In Vogue: Alternative Financing - A General Overview of Islamic Finance and its Emergence in Turkey

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According to Standard & Poor's, the Islamic finance industry is worth about USD 500 billion in assets and has been growing over the last decade at a rate of about ten percent (10%) per year. As Muslim investors are seeking alternative solutions for their financial needs and also because, especially since the market crisis, Islamic banking and finance are expanding rapidly, Turkey and Europe have began to participate actively in this economic boom.

This article introduces the basic principles of Islamic finance and gives an overview of the established Islamic finance products, because, now more than ever, Islamic finance offers an alternative financial paradigm for commercial and financial behavior, transactions and investments.

Turkey, with a population of about seventy million people and with a strong industrial base and private sector, will become a natural market for Islamic banking and finance, which will in turn be an important avenue to attract foreign investors to the Turkish capital market.

Basic Principles

Islamic Requirements

First and foremost, agreements are (failing an explicit choice of law) subject to the legal system of the state in which the transaction takes place or is administered. In addition to this, Muslim parties also aim to comply with Islamic requirements.

Islamic finance is grounded on the principles of partnership, fair risk distribution, social equity, prohibition of monopoly and a social linkage between stakeholders, which form the basis of the Islamic-compliant economic system.

Based on the Islamic legal principle of permissibility, which suggests that everything is permissible unless otherwise stated, a transaction is classified as lawful or unlawful depending on whether it contains an element that makes it prohibited. In that regard, the fundamental prohibitions to take into account for structuring a banking or finance product are described below:

Transactions in Unethical Goods and Services (Haram)

Direct or indirect investment in business deals which are considered unethical or impure, such as investing in alcohol or pork products industries, is forbidden. Where the profit of a business is only marginally derived from haram sources, like an airline that earns some income from alcohol sales, that part can be segregated by donation to charitable organizations.

Earning Returns from a Loan Contract (Riba/Interest) and Compensation-Based Restructuring of Debts

Interest as a contractual cost solely for the temporary allocation of capital and unearned income is forbidden. From the Islamic point of view, if the investor expects a profit for the allocation of money, he/she has to share the entrepreneurial risk. Finance deals without real underlying economic assets are not permitted as a rule. The shares and profits of investments in fund shares are not seen as interest revenues, because the investor participates in the earnings and losses of the business (i.e. a dividend is not seen as interest).

Therefore, Islamic financing can be formed and provided on a cooperative basis.

Besides this structuring concept, another intention of the interest prohibition is to encourage investment in businesses which observe the abovementioned prohibitions. In this context, minority shareholding may result in problems, because compliance with Islamic rules has to be unanimously chosen by all investors.

Another important point is the capitalization of the target company. The company has to be capitalized with a tolerable ratio of interest-based debt to equity. In general, particularly by the Supervisory Board of the Dow Jones Islamic Market, thirty-three percent (33%) is considered acceptable. Some Islamic jurists require interest-based debt to be exchanged for Islamic-conforming financing within three (3) years. Furthermore, the target is not permitted to have interest revenues of more than five percent (5%) of total receivables.

Excessive Uncertainty in Contracts/Speculation (Gharar) and Gambling and Games of Chance (Quimar and Maysir)

Maysir issues arise in contracts, where the ownership of a good depends on the occurrence of a predetermined uncertain future event, whereas Gharar applies to speculative transactions. Both concepts involve excessive risk and are thought to foster uncertainty. In Islamic finance, transactions that are highly uncertain or may cause any injustice to or deceit of any of the parties are prohibited. Since every business transaction involves an element of risk and uncertainty, Islamic rules differentiate between uninformed speculation and business transactions where the uncertainty is minimized through in-depth analysis of the risks faced. The difficulty is to determine when the acceptable level of business risk is exceeded. In finance, Gharar is generally observed within derivative transactions, such as forwards, futures and options, in short selling and in speculation. In Islamic finance, most derivate contracts are forbidden and considered invalid because of the uncertainty involved in the future delivery of the underlying asset. Islamic financial and banking instruments have to be formed observing these principles and prohibitions.

Advisory Board

Islamic banks and financial institutions are created with the purpose of achieving the objectives of an Islamic economic system; this mission is ensured by a special board. The board, composed of jurists or academics with expertise in Islamic economic law and in finance, reviews and oversees potential new product offers. The board members have a significant investigatory function to interpret different financial concepts and determine whether the transaction conforms to Islamic requirements and meets the standards described above. The board works closely with the product development team, legal department, tax advisors and compliance departments to offer practical advice as how to legitimate or amend conventional structures to make them compliant.

Categories of Islamic Finance Products

The Basic Models of Islamic Banking and Finance

There are six basic models which are pertinent for the structuring of several Islamic banking and financial contracts and instruments:

Mudarabah (Profit Sharing Agreement)

Mudarabah is a special kind of partnership in which one party provides the capital (the investor, rabb-al-mal, is typically a bank or the investment arm of a company) to the other party (mudarib), which provides the labor and skill as agent or manager. The investor may specify the business in which to invest. Such limited mudarabah is called mudarabah al-muqayyadah. If the investment object is not specified, it is called mudarabah al-mutalaqah. Profits earned from the investment project have to be split in a predetermined proportion, whereas losses are sustained solely by the investor; in event of loss the entrepreneur does not receive any remuneration. The loss risk for the investor is limited to the amount of capital invested.

Musharakah (Equity Participation)

Instead of solely providing capital (as in the concept of Murabahah) the investor joins the enterprise temporary, engaging in the management of the business. Each partner acts as an agent of the partnership and any action by one of the partners must be authorized by all partners. However, if the partners wish, they can contract under alternative arrangements for the management of the partnership.

The applicable area for Musharakah is that of joint venture or private equity transactions. This method combines co-entrepreneurship with a joint venture. The risk of loss is sustained jointly according to the respective investment, while the distribution of profits may be fixed irrespective of the capital interest by specially stipulating the distribution proportion. In practice, two (2) variants have developed: Permanent Musharakah and Diminishing Musharakah. While the contract period of a Permanent Musharakah is indefinite, in a Diminishing Musharakah the term (and the involvement of the investor) is gradually reduced by the capital return from the profits of the undertaken project until all shares are assigned with the completed repayment of the principal.

Murabahah (Cost Plus Financing)

Murabahah is a popular concept for financing assets, properties and commodity exports and imports. Murabahah is essentially a consecutive sale concept; in this context it is a fundamental and self-evident requirement that the transactions cannot be combined in one agreement.

The buyer (i.e. the bank's customer) instructs the bank/financier to acquire the object of purchase, gives a binding bid to the bank/financier, and accepts a certain profit which the bank/financier will add to the price. The bank/financier itself has to give a binding, formal commitment that it will sell the object of purchase to the buyer. Conventionally, this concept is called cost-plus-financing. One key feature is that the bank/financier has to disclose the actual cost. The added profit may be a lump sum or may be based on a percentage. Sine qua non of this concept is that the asset/property/commodity exists at the time of sale. An object which has not yet come into existence, is not material, the seller does not actually possess or is not owned by the seller (such as the subject of a second sale transaction by the bank/financier) cannot be sold.

Ijarah (Leasing)

The concept of Ijarah is roughly equivalent to a conventional operating-leasing facility which authorizes the lessee to utilize and benefit from the asset and ends with the return of the leased item, i.e. without a right of purchase. In the Ijarah method the lessor (financier or bank; mu'jir) buys the selected asset which is leased to the lessee (musta'jir) for a one-time or recurring fee or a rental income for a determined duration. The leased item remains under the ownership of the lessor, who is responsible for its maintenance. When used in combination with a Wa'd agreement, the lessee is entitled to buy the asset at the end of the determined lease period. Fees previously paid are deducted from the purchase price.

Salam (Deferred Delivery Transaction)

This method facilitates the forward sale of products not existing at the time of sale, and is comparable to a forward transaction in conventional finance. The financier (rabb- as-salam) pays the full determined price in advance of the delivery of the desired item, which the seller supplies on a previously agreed upon date. The asset has to be specified with respect to quality and quantity. The date and place of delivery have to be included in the agreement.

Istisnaa (Contract of Manufacture)

Like the Salam method, an Istisnaa facility is a kind of sale contract before the good comes into existence and allows for a future exchange. The subject of an Istisnaa agreement is always an asset which needs to be manufactured (like the construction of buildings or machines, no natural things or products that are not manufactured), while a Salam facility can be conducted on anything, regardless of whether it is manufactured. The concept also can be used for export financing as well as to meet working capital requirements in industries where sale orders are received in advance. In the Istisnaa concept, the financier is not obligated to pay the price in advance; payments may be staggered.

General Overview of Financial Products

The following list illustrates that almost all conventional banking and finance products can be formed taking the abovementioned principles/prohibitions into account:

Retail/Consumer Banking	
Housing and Property Finance	Bai-bi thaman-Ajil (BBA), Ijara wa Iqtina, Diminishing Musharakah
Hire Purchase	Ijara Thumma Al-Bai
Share Financing	BBA, Mudarabah, Musharakah
Working Capital Financing	Mudarabah, Bai al-Inah, Tawarruq

Corporate Banking/Trade Finance	
Project Financing	Mudarabah, Musharakah, BBA, Istisnaa, Ijara
Letter of Credit	Musharakah, Wakala, Murabahah
Venture Capital	Diminishing Mudarabah, Musharakah
Financing Syndication	Musharakah plus Murabahah, Istisnaa, Ijara
Revolving Financing	Bai al-Inah
Short-Term Cash Advance	Bai al Inah, Tawarruq
Working Capital Finance	Murabahah, Salam, Istijara
Letter of Credit	Murabahah letter of credit
Letter of Guarantee	Kafala plus Ujr
Leasing	Ijara
Export/Import Finance	Musharakah, Salam, Murabahah
Work-in-Progress, Construction Finance	Musharakah, Salam, Murabahah
Bill Discounting	Bai al-Dayn
Underwritıng Advisory Services	Ujr

Treasury/Money Market Investment Products	
Sell and Buyback Agreements	Bai al-Inah
Islamic Bonds	Mudarabah, Musharakah plus BBA, Istisnaa, Ijara
Governmental Investment Issues	Quard Hasan, Salam, Mudarabah

Other Products and Services	
Stock Broking Services	Murabahah, Wakala, Joala
Funds Transfers (Domestic and Foreign)	Wakala, Joala
Factoring	Wakala, Joala, Bai al-Dayn
Administration of Property, Estates, Wills	Wakala

Sukuk (Bonds)

The concept of Sukuk represents a new development in the global capital market. It is one of the fastest growing sectors in Islamic finance and is considered the most innovative product in Islamic finance. Sukuk bonds are equivalent to asset-backed securities, which are underwritten with one or more real assets and which represent the ownership of the asset(s). Compared with conventional bonds, Sukuk generally have lower costs. Especially because of lower fees and expenses, Sukuk bonds will become attractive for all kinds of investors.

Sukuk are structured based on the previously stated principles of exchange contracts (e.g. Ijarah, Murabahah, or Istisnaa) or participation contracts (e.g. Musharakah or Mudarabah). The Standards for Investment Sukuk stipulated by the AAOIFI (Accounting and Auditing Organization for Islamic Financial Institutions) provide 14 eligible asset classes for these securities, but only seven are used in practice; Ijarah, Musharakah, Mudarabah, Murabahah, Salam and Manfa'a. Sukuk may be issued by private or public institutions and are used to finance projects.

In 2008 the Turkish Undersecretariat of the Treasury announced that it was exploring the possibility of issuing a sovereign Sukuk in the international market. In 2010, particularly the Ijarah-Sukuk was regulated by the "Communique on the Principles Regarding Ijarah Certificates and Asset Lease Companies" Serial III No. 43 ("Kira Sertifikalarına ve Varlık Kiralama Şirketlerine İlişkin Esaslar Hakkında Tebliğ" Seri: III No: 43), which was published in the Official Gazette and came into force on April 1, 2010. This Communique regulates the Ijarah-Sukuk Bonds to be issued in Turkey. The legal basis for Sukuk issuances in Turkey was further enhanced in June 2011 by a new legal regulation, whereby Sukuk are subject to the same tax law requirements as conventional bonds which are issued to be sold abroad and provides for tax neutrality. The current legal developments appear likely to cause an expansion of the Turkish Islamic banking and financial sector.

Importance and Current Development

Turkey has long been a favored destination for Islamic financial institutions. Currently the country is in a position to establish its standing in the sector and expand its market share. For more than twenty (20) years, Turkey has developed Islamic finance techniques through financial institutions that have been classified as participation banks (Katılım Bankası). To preserve religious neutrality, Turkey's Islamic banks are referred to as "participation banks," and Islamic finance is commonly known as "interest-free" banking/financing. Participation banks mainly offer Murabahah facilities, under which funds are made available to companies in need of capital using a consecutive sale concept; the other prevalent instrument is Ijarah agreements, a financial-leasing concept.

In 2010, a participation bank issued the first Turkish Sukuk bond. There was overwhelming demand for this three-year, USD 100 million Sukuk. This Sukuk was also the first ever to have been offered by a private financial institution in Europe. The Sukuk was listed on the London Stock Exchange and arranged through a special purpose vehicle in the Cayman Islands.

Prior to this, the German Federal State of Saxony-Anhalt issued the first European five-year, EUR 100 million Sukuk via a special purpose vehicle, the Stichting Sachsen-Anhalt Trust.

Because of the overwhelming interest in Islamic banking and finance and its recognized crisis-resistance and lower costs compared with conventional banking and finance, this sector promises to open up a whole new market in Europe and Turkey.

Conclusion

Although there are strict requirements to be considered in the structuring of Islamic banking and financial products, the Islamic banking and finance sector has established instruments which economically approximate the conventional products. Greater market transparency, rising international acceptance and increasing capital expenditure will open up new opportunities for the Turkish and European Islamic financial markets.

Glossary

Bai Bi thaman-Ajil

Under this concept, the bank will purchase an asset at cost and sell the same to the customer at cost plus profit on deferred payment basis at the time and price agreed to by both parties, payable by fixed instalments.

Bai Dayn

This is the Islamic principle that governs the sale and purchase of debt certificates.

Bai al-Inah

This is a contract for a buyback. Under this contract, a customer buys back the assets he/she sold to a financier on a deferred basis but at a higher price.

Joala

The undertaking of one party (the Jael, bank or employer) to pay a specified amount of money to another party in return for rendering a specified service in accordance with the terms of contract.

Kafala, Ujr

Guarantee to pay the price or sum, if it is unpaid by the person originally liable (Kafala). This term broadly refers to a fee or finance charge for services (Ujr).

Quard Hasan

These no-cost loans, designed for impoverished people, are mostly backed by collateral securities. Otherwise, loans provided by banks generally do not charge any interest but they take service charges to cover the costs.

Tawqarruq

This is considered a Reverse Murabahah concept. The bank purchases a commodity and sells it to a client on an installment basis. The client then in turn sells it to a third party, receiving a lump sum for which it effectively pays the bank in installments.

Thumma al Bai

The parties enter into serial contracts; first one addressing the terms of lease of a commodity, then another enabling the purchase of the item.

Wakala

This investment product is similar to Mudarabah, except rather than sharing the profits, the investor receives only the agreed upon against the investment.

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