred lump-sum basis or via instalments; this is specified in the agreement.

Murabahah is the most popular and most common mode of Islamic financing. It is also known as mark-up or cost-plus financing. The word *Murabahah* is derived from the Arabic word *Ribh*, which means profit. *Murabahah* is a contract of sale in which a

commodity is sold for profit. In this case, the seller is obliged to tell the buyer his cost price and the profit he is making.

There are a number of requirements for this transaction to be a real transaction, in order to meet the Islamic standards of a legal sale. The entire *Murabahah* transaction must be completed in 2 stages. In the first stage, the client requests the bank to undertake a *Murabahah* transaction and promises to buy the commodity specified by him, if the bank acquires the same commodity. Of course, the promise is not legally binding. As the client may renege on his promise, the bank risks the loss of the amount it has spent. In the second stage, the client purchases the item acquired by the bank on a deferred-payments basis, and agrees to a payment schedule. Another important requirement for a *Murabahah* sale is that the 2 sale contracts, one through which the bank acquires the commodity and the other through which it sells the same to the client, should be separate and real transactions.

2) Bai Bithaman Ajil

A contract that refers to the sale and purchase transaction for the financing of an asset on a deferred basis. The buyer may be allowed to pay by installments within a pre-agreed period, or in a lump sum. The sale price includes a profit margin. Although this principle had been popular in the past, it is now not as widely used for Islamic securities in Malaysia given the lack of acceptance by Islamic jurists in other parts of the world.

In the next article, we will be discussing other types of Islamic contracts, namely Istisna, Ijarah, Mudharabah and Musharakah.

This series of articles on non-conventional financial instruments is proudly brought to you by RAM Ratings (Lanka) Ltd. For those interested in learning more about sukuk, please contact RAM Ratings Lanka at +9411 2553089 to find out about the available workshops.

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NON-CONVENTIONAL FUNDING: ISLAMIC BONDS OR SUKUK – Part 2

In the previous article, we introduced 2 types of Islamic contracts, namely *Murabahah* and *Bai Bithaman Ajil*. This week, we present 4 more structures that are common in Malaysia. As mentioned before, these structures are not meant to be prescriptive, and there can be variations over time.

3) Istisna

Istisna is a purchase contract for an asset, whereby the buyer places an order with the seller to purchase the asset to be constructed or delivered on a certain date in the future, according to the specifications in the contract.

The settlement of the purchase price by the buyer is concluded according to the agreement between the 2 parties. Both parties decide on the sale and purchase prices, and settlement can be delayed and arranged based on a schedule of work completed.

4) Ijarah

Ijarah is a contract for the sale of benefits and services between the owner of the assets (lessor) and the user of those same assets (lessee), at an agreed price. Under Islamic financing practices, the *Ijarah* concept is where the issuer sells the *Ijarah* assets (normally plant, equipment, machinery or transportation vehicles) to the financier via an asset-purchase agreement. The financier, having obtained ownership of the assets, will then lease them back to the issuer via an *Ijarah* contract. The title to the assets will remain with the financier throughout the tenure of the *Ijarah* contract. Upon payment of the final instalment, the lessor and the lessee may agree to transfer the title from the lessor to the lessee; otherwise the title will remain with the lessor. *Al Ijarah Thumma Al Bai* is a contract that begins with an *Ijarah* contract for the purpose of renting out a lessor's asset to a lessee. Upon expiry of the lease period, the lessee purchases the asset at an agreed price from the lessor, by executing a purchase (*bai'*) contract.

5) Mudharabah

The term refers to a form of business contract where a party contributes capital while the other one provides expertise and effort. Their proportionate shares of the profits are determined by mutual agreement. On the other hand, the loss - if any - is borne only by the owner of the capital; as such, the entrepreneur would get nothing for his labour. The financier is known as *rabb-ul-maal* while the entrepreneur is *mudharib*.

As a financing technique adopted by Islamic banks, *Mudharabah* is a contract where all the capital is provided by the Islamic bank while the business is managed by the other party. The profit is shared according to pre-agreed ratios; any loss - unless caused by negligence or violation of the terms of the contract by the *mudharib* - is borne by the Islamic bank. The bank passes on this loss to its depositors.

In theory vis-à-vis Islamic banking, *Mudharabah* has been suggested as a technique that will provide the basis for the Islamic reorganisation of the commercial-banking sector. In practice, however, *Mudharabah* has not made much progress on the asset side of the balance sheet. Nonetheless, on the liability side, Islamic banks accept funds based on *Mudharabah* in investment accounts.

Although *Mudharabah* is translated into English as profit- and loss-sharing, there is actually no loss-sharing in a *Mudharabah* contract. Profit- and loss-sharing is a more accurate description of the *Musharakah* contract. The *Mudharabah* contract may be better represented by the expression "profit-sharing" as it is an Islamic contract where one party supplies the money while the other provides management in order to undertake a specific trade. The party supplying the capital is called the owner of the capital. The other party is referred to as a worker or agent who actually runs the business. In Islamic jurisprudence, different duties and responsibilities have been assigned to each of these 2 parties.

As a matter of principle, the owner of the capital does not have the right to interfere in the management of the business enterprise, which is the sole responsibility of the agent. However, the capital owner has every right to specify conditions that would ensure better management of his money. That is why *Mudharabah* is sometimes referred to as a sleeping partnership.

An important characteristic of *Mudharabah* is the arrangement of profit-sharing. The profits in a *Mudharabah* agreement may be shared according to any pre-agreed ratio between the parties. However, any loss is completely borne by the owner of the capital. In the case of a loss, the capital owner will bear the monetary loss while the agent will lose the reward for his efforts.

Islamic banks practice *Mudharabah* in both individual and joint forms. In the case of an individual *Mudharabah*, an Islamic bank provides financing to a commercial venture run by a person or a company, on a profit-sharing basis. On the other hand, joint *Mudharabah* may be between the investors and the bank on a continuous basis. The investors who keep their money in a special fund and share the profits, have the flexibility to withdraw from the *Mudharabah* funds. Many Islamic investment funds operate on the basis of a joint *Mudharabah*.

6) Musharakah

A partnership arrangement between 2 parties or more, to finance a business venture where all parties contribute capital, either in the form of cash or in kind, for the purpose of financing the business venture. Any profit derived from the venture is distributed according to a pre-agreed profit-sharing ratio, but a loss is shared on the basis of equity participation.

Musharakah is another popular financing technique used by Islamic banks. It can roughly be translated as "partnership". In this case, 2 or more financiers provide funding for a project. All the partners are entitled to a share in the profits resulting from the project, in a ratio that is mutually agreed upon. However, any loss must be shared according to their proportion of capital contribution. All the partners have the right to participate in the management of the project; they also have the right to waive their right of participation in favour of any specific partner or person.

There are 2 main forms of *Musharakah*: permanent and diminishing. These are briefly explained below:

- *Permanent Musharakah - In this form of Musharakah, an Islamic bank participates in the equity of a project and receives a share of the profits on a pro rata basis. Since the period of the contract is not specified, it can continue as long as the parties concerned wish so. This technique is suitable for the financing of projects with longer life spans, where funds are committed over a long period; the gestation period may also be lengthy.*

- *Diminishing Musharakah - This allows equity participation and sharing of profits on a pro rata basis. It also provides a method by which the bank's equity in the project keeps on reducing; ultimately, ownership of the asset transfers to the participants. This form of Musharakah provides for a payment over and above the bank's share in the profits i.e. the bank gets a dividend on its equity and at the same time, the bank also gets a payment from the entrepreneur who purchases some of its equity. Thus, the equity held by the bank is progressively reduced. After a certain time, the equity held by the bank will become zero and it will cease to be a partner.*

The *Musharakah* form of financing is increasingly being used by Islamic banks to finance domestic trade and imports as well as to issue letters of credit. It may also be applied in agriculture and industry.

In the next article, we will be discussing the essential building blocks for the proliferation of non-conventional financial instruments in a new market.

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