Islamic Finance Summit 2002

EuroMoney Seminars
London Hilton
January 23 - 24

Developing Shariah-Compliant Product & Services to Fit Today’s Market

Aamir Khan – CFO
ABN AMRO Private Equity
Chicago, IL
“There is nothing more difficult to take in hand, more perilous to conduct, or more uncertain in its outcome, than to take the lead in introducing a new order of things” Niccolo Machiavelli.
General Investment Climate

- Investors focus on capital preservation rather than capital appreciation
- WSJ survey: investors adding approx. $25 billion weekly to Money Market Funds later half of 2001
- $450 billion moved into savings account in ‘01
- Warren Buffet: estimates stock returns to average 7-8% over the next decade
- Libor around 2%; US Prime rate ~3.5% and going lower to....
General Islamic investment climate

- Islamic banks are 40% more liquid than their conventional counterparts
- Lack of acceptable liquidity mgmt. products
- Holding large balances of lower yielding assets
- Overwhelming response 3x to BMA’s short-term Sukuk Al-Salam, Islamically structured Govt. bills with annual rate of 2%
- Malaysia has designed products with some downside rate protection for Pensioners, etc.
Current Higher Yielding Conventional Products

- Investment grade rated securities, e.g. preferred stocks, corporate bonds & semi-govt. agencies return an avg. of 6 - 8%.
- Private placements & middle market companies are paying investors an avg. of 12 - 15%.
- IPOs of 28 companies raised $4 billion in Oct.’01 and have gained an avg. of 26% (per Dealogic). These have an average operating history of 12 years and have that novel concept of profits!
Product Development - Basic Questions

- Why a particular product is needed?
- Who are the potential users?
- What gap or sector is it fulfilling?
- Is it a replacement or a new product?
- How big is the market for the product?
- What rules & regulations will apply?
- What is the cost of development?
- What is a reasonable margin expected?
- Could it be traded in secondary market or will be held to maturity?
Standard Product Development Process

- Market Intelligence
- Resources Allocation
- Team Selection
- Marketing & Distribution
- Research & Development
Case for Musharakah & Mudarabah contracts for contemporary financing structures

Basic Principles (agreed by majority of scholars):

- Financing through M&M never implies advancing of money, rather it means participation in business.
- Investor/financier must share loss incurred by the business to the extent of his financing.
- Partners are at liberty to determine ratio of profit allocated to each one of them, different from the ratio of investment. However, the partner who excludes himself from management of the business cannot claim more than the ratio of his investment.
- Loss suffered by each partner must be exactly in proportion to his investment.
Musharakah & Mudarabah cont...

Application of principles to different types of financings:

**Project Financing:**
- One financier can sponsor the whole project- Mudarabah
- Both parties contribute capital with either dual or sole responsibility for mgmt. - Musharakah
- Participation from inception simplifies valuation of capital
- Distribution of profits per accounting standards are smooth
- One financier can withdraw from Musharakah by selling his entire share to another at an agreed price
Securitization of Musharakah:

- Issue M certificates representing subscribers proportionate share of ownership in the assets
- Certificates are treated as negotiable instruments & could be traded in secondary market for any agreed upon price between parties
- Compliance with specific Shariah rules when determining price of certificates with mixed liquid & non-liquid assets
- Examples: Infrastructure projects, large commercial complexes, etc.
Application-Musharakah & Mudarabah cont…

**Financing of a single transaction:**

- Adaptable for Imports & Exports
- Letter of credit both with or without margin

*Rationale for Import Financing:*

- Option of restricting the transaction to an agreed term
- Proceeds from sale of the imported item could be shared b/w importer & financier per a pre-agreed ratio
- Ownership of the imported goods remain with the financier to the extent of the ratio of his investment

*Rationale: Export financing:*

- Price of the item known
- Expected profit calculation easily determinable
- Share the amount of export bill on a pre-agreed percentage
Financing of Working Capital:

- Non-liquid assets could be contributed as Capital
- Rationale: Value of the business can be treated as the investment of the person seeking finance
- Amount of the financier treated as his share of investment
- Time period is flexible from 1 month to 1 year
- Agreement over percentage split of the profit to the financier not to exceed his investment amount
- Upon expiry of the term, all liquid & non-liquid assets are re-evaluated to determine profit basis
- Sharing in GP for running businesses with fixed assets
Running Musharakah accounts similar to a Credit Line:

- Certain percentage of actual profit must be allocated to the management
- Remaining percentage of the profit must be allocated to the investors
- Loss, if any, should be borne by the investors only in exact proportion of their respective investments
- Avg. balance of contributions made to Mkah acct calculated on daily basis shall be treated as the share capital of the financier
- Profit accruing to the Mkah portfolio at the end of the term will be divided on capital utilized per day and distributed
Application-Musharakah & Mudarabah cont…

**Diminishing Musharakah for House Financing:**

- Financier & his client participate in the joint ownership of a property
- Share of the financier divided into a number of units
- Giving the share of the financier to the client on rent
- Promise from the client to purchase the units of the financier - separate contract
- Actual purchase of the units at different stages
- Adjustment of the rental according to the remaining share of the financier in the property
Application-Musharakah & Mudarabah cont...

Diminishing Musharakah for Carrying Business of Services:
  (e.g. purchase of a Taxi)
  ▶ Creating joint ownership in a taxi in the form of Shirkat-ul-Milk.
  ▶ Musharakah is the income generated through the services of taxi.
  ▶ Purchase of different units of the share of the financier by the client adjusted for the depreciation
Application-Musharakah & Mudarabah cont…

**Diminishing Musharakah in Trade:** (garments)

- Financier contributes majority of capital to launch the business
- Independent promise to purchase different units of the share of the financier by the client
- Price of the units of financier cannot be fixed otherwise appearance of a guarantee without risk
- A practical option is to sell the units on the basis of valuation at the time of purchase by the client
Ijarah / (Leasing)

Two meanings in Islamic Jurisprudence:
- To employ services of a person for wages paid
- To transfer usufructs, i.e. the right, to use assets & properties to another person or entity in exchange for rent, for an agreed period for agreed consideration.

Basic Rules of Islamic Leasing/Ijarah:
- The subject of lease must have a valuable use.
- Consumable items cannot be leased.
- All liabilities emerging from the ownership shall be borne by the lessor. Though, liabilities referable to the use of property shall be borne by the lessee.
Ijarah / (Leasing) cont...

- Risk associated with the leased asset shall remain with lessor throughout leased period.
- It is permissible that different amounts of rent are fixed for different phases during the lease period.
- Rent is allowed to be determined on the basis of aggregate cost incurred in purchase of the asset by the lessor.
- Lease period shall commence from the date on which the asset has been delivered to the lessee.
- True operating lease. Not a financial or Synthetic lease.
- Residual value of the leased asset should be effected in a separate contract, under ijara wa-iqtina.
Securitization of Ijarah

Rationale:
- Excellent form to create a secondary market for financiers
- Lessor owns the leased assets, he can sell the asset in whole or in part to either one or several parties.
- New buyers can replace the seller in the rights & obligations as the lessor.
- This purchase by other parties could be evidenced by Ijarah Certificate.
- These certificates can then be negotiated and traded freely in the market.
- Easily convertible into cash
Salaam

- Contract for the sale of goods, where price is paid in advance, but the delivery of goods is deferred for a future date.

- Conditions:
  - Buyer should pay the price in full to the seller at the time of effecting the sale
  - Only for commodities where both the quality and quantity can be specified exactly
  - Commodity should be available in the market at the time of delivery

- Exact date and place of delivery must be specified in the contract

- Most suitable for small farmers & traders
Istisna

- Contract for acquisition of goods (manufactured) by specification where the price is usually paid progressively

- Current Application:
  - House finance sector: financier undertakes to construct the house on a specified land for the client. Financier is at the liberty to contract with a third party or hire the services of a contractor.
  - Project financing: Financier undertakes to prepare (or outsource manufacturing) an air-conditioning plant for clients’ factory per specifications. Similar set-up could be used for infrastructure, such as, highways, bridges, etc.

- Modern BOT (Build or Buy, Operate, Transfer) could be accommodated in this structure.
Potential Areas for Islamic products

- Property Sale/Leaseback financing in Buyout deals
  - Real estate could be a plant, some store or co. headquarters, is assessed along with investment grade of the tenant. The financier & buyout firm will negotiate rent. Once agreement final, the buyout firm signs a lease for the properties for an agreed-upon period--typically 15 to 20 years and receives 100% value in cash.

- Private Equity
  - Secondary market for VC portfolios
  - Late stage investing
  - Growth capital (many small cos not accessing banks)
Potential Areas - Private Equity cont...

- Acquisition capital (M&A, public to private, carve-outs, Spin-offs) Currently large energy corps selling non-core assets, (Fortune Mag article)
- Re-financings
- Re-capitalizations
Why Invest in Private Equity:

Private Equity has been one of the Best Performing Asset Classes

Source: Salomon Smith Barney/Venture Economics
The Diversification Benefits:

Private Equity acts as a good diversifier of overall portfolio risk

Historical Correlation Between other Asset Classes and Private Equity

- U.S. Equity: 0.30
- U.S. Bonds: 0.17
- Absolute Return: 0.29
- Real Estate: 0.08

Source: Yale Investments Office Estimates
Case Study - Islamic Home finance approval process - New York

Outline of challenges faced by a bank in NY in developing IHFP

- Survey results confirmed that IHFP had the most demand
- Structuring: (three options)
  - Murabaha; bank buys a house on behalf of the client (takes title), client promises to purchase the house from the bank, bank re-sells the house to client at a markup. Client repays the bank in monthly installments over a predetermined period (10, 15, 30 years)
  - Ijarah; bank buys a house on behalf of the client (takes title), client promises to lease the house from the bank for a pre-agreed period. At the end of term, client takes ownership/title once all rent/lease payments are satisfied.
Case Study - IHFP cont...

- Two parallel agreements;
  - Lease agreement
  - Promise to purchase
- Musharakah; both the client & bank purchase a property in partnership. Client’s down payment is the initial equity amount and the bank puts up the remainder. Client pays the bank rent, but part of the payment goes towards paying off bank’s equity stake and the remainder goes to the bank as profit. Once the client has acquired 100% of equity, the terms of agreement are satisfied.
Case Study - IHFP cont...

Adapted structure #1- adopted due to its relative similarity to a conventional mortgage. Reason: bank could amortize financing as it would a mortgage and can issue a security against the property for collateral.

Issues
- Internally, mortgage team was hesitant in adding more risk by taking title to a property. The fear was liability exposure in a lawsuit by the client (since bank is legally the homeowner). However, to satisfy the Shariah requirements, the bank had to take title for the transaction to be a Murabaha. This took a lot of time and education.
Traditionally the Murabaha once priced was fixed. The amount is locked-in whether the client pays entire amount in 1 or 30 years to the bank. Shariah advisors were very disappointed to learn that New York State prohibits prepayment penalties on home finance transactions. Thus, the transaction had to be treated as a conventional product if the client sold the house early or decided to pay it off. This meant that the bank had to calculate amortization amount and give the client a “rebate,” which would be the difference between the total amount due when the transaction closed and the amount paid back to date (similar to a regular mortgage). Thus, Shariah allowed the rebate in order for the product to succeed.
In the next phase, a law firm was engaged with expertise in developing Islamic products to facilitate the document design. This created an additional level of communication with the following teams working side-by-side, mortgage, Islamic banking, Shariah advisors, foreclosure, internal legal counsel, insurance, marketing and an outside legal counsel. Each team had a different idea of how to do things.

Another concern was to file documents with the state to ensure the structure receives an equal tax treatment as conventional products. This identified three issues:

1. Since the title is transferred twice, the state might rule that their needed to be two title transfer taxes,
2. The mortgage recording office might also rule that the tax on the mortgage is due on the entire amount of the Murabaha (i.e. cost of the property plus the markup as quoted in the documents,

3. IRS ruling on the tax deductibility of the profit amount similar to that of interest so that the buyers are not penalized.

These ultimately were resolved with favorable treatment similar to Mortgages.