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AAOIFI World Bank 2011

Potential of using Islamic finance in international trade (products and instruments)

October 2011

By Ghazanfar Naqvi
Head of Islamic Origination and Client Coverage

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wholesalebanking.standardchartered.com

Contents

International Trade

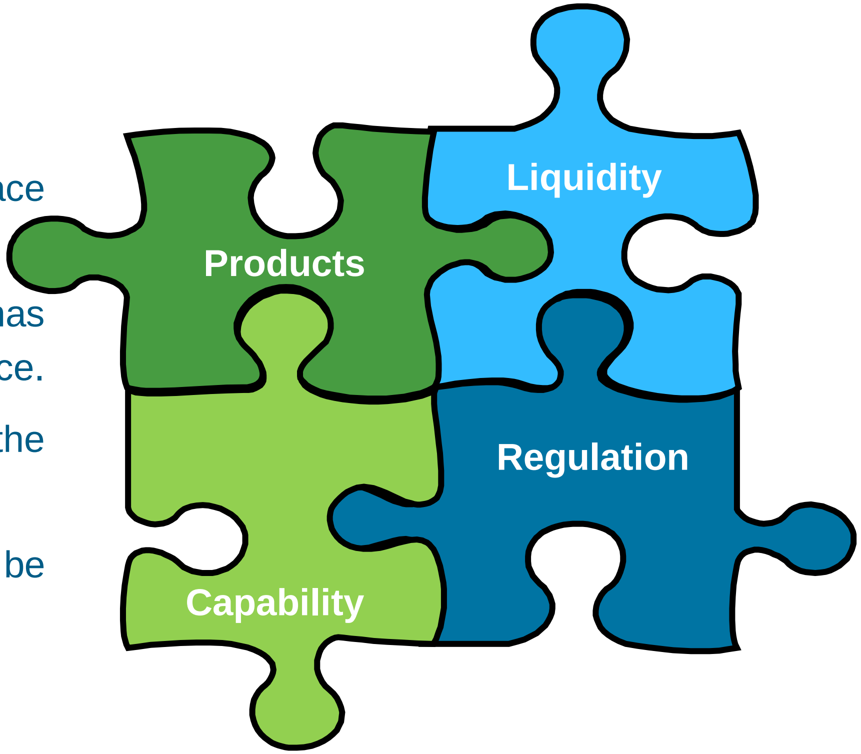
- Trade flows are shifting.
- Lack of trade finance.
- In order to divert more funds from other financial instruments to trade finance, cooperation among OIC countries is essential.
- According to various estimates, Islamic finance could tap up to 20% of the total trading financing, predicted for Islamic Development Bank countries by 2012-2013.

Trade corridors

- *Trade finance currently accounts for around 60-80% of the US$12 trillion trade in global merchandise.*
- *Total trade among the 57 Organisation of Islamic Cooperation (OIC) countries is expected to reach US$4 trillion by 2012.*
- *The OIC aims to increase Islamic trade between member nations to 20% of the total trading volume by 2015.*
- *In 2011 intra-Islamic trade accounted for just 16.5% .*

Islamic Trade Finance

- Trade finance is perfectly suited to Islamic finance.
- Historically Islamic finance has been trade related.
- With Murabaha being used to cover the gap importers inevitably face between their payments to exporters and their receipts from clients.
- As the Islamic banking industry has matured, Islamic trade finance has remained undeveloped in relative terms, despite its fit to Islamic finance.
- Salam, istisna'a and musawamah can also be utilised for meeting the requirements of importers and exporters for Islamic trade finance
- The Islamic trade finance puzzle has four main factors that shall be discussed:
  - *Products*
  - *Liquidity*
  - *Capability*
  - *Regulation*



Structured Export Finance

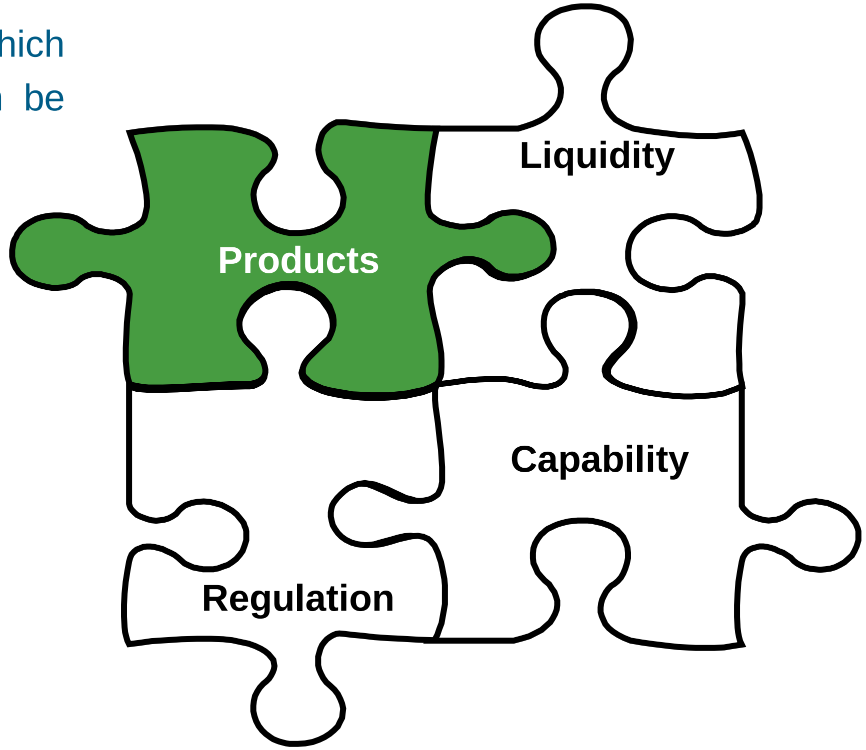
- There is client demand for Shariah compliant structured products as companies operating in the Middle East, north Africa and southeast Asia are under the same pressures as companies everywhere.
  - Sellers are seeing their receivables being stretched out
  - Buyers are being asked to switch their trading activities between open account and more structured forms such as letters of credit.
  - Companies are seeing their inventories increase due to slower pace of sales.
- Meaning companies on both sides are looking to find ways to manage longer payables and receivables cycles
- A few examples of Islamic tools that may be used to address these are:
  - *Islamic Structured Trade Finance*
  - *Islamic Receivable Services*
  - *Islamic Structured Warehouse Finance (inventory finance)*

Trade Finance Structures

- Pre-export finance
- Prepayment finance
- Financing during transportation
- Warehouse (inventory) financing – pre and port shipment financing
- Recent developments:
  - Ownership structure
  - Risk issues
  - Funding issues

Products

- There is a wide range of tools and instruments available, all which determine how cash, credit, investments and other assets can be utilised for trade.
  - Islamic trade finance products:
    - Letters of credit
    - Trust Receipts
    - Accepted bills
    - Export credit financing
    - Working capital financing
    - Shipping guarantees
  - Islamic structured trade products:
    - Receivable services
    - Structured warehouse financing (inventory)
    - Structured trade finance
  - Related need for Islamic hedging products to mitigate:
    - Currency risk
    - Market risk
    - Investment risk

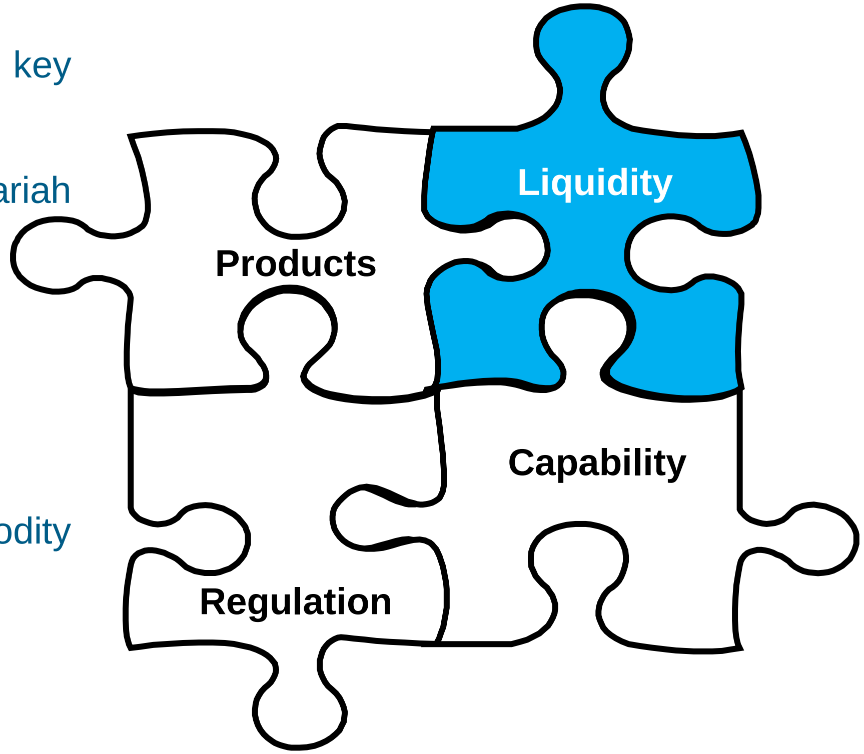


- *Recovering market conditions and a lift in international trade volumes will see an increase in demand for:*
  - *trade products and term finance for capital expenditures*
  - *these are both linked to treasury products for risk profile enhancement.*

Liquidity

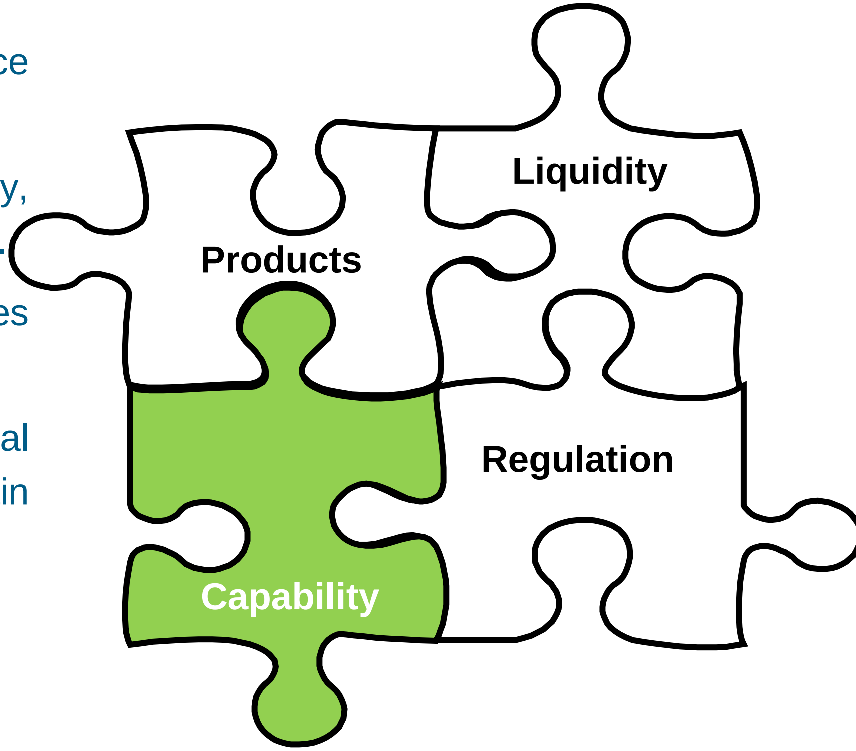
- There is a demand for alternative sources of financing across key markets.
- The future of Islamic finance depends on the development of Shariah compliant liquidity management tools.
- High trade volumes and vast commodity resources.
- Many trades have short-term maturity of less than one year.

- To date, the Islamic finance industry still takes recourse to commodity murabaha for liquidity management



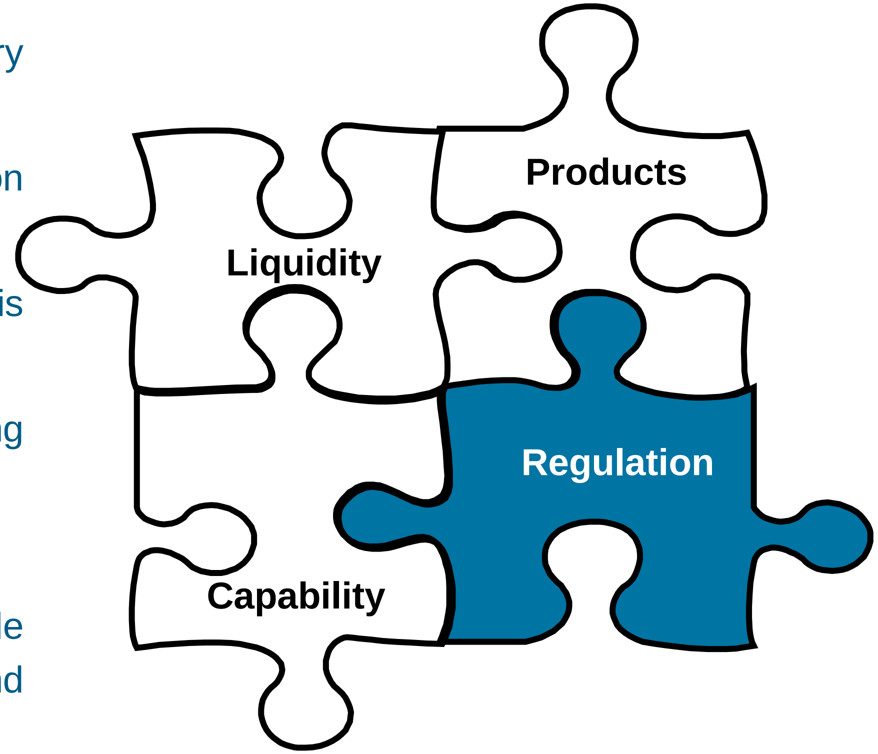
Capability

- It is the smaller clients and emerging economies for whom trade finance is such an important opportunity.
- While these private, smaller scale deals may lack glamour and publicity, they are critical for increasing exports and promoting cross-border trade.
- Building trade capability to help middle market Muslim businesses manage their risk profile is key.
- Local and global banks have a better understanding of the local requirements and have Islamic capability in cross-border supply chain finance and customising solutions to meet customer needs.



Regulation

- Cross border financing requires both the tax and regulatory frameworks.
- Managing processes such as cross-border litigation, standardisation and harmonisation.
- The development of the ISDA-IIFM Tahawwut Master Agreement is an essential and welcome innovation.
- Countries involved in Islamic finance need to create enabling legislative, regulatory, legal and Shariah governance framework.
- Every day new examples of cross border trade financing occur:
    - Korea’s Development Bank’s increased focus on Islamic trade finance to assist Korean conglomerates such as Hyundai and Daewoo
    - The raising of US$70m by Turkey’s Asya Bank from an international syndicate of banks for use in its Islamic trade finance business.



Trade Support

- The main issue in Islamic trade finance is a lack of critical mass to establish a credible network.
- Vital for the industry's developments is to have supranational institutions
- The Islamic Development Bank is currently improving its trade finance policies
- In addition, the International Islamic Trade Finance Corporation (ITFC) trade finance arm is responsible for providing Shariah-compliant trade financing for both public and private sector entities in OIC member countries, with a particular focus on intra-trade between OIC.
- In 2009 the ITFC allocated US$2.17bn in trade funding, which increased to US$2.55bn in 2010, with a target for US$3bn for 2011.
- Further support is being provided by the Islamic Corporation of Export Credit and Investment (ICIEC), which in July 2011 the IDB approved a capital increase from US$ 240m to US$ 640m for the corporation.

Trade Funds

- The continual effect of the global financial crisis necessitates more stringent corporate credit analysis
- Initiatives like Trade Cooperation and Promotion Program (TCPP) can help promoting intra-trade between OIC member countries.
- Advantages:
    1. Trade finance funds will help in providing much needed liquidity to the market.
    2. Facilitating the natural flow of business and kick-starting credit flow in the real economy
    3. Low risk investments whilst achieving good returns, benefiting every stakeholder.
- Focus:
    1. Supporting trade promotion activities
    2. Identification of trade facilitation and trade development needs
    3. Enhancing trade support capacities
    4. Development of strategic products
    5. Facilitating new markets

Africa

- Islamic trade finance is a good connecting point between the GCC and Africa.
- Between 2000 and 2009 Africa's trade with the GCC grew by 170%.
- The IDB has provided up to US$6bn in financing to Africa, out of which US$4.3bn was allocated to finance development projects and US$1.7bn to fund trade.
- The sheer size and volume of the continent affords abundant opportunities

Conclusion

- Trade finance will continue to play an important role within the Islamic finance world, especially as Islamic financial institutions are shifting their attention away from over concentration on equities and real estate.
- Key focus should be on innovation.
- It is clear that Professionals and Academics alike are and will continue to work together to develop documentation and structures which will move away from the reliance on traditional structures.
- The future of Islamic trade finance is in its ability to integrate in overall global trade flows.
- As all these pieces slot together, the Islamic trade finance puzzle is finally coming together.