

# **Islamic Banking – an introduction**

23/2/08

*Islamic Finance*  
*Sharia Finance*

## Key Milestones

**1850s**

A conventional bank opened a branch in Cairo for the construction of the Suez Canal, which caused a stir among Islamic scholars due to the "riba element".

**1950s - 1960s**

Islamic economists offer the first description of interest free banking. The establishment of Islamic deposit taker in Egypt and a Sharia compliant fund for Hajj pilgrimages in Malaysia.

**1970s - 1980s**

1974: Dubai Islamic Bank first commercial Islamic Bank opens.

1975: Islamic Development Bank

Bahrain/Malaysia Investment and Commercial Banks

*Accounting Standards board for Islamic Banks.*

**1990s** AAOIFI (from Murabaha to Zakat)

Takeful

Islamic equity funds

Dow Jones Islamic Index

FTSE Index of Sharia compatible stocks

Launching of sukuk / Islamic bonds

*'Sukuk' = certificates - Persian word  
Suk = means share = Andakiz*

## Conventional Finance

### Debt

*Bonds*  
*—*  
*derivatives*

- Fixed returns
- No upside participation
- Limited exposure to business risk
- Typical Contracts
  - bank loans
  - tradable bonds

### Equity

- Returns depend on business performance
- Unlimited upside participation + *downside*
- Share business losses
- Typical contracts
  - ordinary shares
  - partnership interests

# Conventional bank - interest flows

*(Spread) between what bank pays to customer, and what it earns from debt financing - this is the profit.*

## Assets

## Liabilities

## Cash flow

Fixed

Share capital *(Equity)* ----->

Dividend

Current

Debt (mixture: bonds, loans etc) --> Interest

Investments

Deposits ----->

Interest

Loans

*↳ where the bank makes the money - diversifying its activities.*

# Islamic bank – ‘‘profit’’ flows

<u>Assets</u>	<u>Liabilities</u>	<u>Cash flow</u>
Murabaha	Share Capital----->	Dividends
Mudaraba	Deposits----->	Profit share - <i>but returns are guaranteed?</i>
Ijara	Deposits----->	Fluctuating rate return
Sukuk	Restricted accounts---->	Fluctuating rate return
Wakala	Unrestricted accounts->	or profit share return
Diminishing musharaka	Qard Hassan ----->	None – only hasana
Islamic Equities	<i>(only for Islamic product)</i>	

Backed by tangible assets – no gharar

No riba

Risk shared

Halaal activities

## Islamic Finance: Typical Structures approved by SSB

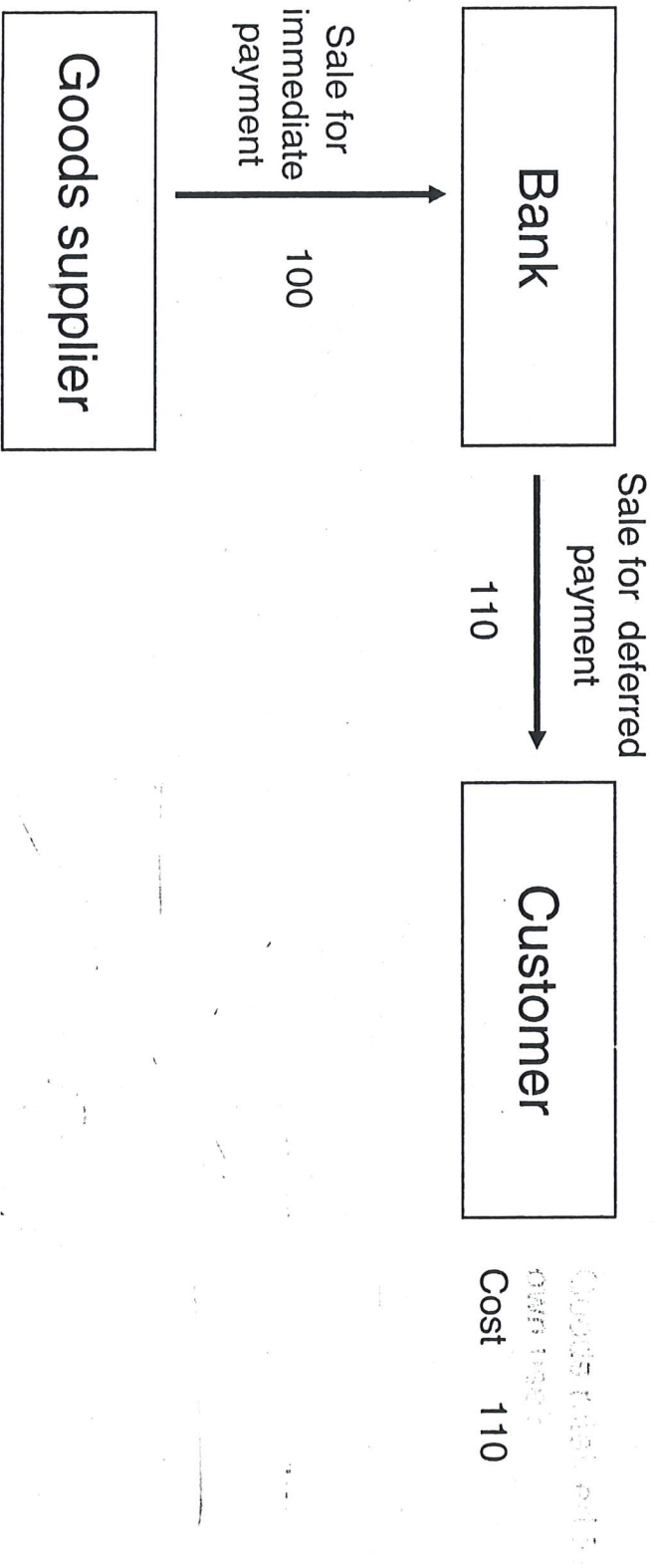
- Murabaha
- Mudaraba
- Wakala
- Musharaka
- Diminishing Musharaka
- Ijara
- Sukuk
- Equities (excl. pork, banks, gambling, tobacco)

✓ Sharia Supervisory Board.

- a lot of zakat / Alms / Sadaqa / Zakat  
amongst Malaysia / Saudi / etc.  
- Zakat is not compulsory - school of thought issue?  
Shafi vs Maliki.

# Murabaha

(Islamic Mortgage)



CONTRACTUS TRINIUS

(- Trade Mediation)

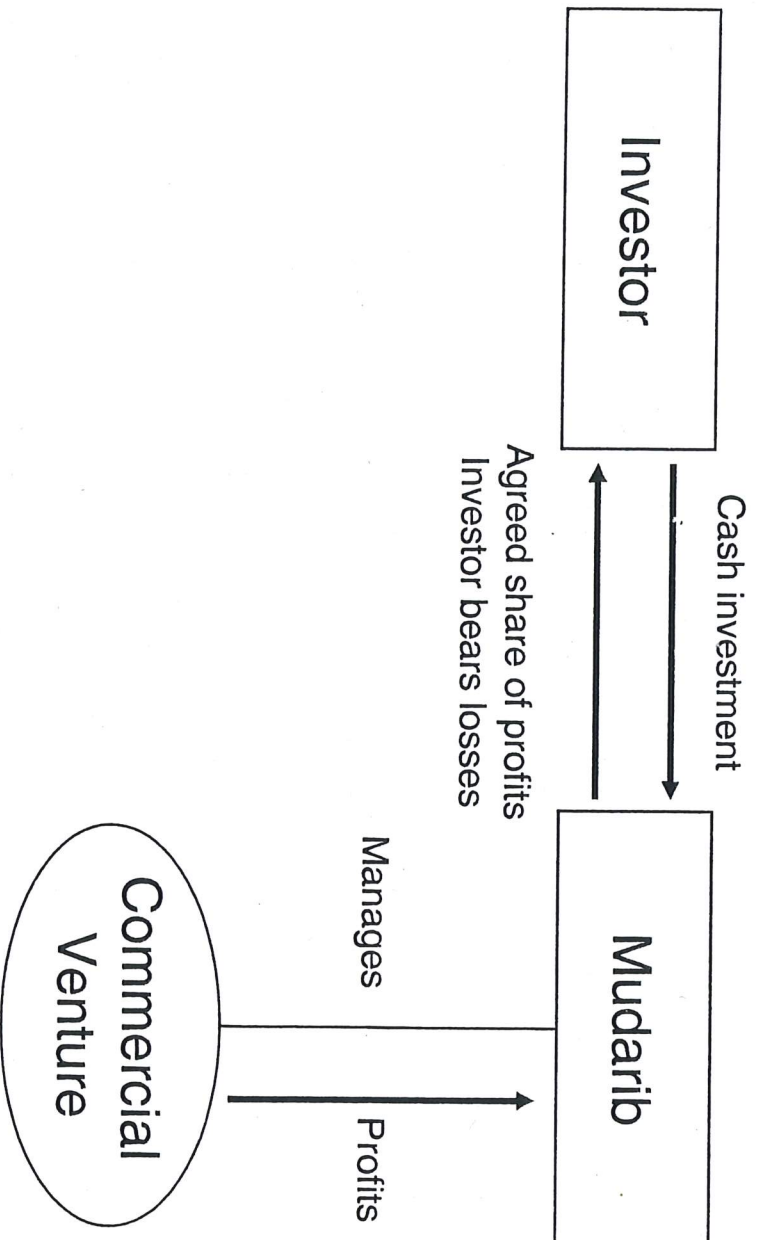
(3 WAY PARTNERSHIP AGREEMENT

ORIGINS 12 CENTURY

.. FLOWNED UPON BY COURT OF

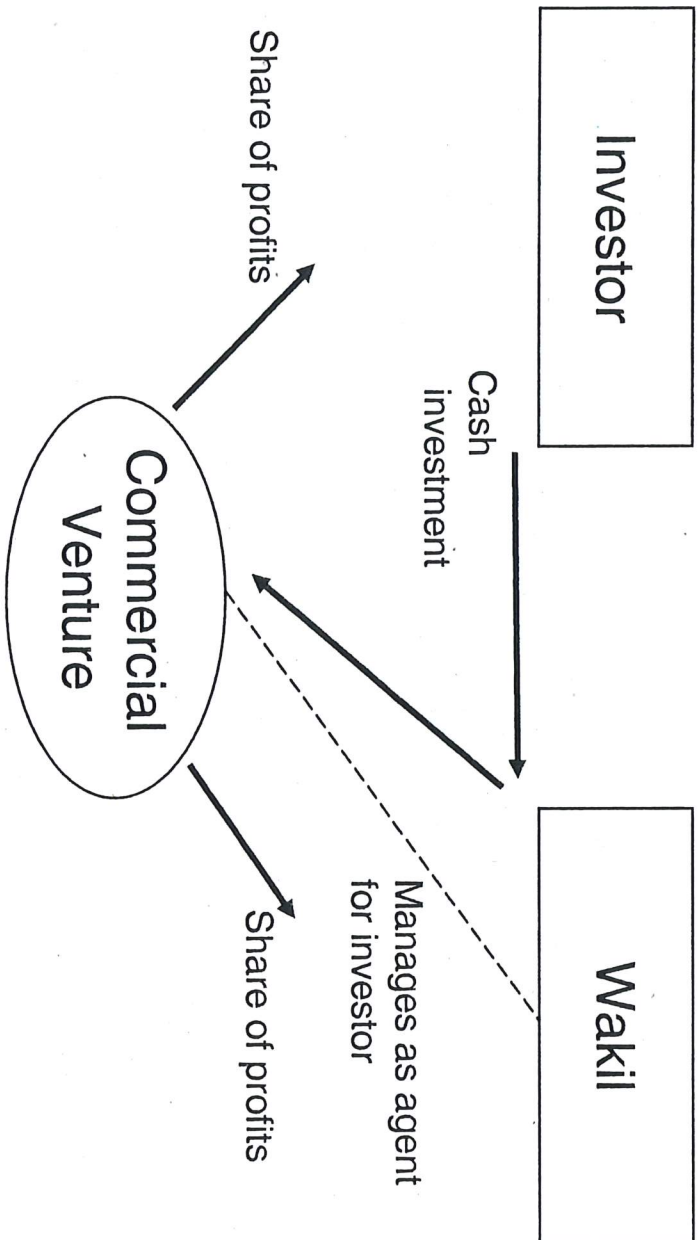
ENGLAND)

# Mudaraba

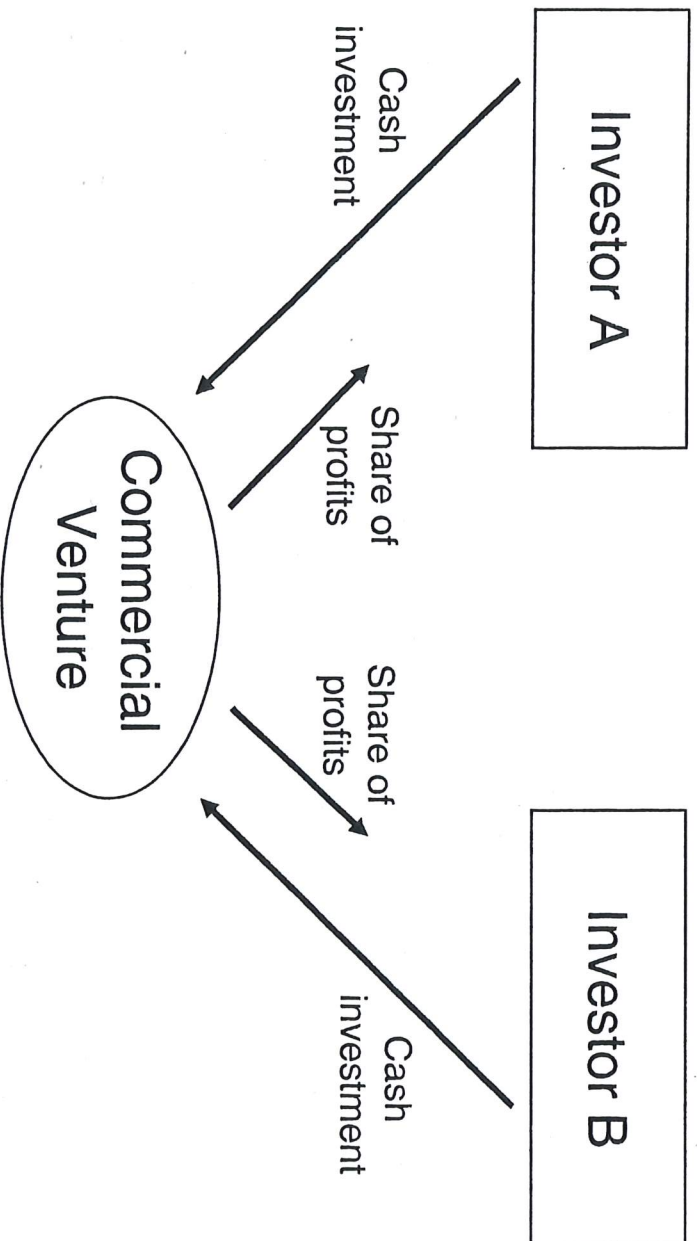




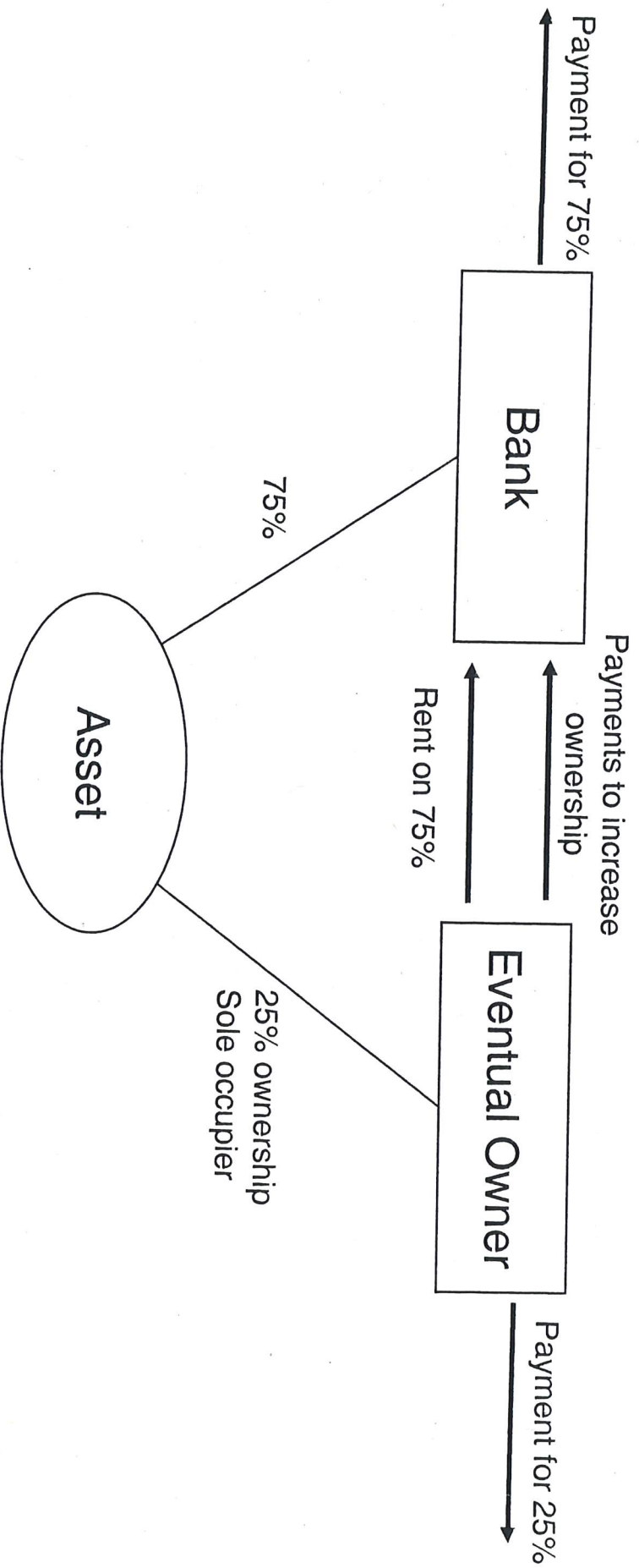
# Wakala



# Musharakaka

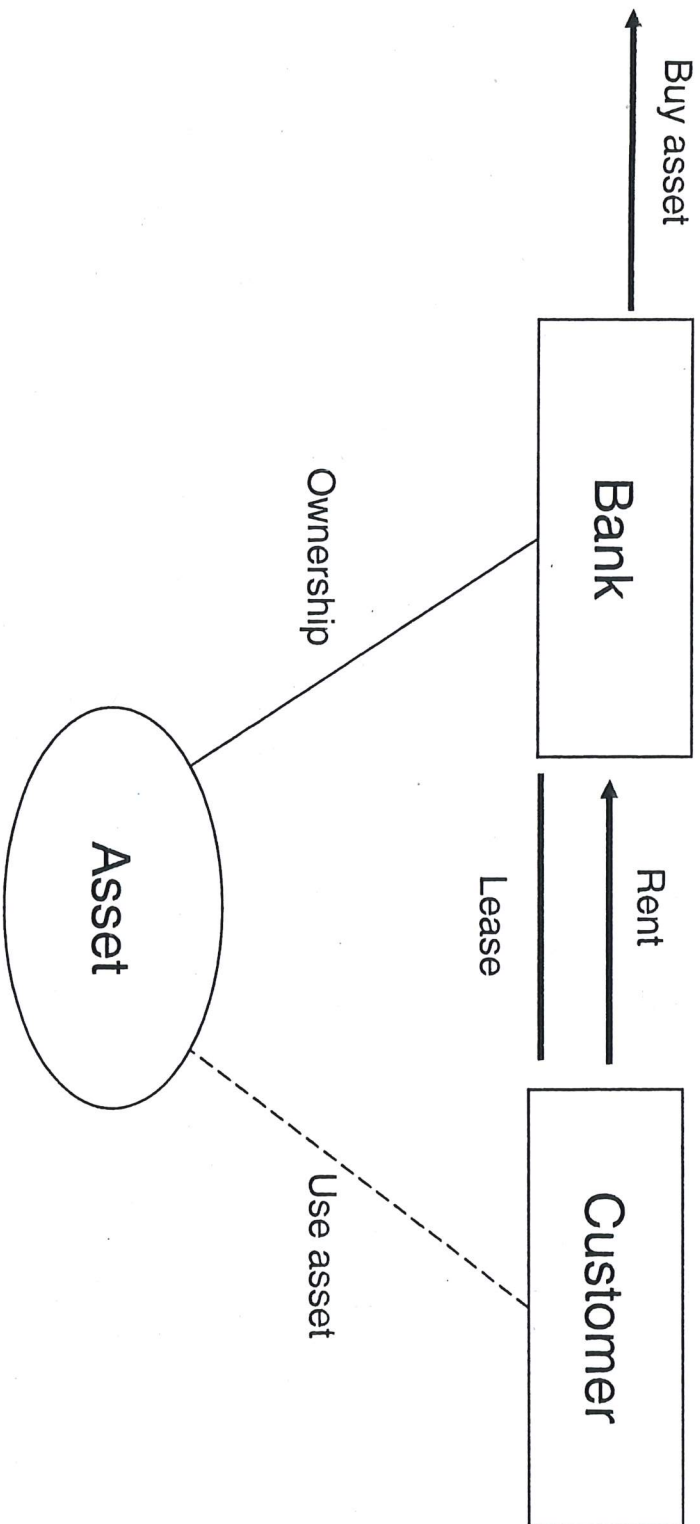


# Diminishing Musharaka

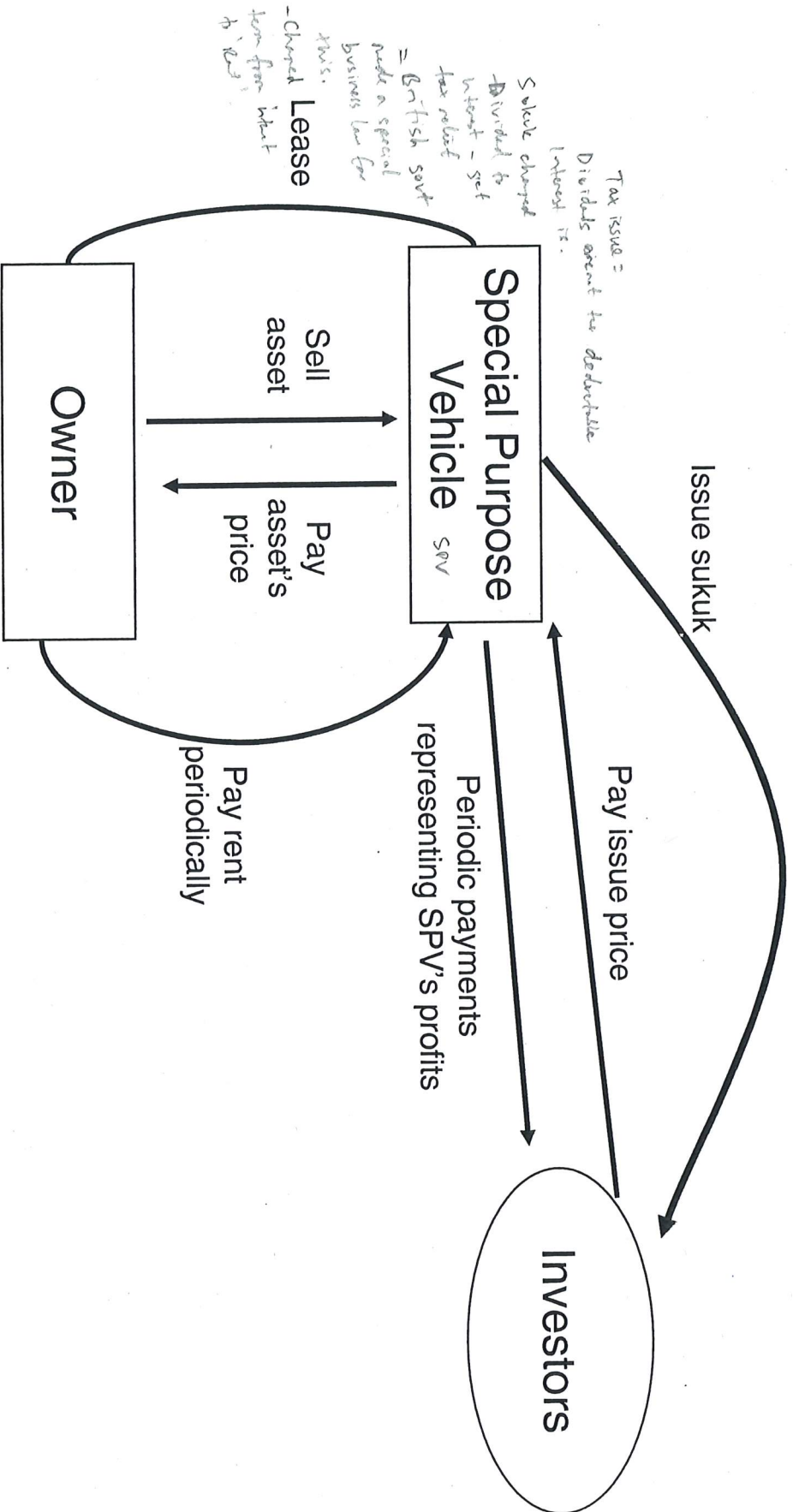


# Ijara

(Islamic Mortgage)



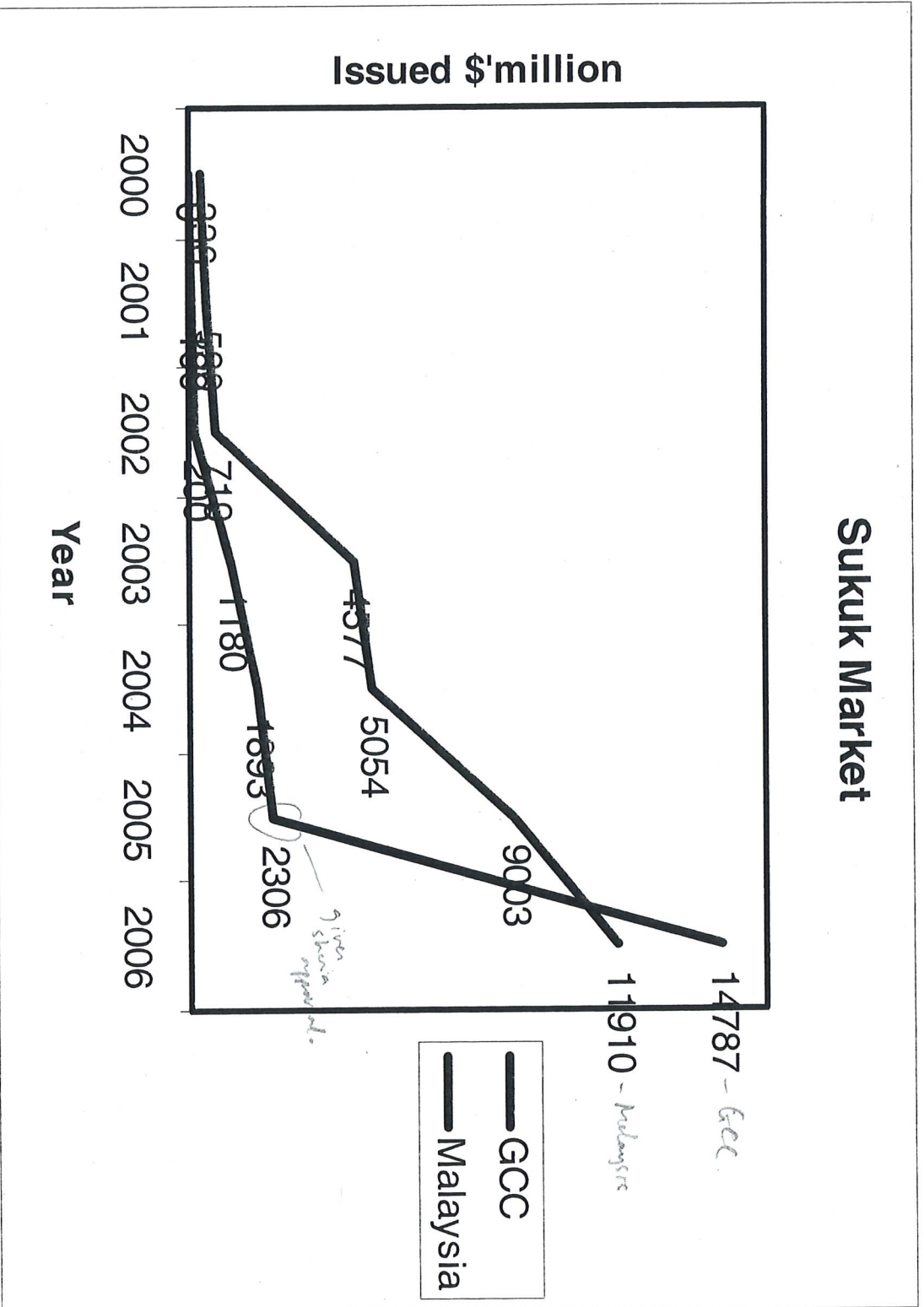
# Sukuk (ijon sukuk)



## **Sukuk mechanics**

1. Owner of asset will want to use this asset to raise finance
2. Owner sells asset to SPV
3. SPV raises cash to pay for the asset by selling sukuk to outside investors
4. SPV rents the asset back to original owner. Rent used to make periodic payments to the investors on the Sukuk bonds. (Not interest but profit paid)
5. Unwind when sukuk rents are due to be repaid
6. Owner buys back from SPV
7. SPV uses the proceeds to redeem the sukuk.

# Malaysian vs GCC sukuku



## Sukuk – Notable Issues / to-be-issued

*— choosing paper dollar = new long thing*

- February 2008 - Japan Bank for International Cooperation (JBIC) plans to issue a sovereign Sukuk on behalf of the Japanese government at an issuance size of between US\$300 million and US\$500 million. The Sukuk will be domiciled in Malaysia, but issued in US dollars.
- Sri Lanka - People's Leasing Company (PLC) plans to raise more than LKR500 million (US\$4.6 million) through Shariah compliant asset-backed securities. The lead arrangers for the landmark Sukuk are First Global Group and Investec Capital.
- Sudan will issue its first sovereign Sukuk worth US\$147 million, via Bahrain-based Sudan Salam Sukuk Company. The Sukuk will mature in 2010, and is expected to attract Middle East investors looking to invest out of the US.
- Q2 2008 – Islamic Bank of Thailand Sukuk Ijarah of USD189 million
- A US company entered the sukuk market for the first time with East Cameron Gas Company's up to USD166 million issue in July 2006 to consolidate assets and fund development of gas fields. The sukuk was also the first Islamic bond using hydrocarbon reserves as an asset class
- Saxony Anhalt Trust (Germany) – USD120 million in 2004



## **The UK viewpoint**

'As I understand the basic principle, it is that making money out of money is contrary to Islamic law - that wealth should accumulate for participation in trade and ownership of real assets. The Bank of England entirely respects that perception and we can readily see the connection of the teachings of the Qur'an about social responsibility and cohesion. Even within a purely secular context we can understand how such an approach can help finance of industry and trade.'

**Eddie George - Governor Bank of England**

## **UK regulation: Financial Services Authority (FSA)**

UK emerging as global hub for Islamic finance

*Reasons for growth of Islamic Finance in UK:*

1. Global expansion of IF
2. Markets and skills base
3. Islamic windows *qibla/mosque/banks*
4. Excess liquidity in the Middle East
5. Public policy and taxation
6. Single financial regulator

## **UK Islamic Banks**

Three Licensed Banks - will increase to 20-21

1. Islamic Bank of Britain (2004)
2. European Islamic Investment Bank (2006)
3. Bank of London and the Middle East

Plus many windows (Al Burag, Al Meezan, Amanah and so on)

## **UK taxation on of Islamic finance transactions**

**New tax law FA 2005 & 2006**

- **Language religion free (relax Archbishop Williams!)**
- **Key concepts**
- **Alternative finance arrangements**
  - (a) **Alternative finance return**
  - (b) **Profit share return**
- **“Equate(s), in substance, to the return on an investment of money at interest”**

## Billionaires of Middle East

World Rank	Name	Citizenship	Age	Net Worth (USD Billion)
62	Naquib Sawiris	Egypt	52	10
158	Onsi Sawiris	Egypt	77	5.0
226	Nassef Sawiris	Egypt	Na	3.9
664	Samih Sawiris	Egypt	50	1.5
52	Nasser al-Kharafi & family	Kuwait	63	11.5
618	Bassam Alghanim	Kuwait	Na	1.6
618	Kutayba Alghanim	Kuwait	60	1.6
717	Mohamed Al-Bahar	Kuwait	Na	1.4
13	Prince Alwaleed bin Talal Al Saud	Saudi Arabia	50	20.3
86	Mohammed Al Amoudi	Saudi Arabia	61	8
97	Maan Al-Sanea	Saudi Arabia	52	7.5
99	Sulaiman Al Rajhi	Saudi Arabia	87	7.4
188	Saleh Al Rajhi	Saudi Arabia	95	4.4

## Billionaires of Middle East (cont'd)

World Rank	Name	Citizenship	Age	Net Worth (USD Billion)
249	Salah Kamel <i>(Founder)</i>	Saudi Arabia	65	3.5
279	Khalid Mahfouz & family	Saudi Arabia	60	3.1
349	Abdullah Al Rajhi	Saudi Arabia	Na	2.6
407	Saad Hariri	Saudi Arabia	36	2.3
618	Ayman Hariri	Saudi Arabia	28	1.6
668	Mohammed Al Rajhi	Saudi Arabia	Na	1.7
717	Sulaiman Algosaibi	Saudi Arabia	Na	1.4
891	Mohamed bin Issa Al Jaber	Saudi Arabia	48	1.0
86	Abdul Aziz Al Ghurair & family	UAE	53	8.0
287	Abdulla Al Futtaim	UAE	Na	3.0
369	Majid Al Futtaim	UAE	Na	2.5
369	Khalaf Al Habtoor	UAE	57	2.5
891	Mahdi Al-Tajir	UAE	74	1.0

Source : Forbes list

# Demographics

## Sovereign Wealth Funds

Country	Fund	Assets (USD billion)	Inception Year
UAE	ADIA	875	1976
Norway	Government Pension Fund - Global	380	1996
Singapore	GIC	330	1981
Saudi Arabia	Saudi Arabian funds of various types	300	n/a
Kuwait	Reserve Fund for Future Generations	250	1953
China	State Forex Inv. Corp + Central Huijin	200	2007
Singapore	Temasek Holdings	159.2	1974
Libya	Oil Reserve Fund	50	2005
Qatar	Qatar Investment Authority	50	2005
Algeria	<i>Fond de Regulation des Recettes</i>	42.6	2000
US (Alaska)	Permanent Fund Corporation	38	1976
Brunei	Brunei Investment Agency	30	1983
Others	-	171.4	-
<b>Total</b>		<b>2,876.3</b>	

Source : Morgan Stanley

Dec, 2007 - Saudi Arabia is set to overtake the \$900 billion sovereign wealth fund (SWF) of Abu Dhabi by setting up the largest SWF in the world, according to a Financial Times report.



## Sovereign Wealth Funds - Others

<b>Country</b>	<b>Fund</b>	<b>Assets (USD billion)</b>
Canada	Alberta Heritage Savings Trust Fund	15
Chile	Economic and Social Stabilisation Fund Pension Reserve Fund	9.83 1.37
Botswana	Pula Fund	over 5b
Dubai, UAE	Isithmar	3
Malaysia	Khazanah	18.3
Australia	Australian Future Fund	40
Russia	Stabilisation Fund	32
South Korea	Korea Investment Corporation	20

## SWF – Most Notable Deals of 2008 &amp; 2007

Date	SWF	Deal
Jan 15, 2008	Singapore, Kuwait, South Korea	Provided \$21 billion lifeline to Citigroup and Merrill Lynch, two banks that have lost fortunes in America's credit crisis
Dec 24, 2007	Temasek	Merrill Lynch says it will sell a stake in itself of at least \$4.4 billion, and up to \$5 billion, to Temasek Holdings, of which Temasek will hold less than 10% of Merrill and have no voting control. Merrill also agreed to sell a \$1.2 billion stake to domestic investors
Dec 10, 2007	Government of Singapore Investment Corp	UBS AG announces that the Government of Singapore Investment Corp. is investing \$9.75 billion for a 9 % in the Swiss banking giant, while an undisclosed strategic investor in the Middle East is contributing \$1.77 billion in UBS AG.
Nov 26, 2007	ADIA	Abu Dhabi Investment Authority, the sovereign investment fund of the Gulf Arab state, acquires a 4.9 percent stake in Citigroup Inc., the largest U.S. bank, for \$7.5 billion.
Nov 7, 2007	Central Huijin Investment Co.	China's largest state-owned investment arm, acquires 71 % of China's joint-stock China Everbright Bank for \$2.7 billion.

## SWF – Most Notable Deals of 2007

Date	SWF	Deal
Oct 29, 2007	Dubai International Capital	Dubai International Capital, owned by Dubai-ruler Sheikh Mohammed bin Rashid Al Maktoum, acquires 9.9% outstanding equity stake in Och-Ziff Capital Management Group, a U.S.-based hedge fund, for more than \$1.1 billion. Och-Ziff goes public in November on the New York Stock Exchange.
Oct 22, 2007	Citic Securities Co.	China's government-controlled Citic Securities Co. and U.S. investment bank Bear Stearns Cos. agree to invest \$1 billion in each other for minority stakes that could be expanded. They will also operate a 50-50 joint venture in Hong Kong to offer capital markets services across Asia.
Sept 20, 2007	Qatar Investment Authority	Qatar's sovereign investment fund, acquires a 20% stake in the London Stock Exchange and nearly 10 percent of Nordic bourse operator OMX AB.
Sept 20, 2007	Mubadala Dev. Co.	Abu Dhabi-based Mubadala Development Co., an investment arm of the Abu Dhabi government, buys a 7.5% stake of the management operations of one of the world's largest private-equity firms, Carlyle Group, for \$1.35 billion

## SWF – Most Notable Deals of 2007

Date	SWF	Deal
July 23, 2007	China Dev. Bank & Temasek	China Development Bank, a Chinese state agency, agrees to pay \$3 billion for a 3.1 % stake in British bank Barclays PLC, and Temasek Holdings, a sovereign wealth fund in Singapore, agrees to pay \$2 billion for a 1.77 % stake in Barclays.
July 13, 2007	Dubai International Capital	Purchases a 2.87 % stake in one of India's largest banks, ICICI Bank Ltd., for \$750 million.
May 20, 2007	China state investment company	Agreed to pay \$3 billion for a 10 percent stake in U.S. private equity firm Blackstone Group LP. The Chinese investment company agreed to buy nonvoting shares in Blackstone concurrent with Blackstone's initial public offering.
May 2, 2007	Dubai International Capital	Bought an undisclosed stake in British bank HSBC Holdings PLC.

## Demographics

### GCC & South East Asia

	Population - millions (July 2007)	GDP - (USD billion) (2006 est.)	GDP per capita (USD) (2006 est.)	GDP real growth (%) (2006 est.)
<b>Saudi Arabia</b>	27.6	371	13,800	4.3
<b>UAE</b>	4.4	130	49,700	8.9
<b>Kuwait</b>	2.5	56	23,100	12.7
<b>Qatar</b>	0.9	26	29,800	7.1
<b>Oman</b>	3.2	45	14,400	6.6
<b>Bahrain</b>	0.7	17	25,600	7.1
<b>India</b>	1,129.0	4,164	3,900	9.4
<b>China</b>	1,321.0	1,021	7,800	11.1
<b>Malaysia</b>	24.8	313	12,800	5.9
<b>Thailand</b>	65.0	597	9,200	5
<b>Indonesia</b>	234.6	948	3,900	5.5

source : CIA The World Factbook

Demographics

Crude Oil Daily Revenue - 2006 *(Based on \$61 barrel - see note row)*

	Daily Production ('000 barrel)	Daily Revenue (USD'000) *
NORTH AMERICA	6,481	396,000
LATIN AMERICA	10,214	624,000
EASTERN EUROPE	11,532	704,000
WESTERN EUROPE	4,497	275,000
MIDDLE EAST	23,000	1,402,000
Bahrain	183	11,000
Iraq	2,020	123,000
Kuwait	2,700	163,000
Oman	687	42,000
Qatar	803	49,000
Saudi Arabia	9,200	562,000
UAE	2,600	157,000
Brunei	198	12,000
China	3,700	224,000
India	676	41,000
Indonesia	883	54,000
Malaysia	703	43,000

\*Based on average crude oil price of USD61 per barrel

## Demographics

### Indications of Muslim Affluent Globally

#### Middle East

- Personal wealth is expected to rise to \$2.2 trillion by 2011 from \$1.4 trillion in 2006, Merrill Lynch and Capgemini said in a 2007 world wealth report.
- The number of millionaires in the region, in dollar terms, rose 11.9% to more than 300,000 last year, according to the report.

#### United States

- Muslims with disposable income estimated at USD170 billion yearly (mid-2007)

#### Germany

- Is home to some 3.2 million Muslims (estimated to reach 7 million by 2020)
- Majority is of Turkish descent — 2.4 million, constituting around 75% of German Muslims or 2.91% of Germany's populations.
- Their annual net income is estimated at €10.5 billion to €13 billion (US\$15.29 billion to US\$18.93 billion).

## Demographics

### Indications of Muslim Affluent Globally (cont'd)

The magnitude of philanthropic donations in Muslim communities is estimated to total between \$250 billion and \$1 trillion annually.

*Usaid, Zakat, The Muslim World Series, September 2005*

We estimate there is not less than \$200 billion in Muslim-owned assets under management in Geneva alone, probably the largest concentration of Muslim wealth anywhere in the world.

*John A. Sandwick, Encore Management S.A.*

The number of GCC wealthy individuals (with liquid wealth in excess of USD 50,000) is expected to increase to over 387 thousand in 2007 from 311 thousand in 2003. Additionally, analysis indicates that the total liquid wealth held by them is expected to grow to USD 80 billion in 2007 from USD 61 billion in 2003.

*Executive Summary for the Ernst & Young Islamic Funds and Investments Report  
2007*