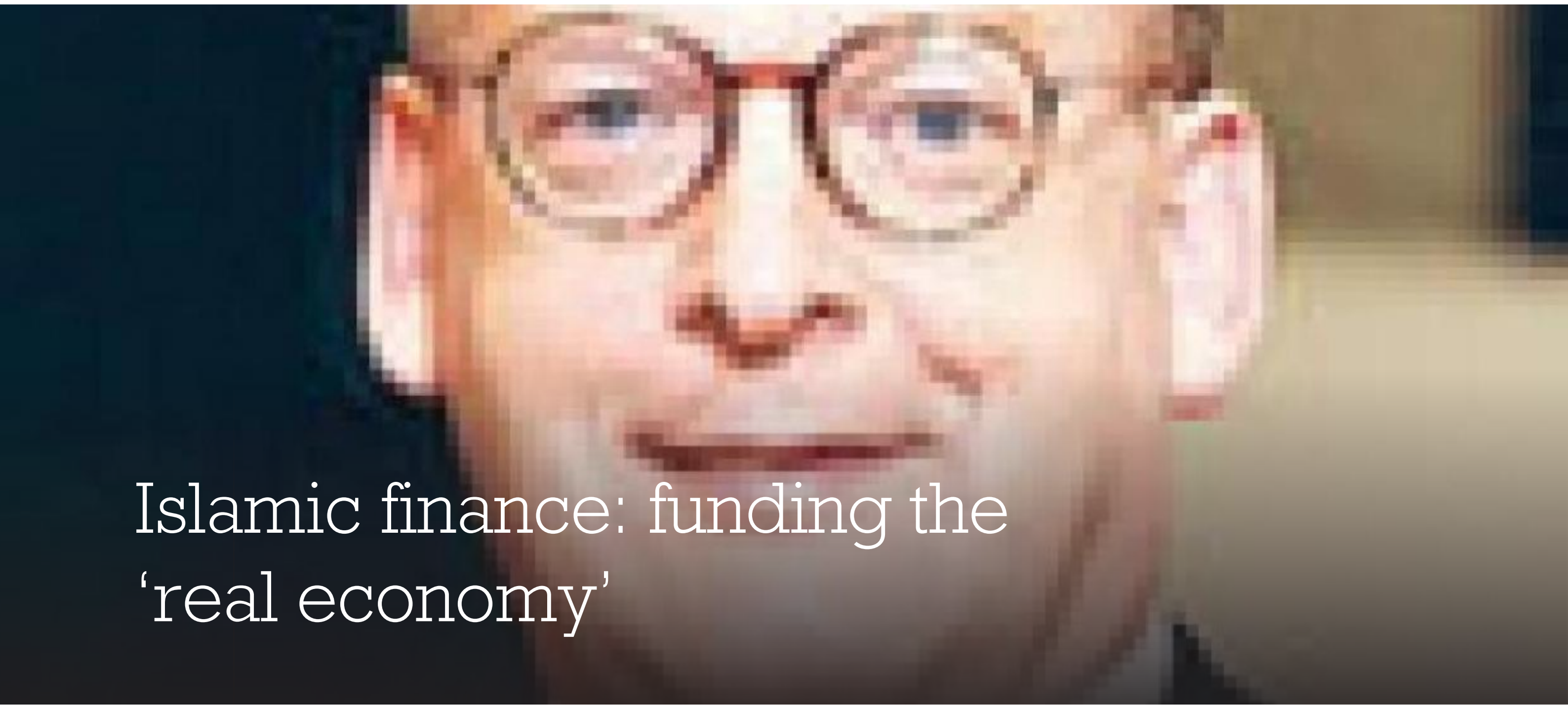

Islamic finance: funding the 'real economy'

The global financial crisis presents an opportunity for the Islamic finance industry to show its credentials, say several practitioners in the field. Speaking to INSEAD Knowledge at the 6th International Islamic Finance Conference here, Daud Vicary Abdullah, COO of Asian Finance Bank, says "the biggest opportunity really is around getting the messages across about the value-proposition of Islamic products and the way in which Islamic finance is done."

Wary investors would perhaps find the more prudent nature of Islamic financing attractive. Based on the principles of Shariah or Islamic law, Islamic banks are not permitted to charge interest; instead they form a partnership with their customer to invest in assets, and share the profits. As **Vaseehar Hassan Abdul Razack**, chairman of Unicorn International Islamic Bank told INSEAD Knowledge in an interview on the sidelines of the school's Leadership Summit Asia 2008, Islamic banks "will follow through exactly what you want to do and be your partner holding your hands from day one, until the project is completed, and then make sure it is properly completed and that the cash flows are generated according to what they are projected, and then they share an equitable proportion of the profit."

In addition, Islamic banks will invest only in tangible assets, he says. "Islamic banks will never finance any paper trading activities or debts. We will only participate in a specific, tangible asset development; whether it's highways or power projects or transportation."

Even for smaller investments, such as the purchase of a house, the value of the asset must be measured not in dollar terms but in terms of the current price of another tangible good.

Yahia Abdul Rahman, chairman and CEO of both LARIBA American Finance House and the Bank of Whittier, says this method of mark-to-market is much more prudent as the dollar price may be overvalued. "I bought my house in 1974 for $46,000 and sold it in 1977 for $65,000. I did very well on my house: $19,000 in two years. That's a fantastic rate of return in dollars, but you know how much I made in gold? 1.28 per cent, because the gold price has changed."

Rahman advocates assessing value in terms of commodities, whether rice, gold, wheat or oil. "Thailand produces rice and buys oil … so it makes sense for them to think about the price of oil in terms of how much rice can be exchanged for each barrel."

Rahman attributes LARIBA's low bad debt rates to the stringent measures the bank takes before making an investment with a client: "Our delinquency rate is, after 30 days, less than 0.25 per cent, compared to [2 months ago] 3 per cent and now 6 per cent. You know why? Because we mark every house to the market. If a similar home rents for a stated price and the rate of return on the investment does not qualify investing in this home, we reject it. We do not finance everybody. We reject (some)."

Islamic finance is currently estimated to be growing at an average of 15 per cent annually. The chairman of Unicorn concedes that Islamic financial institutions will not grow at the rates seen in conventional finance because Islamic banks fund only the 'real economy': "One of the key factors why Lehman Brothers failed, for example, is that they were geared up almost 50 to 60 times their capital, therefore the financial risk to the bank as well as to the depositors was huge. You won't see that kind of activity in the Islamic banks. That is why only the real economy will be funded by Islamic assets."

Rahman says that Islamic banking can still make money though. "Big money can be made in two ways - you make a killing on a small number of clients, or you make a decent profit on a large number of customers when you popularise it … We like to make money by popularising it to a large number, not by 'stiffing' the customers. Freddie Mac and Fannie Mae representatives have been coming to our offices recently to ask 'what's the secret; why are your portfolios performing better?' Insurance companies are coming and saying 'you have the lowest loss-making companies in your portfolios." We tell (them) what the reason is, and they say … we want your business."

Islamic finance is not just for Muslims and the attractions of Islamic banking have led to a proliferation in non-Muslim communities. Rahman says some 95 per cent of his customers are non-Muslims, and his customer base includes Jews and Christians. "We don't use the word Islamic much nowadays, because you don't want to limit yourself."

The industry is starting to build a base even in markets where conventional finance is firmly entrenched, with Hong Kong, Japan and South Korea joining countries which pioneered Islamic banking, such as Malaysia, Saudi Arabia, the Gulf Cooperation Council countries, Singapore, the US and the UK. Major banks are also participating, says Razack: "We certainly see a shift in all the major financial institutions, including HSBC, Citigroup, the old ABN Amro, RBS and Deutsche Bank. All of them have been active in the Middle East."

Abdullah of Asian Finance Bank says the reason for this lies in the current financial situation. "The interest of the non-Muslim countries - or the conventional countries - is now aroused because of the situation they find themselves in, where they are naturally looking toward other options and other alternatives and saying: what if we had done it this way, what will it take to set it up, what are the barriers, what is the governance structure, and how will we implement the regulations, and what do we do about the various tax regimes?"

Abdullah notes that Islamic finance can also provide a better deal for the consumer. "Some of the products we have, can be more profitable than conventional. But it's about getting that message across more clearly … where the benefit is to the consumer and how that can be achieved. And an example that I often use is a deposit-based product, where you are penalised if you break a fixed-term deposit in the conventional world and you get less interest. But in the Islamic world, you get the profit that you're due, up to that point in time when you break the deposit."

Another example that Abdullah uses to show that Islamic finance is an option for Muslims and non-Muslims alike is the use of Musharaka in the UK. Through this product, the financier and the client may buy a house together, with the financier owning a substantially larger stake. The client then agrees to buy portions of the house from the financier over a certain period of time, while paying rent to the financier for whatever portion the client does not yet own. Abdullah says this was implemented in the UK "because of the specific business need to service people in a non-Muslim country. The problem was that many teachers and nurses couldn't afford to buy property in London which is where they're required to live, but diminishing Musharaka allowed them to actually take some ownership and share with the government …. That's an excellent example whereby the political need and the economic need were solved by an Islamic solution."

Practitioners see this as a time when Islamic finance can really make its mark. As Abdullah notes: "We are well established, well regulated, we have the ISFB (Islamic Financial Services Board), we have accounting standards, we have a number of things in place. Are they perfect? No. But then is the conventional world perfect? No. We need to actually play to our strengths but be real about what it is we can do. I'm certainly not looking to take over the world. But I think we have the opportunity to raise our credibility several notches. Particularly if some of the Islamic financial institutions - the major ones - weather the storm more solidly than the conventional ones do."

Razack of Unicorn International echoes this view, but thinks that major Islamic financial institutions have not stepped up to the plate: "The crisis has given a great opportunity to develop Islamic banking but my greatest disappointment with the Islamic banks, especially the GCC banks – (is that) some of the big banks have failed to take advantage of this crisis to promote Islamic banking and take the opportunity of this window to go and do major funding under Islamic principles."

As Islamic finance moves forward, it will continue to grapple with the criticism that its products have failed to break away from the foundations of conventional banking, and that few people really understand how it works. Abdullah of Asian Finance Bank remains positive, however. "The sophistication of the audience is not such to be able to pick up the differentiation yet (between conventional and Islamic banking) and we need a lot more people within the industry who can articulate in words of one syllable what the simple building blocks are so people can be educated and understand … There's still a tendency to get all complicated and talk in Arabic terminology … that's a real turn-off for many people. At the end of the day, people want to say is this good for me? Is it a good price? Does it deliver something that I require?"