CAPCO

ISLAMIC FINANCE HANDBOOK

APPLICATIONS FOR EVERYDAY FINANCE

CHALLENGING CONVENTION

ISLAMIC FINANCE EXPLAINED

Islamic Finance is one of the fastest growing areas in the financial services industry in the world, with expectations of reaching $3.69 trillion in assets by 2024, up from $2.5 trillion in 2018[1]. This type of finance prioritizes sustainable and ethical wealth generation.

5 CORE PRINCIPLES OF ISLAMIC FINANCE

ETHICAL

NO INVESTMENTS ARE PERMITTED IN FORBIDDEN INDUSTRIES ('HARAM') – ALCOHOL, GAMBLING, PORNOGRAPHY, WEAPONS.

JUST

NO SPECULATIVE EXPLOITATION FROM (LEGAL) UNCERTAINTY OR ABUSE OF UNFAIR ADVANTAGES.

CERTAINTY

THERE CAN BE NO ELEMENTS OF UNCERTAINTY IN ASSET QUALITY, PRICE OR DELIVERY.

RIBA

'INTEREST' IS NOT PERMITTED TO BE PAID OR RECEIVED.

TANGIBLE

ALL FINANCIAL PRODUCTS MUST BE TANGIBLE OR ASSET-BACKED.

While Islamic Finance rests on the application of Shariah law, it's core principles strongly align with sustainable and ethical finance and is thus, open to everyone. In this playbook, we aim to delve into the differences between conventional and Islamic Finance and why the latter is an attractive option for consumers. We will also assess the nuances of Islamic Finance instruments, debunking common misconceptions along the way.

1. https://www.bnymellon.com/us/en/insights/all-insights/the-growing-global-appeal-of-islamic-finance.html

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CONVENTIONAL BUSINESSES VENTURING INTO THE ISLAMIC UNKNOWN

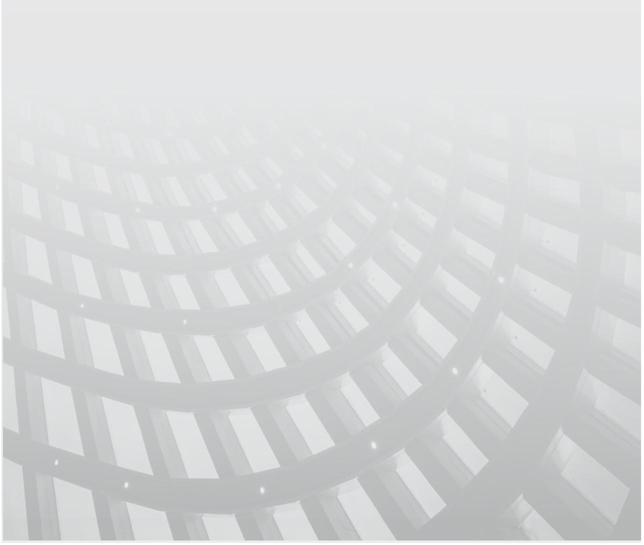
Islamic Finance encompasses the ideals of fair trading, the sustainable spending of wealth and the belief that businesses have a duty to support their local communities. Although only 1% of global assets are backed by Islamic Finance, Islamic Finance witnessed growth of 11.4% in 2019[2] - a global expansion more rapid than conventional finance.

SCENARIO

A high street bank wants to offer Islamic Finance services to capitalize on this growing trend. So, what does the bank need to do to be Shariah-compliant in these services?

WHAT IS REQUIRED

- Preferably a seperate entity must be set up
- Segregation of money from the parent entity – requiring a separate balance sheet
- The Islamic Finance team should ideally be segregated from other teams.



APPROACH

There are four key areas that practitioners and supervisors need to appreciate for Islamic Finance to be successfully introduced into a conventional system.

1. Compliance with Shariah

Shariah is the law, and moral code, that governs how Islamic business should operate, and outlines acceptable risks, details profit-sharing, prohibits interest payments, and encourages ethical investments for the greater good of society.

Shariah compliance will be required against riba (interest), gharar and maisir (contractual uncertainty and gambling), and haram industries (prohibited industries such as those related to pork products, pornography or alcoholic beverages).

2. Segregation of Islamic and conventional funds

Islamic funds should be kept separate from conventional funds to ensure that the Shariah principles applied can be overseen and monitored.

In practice, this requires banks to establish different capital funds, accounts, and reporting systems for each type of activity. In this sense then, when a conventional bank opens an Islamic window, to a large degree, it is in fact establishing a separate entity from the rest of the bank.

2. https://www.salaamgateway.com/story/islamic-finance-to-show-low-to-mid-single-digit-growth-in-2020-2021-sp

3. Accounting standards

In jurisdictions where Islamic Finance is still nascent, regulators and financial institutions should familiarize themselves with the standards set by the AAOIFI (the Accounting and Auditing Organisation for Islamic Financial Institutions) and apply them to the maximum extent possible.

4. Awareness campaigns

Consumers should be duly informed of all the risks they run when entering new contracts, as the public will have a better understanding of conventional deposits than of Islamic deposits (such as Mudaraba, safekeeping, etc.)

Regulators should create dedicated working groups to look at Islamic Finance initiatives. These working groups can be the liaison between Islamic finance institutions and governments. This is high on the agenda for the Bank of England, which regulates financial institutions through the Prudential Regulation Authority.

Regulators should also require institutions offering Islamic products to actively pursue awareness campaigns.

P2P FINANCING: ASSET BACKED AND STRENGTHENED

Peer-to-peer (P2P) lending enables an individual to obtain a loan directly from another individual, cutting out the traditional bank as the middleman, and is usually facilitated through an online platform i.e. app/website. P2P platforms will match you with a borrower (or multiple borrowers), and begin distributing your loan. You - as the lender - will begin to acquire interest once this loan has been dispersed. Regular payments from the borrower will be processed via the platform to the lender. Since interest is deemed as forbidden in Islamic Finance, pre-determined profits are offered to investors and the financing model is backed by an asset.

SCENARIO

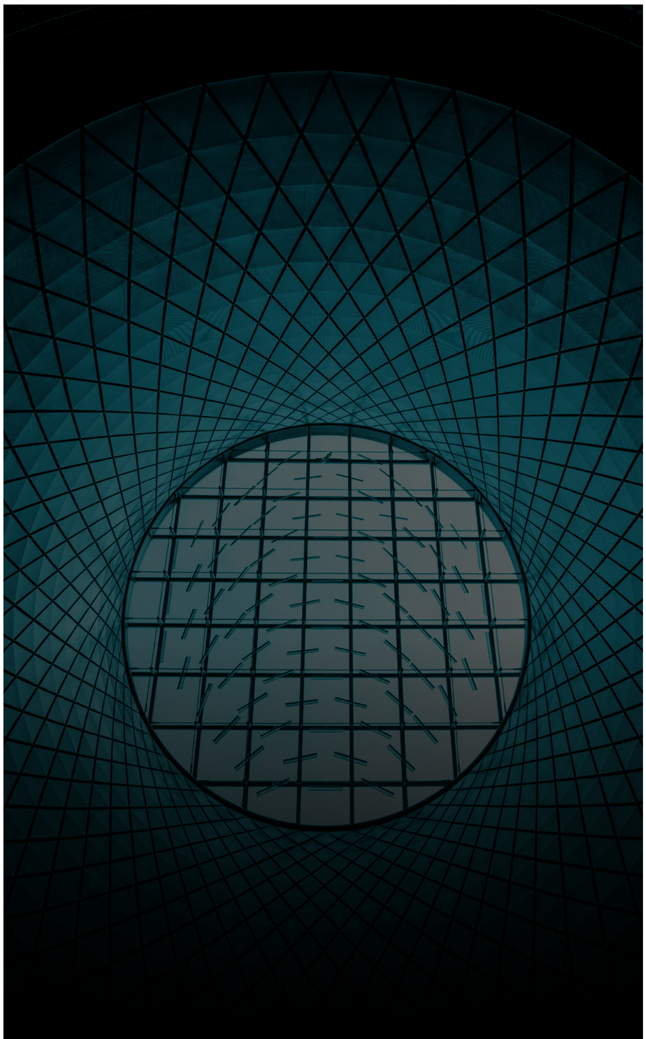
Rahul wants to buy hardware for his company. He wishes to join a P2P funding platform with the target of raising $75,000. He is happy to offer 5% returns on investment. Can this service be offered in a Shariah-compliant way?

WHAT IS REQUIRED

- A **Murabaha Master Agreement** brings together Rahul, the platform, and the investors (crowd) in an understanding that a Murabaha contract will be executed. Once the Master Agreement is concluded, the crowdfunding can begin
- The lenders and suppliers need to be vetted by the platform.

APPROACH

- First, the Crowd, our investors, visit the platform
- After visiting the platform, the investor signs the Murabaha Master Agreement which will allow them to invest in Rahul
- They invest though the platform
- When that investment reaches Rahul, the investors are able to purchase the asset that they have sought finance for, this would be made apparent to the investors on the online platform
- After they purchase the asset from the supplier, using the cash provided from the crowd, the supplier will transfer the ownership of that asset to the crowd
- The asset belongs to the crowd since it was purchased with their money, however, the asset will be utilised by Rahul as he is the end user
- So now at this stage, the crowd owns the asset, but the physical asset is with Rahul
- Rahul will issue an offer to buy the asset from the Investors, who will, of course, accept as this was previously agreed in the Murabaha Master Agreement
- This transfers the asset ownership to Rahul, and in exchange, Rahul will send the payout to the crowd
- Thereafter, the contract of P2P financing has been completed, from the investors to Rahul, via the platform
- On completion of the transaction, the investors will get their principal plus 'the markup'. This is as a result of the asset being sold to Rahul at an additional price on top of the initial amount paid to the supplier
- That additional markup when the crowd sells to Rahul will be the profit to the crowd



KEY DIFFERENCES COMPARED TO CONVENTIONAL FINANCE

- The conventional P2P structure only requires two parties whereas in order to be Shariah compliant, you will need a third party or merchant in place to ensure that the transaction is asset backed. The merchant will take the money from the lender and provide the asset to the borrower, essentially providing a marketplace
- Central to Islamic Finance is the fact that money itself has no intrinsic value; it is a medium of exchange. Therefore, Shariah compliant businesses cannot directly lend money; there needs to be an asset involved.

THE ANGEL INVESTOR PARTNERSHIP

Mudaraba is a partnership in profit whereby one party provides capital, and the other party provides skill and labor.

When you get a loan from a conventional bank and things go wrong, the lender's main priority is to recover its money, even if that means leaving the entrepreneur destitute. Islamic investors, on the other hand, have the obligation to share in both the risks and the rewards when offering investment opportunities to businesses. In this section, we share how Mudaraba differs from an angel investor scenario.

SCENARIO

Mohsin wants to start a business. His wealthy friend, Ceyda, offers a Mudaraba structure. What are the various terms and conditions offered to set this up? In this scenario, Ceyda is the owner of the capital and Mohsin is the entrepreneur.

CONSIDERATIONS

- The term Mudaraba refers to a form of business contract in which one party brings capital and the other personal effort
- The proportionate share in profit is determined by mutual agreement
- But the loss, if any, is borne only by Ceyda, in which case Mohsin gets nothing for his labor
- As a matter of principle, Ceyda does not have a right to interfere into the management of the business enterprise which is the sole responsibility of Mohsin
- However, Ceyda has every right to specify such conditions that would ensure better management of her money. That is why sometimes Mudaraba is referred to as a sleeping partnership

APPROACH

- As a financing technique adopted by Islamic banks, it is a contract in which all the capital is provided by the Islamic bank while the business is managed by the entrepreneur
- The profit is shared in pre-agreed ratios, and loss, if any, unless caused by negligence or violation of terms of the contract by the 'mudarib' (the entrepreneur) is borne by the Islamic bank/investor
- The bank passes on this loss to the depositors

KEY DIFFERENCES COMPARED TO CONVENTIONAL FINANCE

- Loss to be only borne by the investor, whereas profits are shared as per mutual agreement
- Investors typically bring years of expertise to the table of a startup and they already understand what it takes to bring success when starting a business

JOINT PARTNERSHIPS, BUT WITH LESS RISK

Musharaka is a joint enterprise structure where partners share in the profits and losses of an enterprise. Musharaka plays a vital role in financing business operations based on Islamic principles. In this section, we share how Musharaka differs from a 'conventional' joint partnership.

SCENARIO

Mohammed wants to start a business. He has $20,000 and needs an additional $80,000. He meets Leena, who also wants to start a similar business. Leena puts in $80,000 and co-owns the business. What are the various terms and conditions offered to set this up?

WHAT IS REQUIRED

- Musharaka is a joint enterprise or partnership structure in Islamic Finance in which partners share in the profits and losses of an enterprise
- Since the Shariah does not permit profiting from interest in lending, Musharaka allows for the financier of a project or company to achieve a return in the form of a portion of the actual profits according to a predetermined ratio, based on investment amount
- However, unlike a traditional creditor, the financier also will share any losses should they occur, also on a pro rata basis
- Vetting of person and purpose – bilateral
- Capital is not required to be mixed, nor does it necessarily need to be in liquid form

APPROACH

- Mohammed invests $20,000 and Leena invests $80,000 into this new business
- After year 1, there will be a review of profits. The parties share profits on a pre-agreed ratio
- If there is a loss, Mohammed will absorb 0.2 (Loss) and Leena will absorb 0.8 (Loss)

KEY DIFFERENCES COMPARED TO CONVENTIONAL FINANCE

- Musharaka are not binding contracts; either party can terminate the agreement unilaterally
- Loss is distributed exactly according to the ratio of investment and the profit is divided according to the agreement of the partners

HOW AN IJARA MORTGAGE DIFFERS FROM AN INTEREST-ONLY MORTGAGE

Ijara is a term referring to the leasing element of a home purchase plan. In the UK, an Ijara mortgage would function similar to to an interest-only mortgage.

SCENARIO

Saad wants to buy an apartment in Marble Arch and approaches Al-Rayan Bank for an Ijara mortgage. The apartment is £500,000 and he has a 25% deposit. What are various terms and conditions offered by the bank?

KEY NOTES

- Islamic or halal mortgages aren't technically mortgages at all, as borrowing and lending money with interest isn't allowed under Islamic law
- Islamic mortgages are regulated by the Financial Conduct Authority (FCA)

APPROACH

- Over the agreed finance term, Saad will make monthly rental payments (for use of the bank's 75% share of the property)
- Saad will agree to acquire the bank's 75% share of the property at the end of the finance term either by using his savings, or selling the property and paying the bank from the proceeds
- If you have a rent-only product, it's your responsibility to look after any financial arrangements that you expect will provide a lump sum big enough for you to buy the bank's share at the end of the contract
- When the bank's entire share is acquired, the property transfers into Saad's name

KEY DIFFERENCES COMPARED TO CONVENTIONAL FINANCE

- An Islamic Home Finance plan differs from a conventional mortgage loan because under Shariah Law it is forbidden to charge interest on a loan, so in this case, banks will buy the property on your behalf and rent or lease it back to you for a profit, rather than paying a rate of interest to the bank
- All Islamic Finance providers in the UK use the Libor Index as the benchmark for rental payments, and rental rates are reviewed every six months
- Islamic banks will not invest in firms involved with gambling, alcohol, tobacco or pornography

HOW A DIMINISHING MUSHARAKA HOME PURCHASE PLAN DIFFERS FROM A CONVENTIONAL MORTGAGE

Musharaka is essentially a co-ownership agreement. This means that the customer and the bank or building society own the property together, with separate stakes. Each repayment is part rent and part capital (and part charges). A non-Muslim may be interested in an Islamic home purchase plan if they are conscious of how their provider will invest their money. Any investments viewed as harmful to humanity or the environment would not take place via an Islamic Finance provider.

SCENARIO

Saad wants to buy an apartment in Marble Arch and approaches Al-Rayan for a **Diminishing Musharaka** mortgage. The apartment is £500,000 and he has a 25% deposit. What are various terms and conditions offered by the bank?

CONSIDERATIONS BEFORE GOING FORWARD

- Islamic or halal mortgages aren't technically mortgages at all, as borrowing and lending money with interest isn't allowed under Islamic law
- HPPs, halal home purchase plans, enable a financial institution to buy a property and then lease it back to you in the form of rent
- Diminishing Musharaka, also known as the Home Purchase Plan, is the standard Islamic mortgage for residential mortgages
- Islamic mortgages are regulated by the FCA

KEY DIFFERENCES COMPARED TO CONVENTIONAL FINANCE

- In an Islamic mortgage the buyer enters into a partnership agreement with the bank and a rental agreement as well. In a conventional mortgage the primary agreement is that of the secured loan
- Islamic Home Finance differs from a conventional mortgage loan because under Shariah Law it is forbidden to charge interest on a loan, so in this case, banks will buy the property on your behalf and rent or lease it back to you for a profit, rather than paying a rate of interest to the bank
- Under the conventional financial system, interest is charged which is determined on the basis of demand and supply of the capital while under the Islamic financial system rent of the property is charged, determined via demand and supply of a real asset
- All Islamic Finance providers in the UK use the Libor index as the benchmark for rental payments, and rental rates are reviewed every six months
- Islamic banks will not invest in firms involved with gambling, alcohol, tobacco, or pornography

APPROACH

- The HPP provider (Al Rayan, in this case) uses a combination of freehold and leasehold to deliver a Diminishing Musharaka/Ijara model
- Over the agreed finance term, Saad will make a monthly payment consisting of a rental payment (for use of the bank's share of the property) and acquisition payments (to increase Saad's share in the property)
- With each acquisition payment, Saad's share increases, and the bank's diminishes
- When all the payments are made, the property transfers into Saad's name

SUKUK, THE 'BOND' THAT GIVES BACK

Sukuk are financial certificates, similar to bonds, which comply with the principles of Islamic Finance. The UK has bolstered its position as a world leader in Islamic Finance by issuing its second sovereign Sukuk in March 2021.[3] This second issuance attracted high-quality global demand, with orders totaling in excess of £625 million[4], and was sold to a broad range of high-quality institutional investors around the world.

CONSIDERATIONS BEFORE GOING FORWARD

- Since the traditional conventional interest-paying bond structure is not permissible, the issuer of a sukuk essentially sells an investor group a certificate, and then uses the proceeds to purchase an asset that the investor group has direct partial ownership interest in
- The issuer must also make a contractual promise to buy back the bond at a future date at par value
- Financing can only be raised for identifiable assets
- The sukuk issued in global capital markets have been predominantly structured as trust certificates, typically governed by English law
- Alternative structures have begun to emerge so as to allow for sukuk transactions to be carried out in accordance with local laws

KEY DIFFERENCES COMPARED TO CONVENTIONAL FINANCE

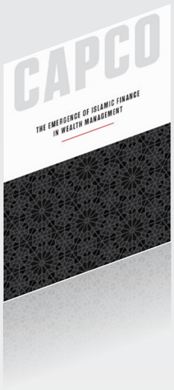
- Islamic law prohibits 'riba', or what we understand as 'interest' in conventional finance. Sukuk were created in order to link the returns and cash flows of debt financing to a specific asset being purchased, effectively distributing the benefits of that asset
- Sukuk involves a direct asset ownership interest, while bonds are indirect interest-bearing debt obligations
- Both sukuk and bonds provide investors with payment streams, however income derived from a sukuk cannot be speculative
- An investor in a sukuk, therefore, does not own a debt obligation owed by the bond issuer, but instead owns a piece of the asset that's linked to the investment
- Sukuk holders, unlike bond holders, receive a portion of the earnings generated by the associated asset

3. https://www.gov.uk/government/news/uk-bolsters-islamic-finance-offering-with-second-sukuk
4. https://www.gov.uk/government/news/uk-bolsters-islamic-finance-offering-with-second-sukuk

HOW WE CAN HELP

Capco's Islamic Finance Practice leverages the core principles of Shariah law in transformation projects for both Islamic and non-Islamic financial institutions. We help firms to build and deploy front-to-back offerings with technology solutions at its core, allowing us to provide end-to-end support for financial institutions seeking to bring innovative offerings to the market.

Please feel free to contact us about your business needs and discover our other thought leadership publications on Islamic finance on capco.com



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ABOUT CAPCO

Capco is a global technology and management consultancy dedicated to the financial services industry. Our professionals combine innovative thinking with unrivalled industry knowledge to offer our clients consulting expertise, complex technology and package integration, transformation delivery, and managed services, to move their organizations forward.

Through our collaborative and efficient approach, we help our clients successfully innovate, increase revenue, manage risk and regulatory change, reduce costs, and enhance controls. We specialize primarily in banking, capital markets, wealth and asset management and insurance. We also have an energy consulting practice in the US. We serve our clients from offices in leading financial centers across the Americas, Europe, and Asia Pacific.

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