Islamic rate of return: the new IRR

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The issue is discussed by Joseph DiVanna, MD of Maris Strategies, a Cambridge-based strategy think tank for financial services specialising in economic, demographic and consumer intelligence in emerging markets.

Islamic finance is poised for a significant surge as world markets reorganise and Shari'ah-compliant banks reassess their position in local markets. As a global market, Islamic banking has grown at an impressive 27 per cent per annum over the past five years, and is estimated to reach $1 trillion in 2010. Growth in the Islamic finance industry will occur along three distinct fronts: organic growth, new market growth and product growth. Organic growth will continue as Shari'ah-compliant banks persist in engaging their clients with additional services (aiming to increase deposits). New market growth will consistently rise as more banks are engaging previously unbanked populations in Africa, the Middle East and Southern Asia where the ratio of people banked is very low. It is however the third area of product growth which holds the most long-term benefits for Islamic finance.

Shari'ah-compliant institutions are emerging from 2009 with a renewed sense of confidence as the impact of the financial crisis is passing from a panicked search for guilty parties to a refocused approach to risk management. Islamic banks have been somewhat insulated from the global financial crisis because of their lack of access to what is now labelled as 'toxic assets'. What Islamic banks have noticed during the crisis is a steady increase in assets as investors/depositors take conservative postures and a marked reduction in the generation of fee and investment income. Unlike their conventional counterparts, during 2008-09 Shari'ah-compliant institutions continued a deliberate plan of innovation, mainly in retail banking distribution, experimenting with technology. Now these banks are turning their attentions toward a longer-term growth agenda which includes product innovation that is more distinctly a representation of Islamic values and beliefs.

However, the rate at which this potential for growth is achieved is predicated on the establishment of additional national and international financial infrastructure. One key area of discussion is in the use of LIBOR (London Interbank Offered Rate) as an industry benchmark for sukuk and other instruments. Today, the performance of Shari'ah-compliant products such as sukuk are measured (or linked) to LIBOR as a benchmark, not by design, simply as a matter of convenience in the early stage of market development. To compete with conventional banks, which many of their clients have been using for decades, Shari'ah-compliant institutions have adopted the use of LIBOR so customers have a readily recognised mechanism to assess the relative rate of return on their product offerings.

Shari'ah scholars have been divided on the use of LIBOR as it gives the appearance of an interest-like quality to Shari'ah-compliant financial instruments. Conversely, some Islamic scholars have argued that simply using an interest rate as a benchmark for determining the relative rate of return for a Shari'ah-compliant instrument does not render the instrument non-compliant.

'In the final analysis, a benchmark is no more than a number, and therefore non-objectionable from a Shari'ah perspective. If it is used to determine the rate of repayment on a loan, then it is the interest-bearing loan that will be haram. LIBOR, as a mere benchmark, has nothing to do with the actual transaction or, more specifically, with the creation of revenues or returns,' says Shaykh Yusuf Talal DeLorenzo, chief Shari'ah officer and board member of Shariah Capital, a US-based Shari'ah advisory firm.

The key point of debate is the appearance of a Shari'ah-compliant financial instrument to generate a fixed rate return. Under Shari'ah principles, money cannot generate money, which in modern times is represented by interest. Numerous Shari'ah scholars have argued that instruments such as murabaha (debt) cannot be securitised, since sukuk-backed pools of murabaha are simply the sale of documents representing money, which can be interpreted as merely trading of monies. On the other hand, Malaysian scholars have argued that if the underlying receivable is associated with a true trade transaction or to a commercial transfer of a non-monetary interest, such a receivable can be traded freely for the purposes of Shari'ah.

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Theoretically, a hybrid (debt/equity) sukuk could be structured to emulate a quasi-fixed return found in conventional bonds whereby the LIBOR benchmark would give investors an understanding of the instrument's return relative to a conventional counterpart. Thus if structured properly the hybrid sukuk can generate a profit-based return that is comparable to a conventional LIBOR-based product. What this boils down to is the fundamental need for the industry to mature to a new level through a process of product/market innovation that increases the depth of market offerings. Market infrastructure such as a Shari'ah-compliant money market instrument, the establishment of a secondary market and secondary market pricing are but a few of challenges in the years to come, which will reach higher levels of discussion in 2010. Islamic rate of return (IRR)

Fundamentally, the industry, or more specifically central banks, must address the creation of a benchmark that represents the cost of capital in Shari'ah-compliant terms. Without a clear Islamic rate of return (IRR) LIBOR will continue to be used. The use of LIBOR and the development of an alternative has been discussed and debated during the past five years resulting in few alternatives. The central issue is the cost of capital and the establishment of an Islamic rate of return for procurement and placement of funds. Some scholars advocate the development of a mechanism similar to a rent index used when working with ijara instruments. Hence the industry will continue to use LIBOR as the only recognised benchmark. That said, the Islamic International Financial Market (IIFM), a Bahrain-based non-profit international infrastructure development institution, identifies several alternative theories:

- Abbas Mirakhor approach: proposes that the cost of capital be measured without resort to a fixed and predetermined interest rate using equity financing as the source of financial capital (Tobin 'q' theory).
- Sheikh Taqi Usamni approach: a benchmark can be achieved by creating a common pool which invests in asset-backed instruments (e.g. musharakah, ijara) where units can be sold and purchased on the basis of their net asset value determined on a periodic or daily basis.
- Bank Negara Malaysia (Malaysia's central bank) approach: proposed in 'Framework of the Rate of Return' sometimes referred to as mudarabah interbank investments (MII) – a standard methodology to calculate the distribution of profits and the derivation of the rates of return to depositors. A calculation table prescribes the income and expense items that need to be reported. It also sets out the standard calculation in deriving the net distributable income and a distribution table sets out the distribution of the net distributable income posted from the calculation table among demand, savings and general investment deposits according to their structures, maturities and the pre-agreed profit sharing ratios between the bank and the depositors.

Another alternative, which was introduced in 2004 by the State Bank of Pakistan (SBP) and the Pakistan Banks' Association (PBA), is the KIBOR (Karachi Interbank Offered Rate) a benchmark for corporate lending in local currency defined as 'the Average rate, Ask Side, for the relevant tenor, as published on Reuters page KIBOR or as published by the Financial Markets Association of Pakistan in case the Reuters page is unavailable. The banks and the borrowers are free to decide the relevant tenor of KIBOR and the spread over KIBOR at their discretion. KIBOR will be set for the lending facility on the date of drawdown or on the mark-up reset date. The offer letters from the banks to their clients should clearly indicate the KIBOR's tenor and the agreed spread, frequency of revision'. The six-month KIBOR is most widely used as a benchmark.

How will an Islamic interbank rate work?

One theoretical construct is the use of a mudarabah concept whereby Shari'ah-compliant institutions with excess reserves (surplus banks) can invest in the interbank money market which in turn provides funding to banks looking for funds (deficit banks). Surplus banks act as investors while the central bank acts as an entrepreneur. The parties agree on a profit sharing ratio between the surplus banks (70 per cent) and the central bank (30 per cent). The surplus bank receives 70 per cent profit while the central bank will receive 30 per cent. The profit rate is based on the benchmark calculation of the profit as: profit equals (principal x profit rate x time x profit sharing ratio) divided by 365. Although theoretically, profit rates are acting under a similar means as an interest rate there is a built-in risk associated with the performance of the underlying assets associated with all the transactions initiated by the banks. Clearly, these types of mechanisms are in their infancy and will require a great deal of discussion between Shari'ah scholars, central bankers, monetary policy makers and bankers.

Conclusion

The Islamic finance market will continue to grow and strengthen during 2010. The rate at which the growth will occur is dependent on two things: the development of supporting market infrastructure such as a replacement for LIBOR and the confidence in the bankers themselves to conduct business in challenging economic times. The development of alternative benchmarks demonstrates the rising independence of Islamic finance as a viable alternative to conventional financing. As new economic data slowly reveals the emergence of renewed growth, Islamic finance is poised to enter 2010 as the first year of a new generation of development.

Labels: Islamic Banking