



Basics of Islamic Banking

USAID-Funded Economic Governance II Project

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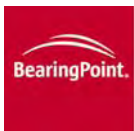
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Presentation Objective

- Create an awareness that an Islamic Bank is more than a bank that does not collect or pay interest.
 - Explain differences between US Retail Banking and Islamic Banking.
 - Review the possible structures of Islamic Banks.
 - Discuss basic Islamic Banking transactions available.
- Create a better understanding of Islamic Banking in Iraq.

Disclaimers.

- Unaware of USG Policy in Iraq regarding Islamic Banking.
- Content is not a comment on USG Policy.
- Not an attempt to establish USG policy.
- Briefing is for informational purposes only.
- No religious expertise is implied.

What is Banking in the US?

- Usually refers to a broad array of financial services.
 - Banks.
 - Savings and Loans.
 - Credit Unions.
 - Stock Brokerage Firms and Investment / Financial Advisors.
 - Investment Bankers – simple to complex transactions.
 - Consumer Finance Companies.
 - Commercial Factors, etc, etc.
- True Banks occupy a small niche in the universe of the financial service markets.
- Retail Banking is most familiar to us, but is a small sliver of what we call Banking.

How do US Retail Banks operate?

- Function as intermediaries.
- Banks take deposits and make loans.
- Bank profit is tied to the interest margin they earn as intermediaries.
- Bank Management is responsible to the Bank's Shareholders.
- 10-2-3

How do we measure Retail Bank's condition and performance?

- Banking in US is tied to the “time value of money”.
- My personal three basic measures of performance and condition:
 - Net Interest Margin Ratio (what they generate).
 - Net Operating Income Ratio (what they get to keep).
 - Tier One Leverage Capital Ratio (what they have retained).

What is the purpose of an Islamic Bank?

- Per the International Association of Islamic Banks (1990) with emphasis added.
- “The Islamic banking system involves a social implication, which is necessarily **connected with the Islamic order itself**, and represents a special characteristic that distinguishes Islamic banks from other banks based on **other philosophies**. In exercising all its banking or developmental activities, the **Islamic bank takes into prime consideration the social implications** that may be brought about by any decision or action taken by the bank. **Profitability**—despite its importance and priority—**is not therefore the sole criterion or the prime element in evaluating the performance of Islamic banks**, since they match both between the material and the social objectives that would serve the interests of the community as a whole and help achieve their role in the sphere of social mutual guarantee. **Social goals are understood to form an inseparable element in the Islamic banking system** that can not be dispensed with or neglected.”

Why the difference in Islamic Banks?

- HSBC says that:
 - “Islamic Banking is an ethical and equitable mode of financial services that derives its principles from Shariah (Islamic law)...is based on the Quran...and it governs all aspects of personal and collective life.”
- So what are the implications in basing a bank’s operations on Shariah?
 - Under Shariah, Riba is prohibited.
- Riba is considered to be:
 - Any amount of interest, no matter how great or how small, over the principle in a contract of loan or debt, regardless of whether the purpose of the loan is for personal or commercial activities.

So why is Riba in the form of Interest prohibited?

- It is a principal of justice and fairness.
- Neither Bank, nor depositor, should not be entitled to a positive return without adding any value or taking any risk, while the borrower does all the work and is not assured of a return on their contribution.
- With a prohibition on interest, none of our US Bank measurements can be applied.
- Concept of Riba effects not only banking services, but also effects availability of all financial products, including insurance products.

When and how did Islamic Banking evolve?

- Conceptually stated to take shape in the late 40's.
- Dubai Islamic Bank – in 1976, possibly first Shariah compliant commercial bank.
- Egyptian Islamic Banks may have come before 1976.
- Islamic Banking then spread to Asia and the rest of the Middle East.
- Deutsche Bank, Citi, Chase, HSBC now have Islamic Banking operations.
- No chartered Islamic Banks, as yet, in the USA.

How are Islamic financial institutions structured?

- In Iraq and other countries they can be stand-alone chartered banks.
- Some countries allow commercial banks to operate an Islamic Banking “Window”.
- In Iraq - considered to be commercial banks by Bank Supervision Department.
- Islamic Banks in Iraq:
 - Iraqi Islamic Bank for Development and Investment – nine locations.
 - Kurdistan International Bank – three locations.
 - Digla & Furat for Development & Investment (Tigris & Euphrates) – two locations.
 - Al-Belad Islamic Bank.
 - Regional Cooperative Bank for Investment and Development
 - Agricultural Bank of Iran
 - National Islamic Bank

What are the characteristics of an Islamic Bank?

- Operate on a principal of justice and fairness.
 - Bank and depositor should not be entitled to a positive return without adding any value or taking any risk.
 - Borrower should not have to do all the work and not be assured of a return on their contribution.
- Islamic Banks functions as:
 - Business partner; or,
 - Middle man; or,
 - Investment manager; or,
 - Lessor; or,
 - A variety of other roles which we would consider to be non-banking activities.

How does an Islamic Bank operate?

- Usually has a Shariah Advisory Board or Committee in addition to a traditional Board.
- “Depositors” are what we would normally view as investors and share in profits of the bank. And may be referred to as a “funding source”.
 - “Profit Sharing Investment Accounts” (PSIA’s) are largest funding source.
 - “Non-Profit Sharing Investment Accounts” (non-PSIA’s) for demand accounts.
- “Borrowers” usually grant the bank a partnership interest, give up or forgo title to property or assets, or enter into reciprocal transactions to buy and sell products with the bank.
 - May be referred to as “financing assets”.
- An Islamic Bank may also have two distinct sets of financial and product books.
 - One funded by Unrestricted Investment Accounts.
 - One funded by Restricted Investment Accounts.

What types of Financing Transactions may an Islamic Bank Offer?

- That depends on the region of the world and the bank's Advisory Board.
- Islamic Financial Services Board recognizes 21 Shariah-compliant contracts.
- Two primary standardized categories:
 - Profit-Sharing (PS); or,
 - Non-Profit-Sharing (non-PS).
 - Categories are used on both asset and liability side.

What types of Financing Transactions may an Islamic Bank Offer?

- Profit-Sharing instruments in Islamic Banks can be either:
 - Profit-sharing-and-loss-bearing; or,
 - Profit-and-loss-sharing.
 - These are usually commercial transactions.
- Non-Profit-Sharing Instruments can be:
 - Sales-based contracts (asset-backed); or,
 - Lease-based contracts (asset-backed); or,
 - Contracts to produce or manufacture (asset-backed); or,
 - Benevolent contracts; or,
 - Services-based contracts; or,
 - Other (Mugawala).

Benevolent Contracts – easiest to understand (two types).

- Qard or Qard Hassan.
 - Debtor is only required to pay back the amount borrowed.
 - Accepted by some as the only permissible loan.
 - Debtor may pay, at their discretion, an extra amount to Lender as a token of appreciation.
 - Debtor may not promise to pay back more than principle.
- Hibah.
 - Token gift.
 - Least common of all transactions.

Sales-Based Contracts - Asset-Backed (six types).

- Murabahah (not Mudarabah).
 - Similar to a “lease to own” in the US - usually small purchases.
 - Transaction includes an agreed upon profit margin for the Bank.
 - Bank purchases asset, owns the asset and adds profit margin to origination cost.
 - Customer makes installment payments and bank transfers at end of contract.
- Tawarruq.
 - Form of Murabaha.
 - Similar to a Murabaha, except customer is allowed by the Bank to sell the asset and utilize the proceeds.
 - Customer makes installment payments to Bank as agreed.
 - Very uncommon.

Sales-Based Contracts - Asset-Backed (six types).

- Bay Bithaman Ajil.
 - Similar to Murabahah.
 - Customer wants use of an asset.
 - Bank and customer agree to purchase price of asset, not an added mark-up.
 - Bank purchases asset and provides to customer.
 - Payment of purchase price is deferred, possibly until end of contract.

Lease-Based Contract – Asset-Backed (two types).

- Ijarah.
 - Basically a lease.
 - Sometimes in a small commercial setting for something like a machine tool.
 - Can also be land, building, etc.
 - Bank holds and maintains title to the asset.
 - Debtor only owes periodic payments.
- Ijarah Muntahia Bittamleek.
 - Basically a lease with an option for debtor to acquire at end of lease.
 - Token consideration at end of lease period; or,
 - Payment of market value at end of lease period; or,
 - Acquisition through a gift contract.

Sales-Based Contracts - Asset-Backed (six types) continued.

- Salam / Parallel Salam.
 - Contract between Bank and Seller with full advanced payment for product or commodity not available to Seller.
 - An exception to the Shariah rule that product must exist before payment.
 - Parallel Salam is contract for Bank sale of specific asset to third party at a later date.
 - Parallel Salam commodity must match the commodity in the Salam contract

Contracts to Produce or Manufacture – Asset-Backed (one type).

- Istisna / Parallel Istisna
 - Contract agreement for construction or manufactured goods.
 - Mostly commercial-type usage.
 - Construction of houses, manufacturing plants, large projects with specific detail:
 - 1) Company requires a new building and contracts with Bank for future delivery.
 - 2) Bank contracts with builder to complete construction of new building with company specifications for future delivery. This is the “parallel” contract.
 - 3) Builder delivers new building to Bank, Bank delivers new building to company and Bank retains difference between the two contracts as compensation.
 - Contract may allow for cash payments in advance for future delivery of product.
 - Contract may allow for future payment for future delivery.

Services-based contracts (six-types).

- Wadiah
 - Safekeeping of funds by a bank.
 - Bank guarantees refund of entire amount.
 - Depositor (at bank's discretion) may be rewarded with a Hibah (gift).
- Wakalah
 - Similar to power of attorney.
 - Bank acts as agent for a fee.

Profit-Sharing Contracts (three types).

- Mudarabah (not Murabaha).
 - Partnership agreement in a business activity.
 - Probably most used for entrepreneurial activity – something like venture capital.
 - Bank provides capital funding.
 - Entrepreneur provides expertise and management (Mudarib).
 - Profit is shared between Mudarib and Bank based on prior agreement and success of the business venture.
 - Loss is absorbed by Bank.
 - Profit sharing continues until loan is repaid.

Profit-Sharing Contracts (three types) – continued.

- Musharakah
 - A form of what might be a Limited Partnership in the US.
 - May be real estate or a moveable asset.
 - Bank supplies partial funding which is commingled with other investor funds.
 - All “investors” are entitled to participate in management of project, but are not required to.
 - Profit shared by prearranged agreement.
 - Loss is shared based on pro rata investment.

Profit-Sharing Contracts (three types) – continued.

- Diminishing Musharakah.
 - Type of partnership.
 - Bank owns asset such as property, equipment, or any fixed asset.
 - Property ownership is divided into units.
 - Counterparty periodically purchases ownership units, one at a time.
 - Counterparty can only promise to purchase ownership units and has no contractual obligation to do so.
 - Eventually counterparty may have sole ownership of asset.

Conclusions About Islamic Banking.

- Bank earns profit by:
 - Taking or facilitating an ownership position in an asset or project.
 - Adding tangible value in some way to a transaction.
- Structure and operation are very much unlike US Banks.
- Tools utilized to analyze US Bank do not work.
- Allowed transactions vary and depends upon the Shariah Board or Committee.
- Most transactions would never be allowed in US Banks.
- Provide a wide array of financial services.
- Services acceptable to customers who would otherwise go without financial services.
- There are many more Islamic financial services than we discussed today.

Will there ever be Islamic Banking in the US?

- A USG specialist in regulatory issues has been reported to have remarked:
 - “There has never been an application for an Islamic establishment to set up either as a bank or as anything else. So there is no precedent to guide us. Any institution that wishes to use the word ‘bank’ in its title has to guarantee at least a zero rate of interest -- and even that might contravene Islamic laws.”
- In New York City a few years ago, however, a USG Regulator said at an Islamic Finance meeting:
 - “...In closing, let me emphasize that, as U.S. bank regulators, we have an open mind on how to approach the issues raised by Islamic finance. These issues may not always be easy to resolve, but we are prepared to rise to the challenge....”
- Possibly 20% to 25% of the world market is receptive to Islamic Financial Services.

Current US Islamic Banking Activities

- US Multinational Banks have opened Islamic Banking Windows.
- There are financial service providers in US catering to those seeking Islamic Banking services.
- Devon Bank in Chicago – says:
 - 75% of the their mortgage portfolio is Shariah compliant.
 - Have made Shariah compliant mortgages in 36 U.S. states.
- Fannie Mae and Freddie Mac now buy Shariah compliant loans.

References:

- Islamic Financial Services Board publications,
 - Compilation Guide on Prudential and Structural Islamic Finance Indicators*
 - Guidance on Compilation and Dissemination of Prudential and Structural Islamic Finance Indicators for Banking and Near-Banking Institutions Offering Islamic Financial Services (March 2007)*
 - Guiding Principles of Risk Management for Institutions (Other Than Insurance Institutions) Offering Only Islamic Financial Services (December 2005)*
- HSBC Website.

Basics of Islamic Banking

Thank you.

End of Presentation
