Banking and Capital Markets

Growing pains: Managing Islamic banking risks*

*connectedthinking

PricewaterhouseCoopers

Contents

Introduction	02
Overview	04
Risk management challenges	06
Displaced commercial risk	08
Liquidity risk	10
Real estate risk	12
Operational risk	14
Fiduciary and reputational risk	16
Capital management and Basel II	18
What the future holds for risk management in Islamic banking	20
How PricewaterhouseCoopers can help	21
Appendix	22
Contacts	24

Introduction

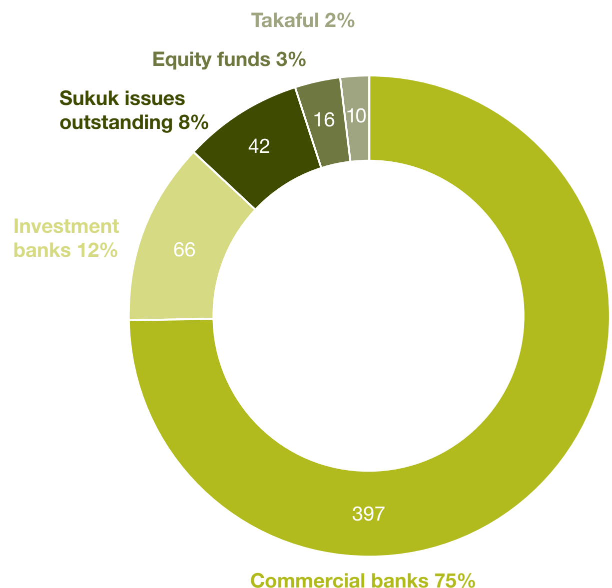
While conventional banks are in the midst of the worst financial crisis in living memory, the Islamic banking sector remains an oasis of relative calm and prosperity.

Shariah law precludes Islamic institutions from getting involved in the kind of complex credit trading that has paralysed their conventional competitors – but that's no reason for complacency. Islamic banks have their own blind spots and frailties.

Islamic banks tend to have significant concentrations of exposure to local real-estate markets – much of it in the form of equity-like investments. They also have a preponderance of long-dated assets and a shortage of instruments with which to manage their short-term liquidity needs; Islamic banks are heavily reliant on the loyalty of their depositors. The contractual complexity of Islamic banking transactions gives rise to awkward operational risks, and the uncertainties associated with Shariah compliance leave them exposed to fiduciary and reputational risk.

Global assets of Islamic finance

$bn, assets at end 2006



Total assets at end 2006: $531bn

Source: International Financial Services London, 'Islamic Finance 2008', January 2008.

Risk management has not been uppermost on the Islamic banking sector's agenda in recent years. Understandably, the focus has been on growth and on the struggle to innovate and compete in this increasingly competitive market. Shariah-compliant assets worldwide are approaching $600 billion and have been growing at more than 10% per year over the past 10 years. There is still huge untapped potential. Standard & Poor's has estimated that the market has a potential size of $4 trillion.[1]

Conventional banks also want to know that Islamic banks make robust counterparties. If Islamic banks are serious about playing a greater role in the financial system, they will need to get to grips with risks which may not currently be well understood or well managed. The time to fix the roof is when the sun is shining: Islamic banks should be dusting their ladders off now.

Shariah-compliant assets worldwide are approaching $600 billion. There is still huge untapped potential.

Written by PricewaterhouseCoopers[2] experts from around the world, this is the second paper in a series dedicated to Islamic finance. It offers a primer for people not familiar with Islamic finance and banking products. It examines the risks associated with those products and with Islamic banking as a whole. It also looks at the future of risk management in this sector and the forces shaping it.

[1] International Financial Services London, 'Islamic Finance 2008', January 2008.

[2] PricewaterhouseCoopers' refers to the network of member firms of PricewaterhouseCoopers International Limited, each of which is a separate and independent legal identity.

Overview

- Islamic bank depositors and investment account holders are contractually obliged to accept lower rates of return and even absorb losses when bank assets under-perform. In practice banks may accept more downside risk than they have to, in order to manage the customer relationship.

  Islamic banks should present mudharaba as an asset management business, providing clients with greater clarity on the performance of their investments, and encouraging them to accept the associated risks.

- There is a shortage of Shariah-compliant money market instruments. As a result, Islamic banks tend to have concentrations of cash and of long-term assets, creating significant liquidity gaps. Islamic banks may also find it difficult to generate enough floating-rate assets to offset their floating-rate liabilities, and they lack the interest rate hedging instruments available to conventional banks.

  Central banks hope to introduce Shariah-compliant repo transactions which would go a long way towards providing the sector with more liquidity and flexibility. Until that market emerges, banks should monitor liquidity, asset/liability and interest rate risks in a rigorous way.

- The sector has a relatively high concentration of real estate exposure. The true size of the risk is not easy to quantify, however, as many Islamic products may be based on real estate assets while actually exposing the bank to counterparty risk.

  Banks need to be clear with themselves – and their external stakeholders – about the precise nature of their risks. Better reporting and disclosure would help foster more confidence in the sector.

- Some products can expose Islamic banks to awkward legal risks – for example, banks often assume the role of contractor in construction projects, and sub-contract out the work, leaving them exposed to claims if the bank's sub-contractor does not perform.

  In addition to a strong operational risk measurement and reporting framework, Islamic banks should pay special attention to legal due diligence, making sure that they are adequately protected in the event of disputes.

The lack of uniform Shariah standards means that compliance is not easy to ensure. The sector should strive for more uniformity.

- Islamic banks have a fiduciary responsibility to ensure that the products and services they provide are Shariah-compliant. The lack of uniform Shariah standards means that compliance is not easy to ensure. If the compliance of a bank or its products were called into question, the reputational damage would be severe.

  This risk may seem distant or unrealistic. Even when calling compliance into question, Shariah scholars have not tried to reverse past rulings. However, Islamic banking products are becoming more complex and there is a real risk of future compliance disputes.

- Applying the Basel II framework to Islamic banks is not straightforward. There is broad consensus among regulators on how to meet this challenge, but much of the detail still needs to be resolved.

  Regulatory capital is one guarantor of a counterparty's confidence. At the moment, Islamic banks operate under disparate regimes. The sector should strive for more uniformity.

Risk management challenges

Islamic banks have a unique risk profile because of the need to make their products Shariah-compliant.

Nuances and complexities can serve to obscure the real risks that Islamic banks face – at both the transactional level and the portfolio or entity level.

The following discussion assumes some familiarity with Shariah law as it applies to banking, and with the standard types of product offered by Islamic banks. A primer can be found at the end of this paper.

Life is not easy for Islamic banks. The story of one hotel financing helps to illustrate why: the project was led by a group of conventional banks, and they invited an Islamic consortium to provide construction finance – an invitation which the banks' Shariah boards rejected on the grounds that the hotel contained a nightclub and bar. The banks made repeated attempts to secure permission from their boards, pointing out first that the hotel was not yet in business, then offering to finance the building above the floors on which the nightclub was located – to which the Shariah boards noted that the rooms of the hotel would contain minibars and alcohol. Finally, the banks argued that the sale of alcohol from minibars was such a minuscule proportion of the hotel's business that it should not play a decisive role in the judgement of the scholars – and the boards agreed. Unfortunately, the whole process took six months and the conventional banks had already gone elsewhere.

This same tension between commercial opportunity and Shariah compliance recurs throughout Islamic banking and it encourages tension between form and substance. For example in a murabaha transaction, the bank's margin is locked in by agreeing to sell an item at more than it was bought for. The form of the transaction is Shariah compliant, but the substance is an exchange of economic value which is hard to distinguish from a conventional loan. These nuances and complexities can serve to obscure the real risks that Islamic banks face – at both the transactional level and the portfolio or entity level.

Displaced commercial risk

Islamic banks typically obtain the majority of their funds from mudharaba and wakala investment accounts and, at first glance, this arrangement appears to provide the institution with a significant buffer against loss.

They should adopt the kind of conduct of business rules and customer reporting practices found at investment funds.

During good times, account holders can expect significantly higher returns than those offered to conventional bank depositors, because Islamic banks often use the investment accounts to fund riskier assets. Contractually, however, customers accept a lower rate of return if the bank's assets underperform, and are also expected to help absorb losses. Islamic banks do their best to protect customers by building up two types of reserve – one (the profit equalisation reserve) to help ensure they can pay the anticipated profits to customers, and a second to be used to help offset severe losses.

In practice, even when a bank's reserves are exhausted, it may be unwilling to cut its customers' returns, fearing that they would take their business to a competitor (hence the term 'displaced commercial risk'). Banks are even more reluctant to use customer money to cover losses. The entirely rational fear is that disappointed customers would withdraw the rest of their funds in a run on the bank. So, mudharaba and wakala funds may only provide a buffer in theory.

Some regulators, such as the Central Bank of Bahrain (CBB), recognise this risk and have told banks that they need to hold capital against some portion of the assets in which their mudharaba and wakala accounts are invested. Under the CBB capital rules for Islamic banks, 30%[3] of the risk-weighted assets of investment accounts are to be included in the denominator for capital computations.

As things stand, the banks' problems stem from their desire to present these contracts as an analogue to savings accounts when, contractually, they are no such thing. Banks should start presenting mudharaba and wakala business as what it is – asset management under another name. They should adopt the kind of conduct of business rules and customer reporting practices found at investment funds. If clients are told up front that their assets are merely in trust and are given regular reports on performance, the threat of a bank run could be tackled head-on.

[3] Central Bank of Bahrain, 'Rulebook Volume 2, Islamic Banks, module CA-A, rule reference CA-A.3.2', March 2005.

Liquidity risk

Islamic banks are so sensitive to displaced commercial risk because they have restricted access to the short-term funding options used by conventional banks.

> … Asset-based financing... serves to lengthen the liquidity gaps because exits from these transactions are not always agreed in advance.

Generally, Shariah scholars insist that all transactions must be linked to a tangible, underlying asset – which rules out purely financial contracts like repos and certificates of deposit. As a result, there is a big, unpopulated gap between cash and long-term bonds. The predominance of asset-based financing and specialised lending products found on the typical Islamic bank balance sheet serves to lengthen the liquidity gaps because exits from these transactions are not always agreed in advance.

Malaysia is a notable exception, where Shariah scholars come from the Shafi'i school of Sunni Islam and allow some money market transactions – for example, Malaysian scholars view a repo contract as a promise to buy back sold Shariah-compliant securities, making such transactions permissible. Other countries have attempted to launch their own repo markets, while still meeting the requirements of their own Shariah scholars. Bahrain has been trying for a number of years to get a local Islamic repo market off the ground, as has Saudi Arabia. Both face tougher compliance obstacles because one of the most influential opinions on Islamic finance in the Middle East is provided by the Shariah board of the Accounting and Auditing Organisation for Islamic Financial Institutions (AAOIFI), which is made up of representatives from a wide range of countries and therefore tends to reach consensus opinions that are tougher than those which might be available in a single jurisdiction.

Until Islamic banks are able to make use of short-term funding markets offering money at a variety of tenors, they will remain vulnerable to a bank run scenario – and would arguably prove less resilient than conventional banks which have suffered liquidity squeezes over the past year.

A related problem is the danger of asset/liability mismatches. Conventional banks have a huge variety of floating-rate assets with which to offset their floating-rate liabilities. As a result, when interest rates change, they are less exposed to differences between the amount they pay and the amount they receive. They also have a host of derivatives which can be used to manage the risk away. Islamic banks have fewer options. Their liabilities pay a rate which is adjusted to more-or-less mirror a floating rate benchmark, but their assets may be fixed rate. If a gap opens up between the two, it's a lot harder for Islamic banks to manage it because, for most Shariah scholars, derivative transactions are not halal.

Real estate risk

Real estate risk concentrations are common among Islamic banks – their geographic reach tends to be limited, as do the type of assets they are able to accept. Hedging is mostly out of bounds, and risk transfer via securitisation may be difficult to achieve.

> The construction boom in the Gulf Cooperation Council means that it is not uncommon to find Islamic banks which have half of their assets linked to real estate.

In particular, there is growing nervousness about the extent to which Islamic banks are exposed to the real estate sector, through musharaka and istisna contracts. The construction boom in the six Gulf Cooperation Council countries means that it is not uncommon to find Islamic banks which have half of their assets linked to real estate.

Unlike conventional banks, real estate exposure for Islamic banks does not come in the form of a loan. Instead, the exposure typically takes the form of a profit-sharing contract – the Islamic bank puts its own money at risk in the form, effectively, of an equity stake. It may not have the same kind of direct management involvement that a private equity firm would insist upon and, as such, the bank's exposure depends on both the skill and honesty of its partner.

On the face of it, Islamic bank real estate portfolios seem like a potent mixture of high risk and awkward moral hazard – and some central banks have been concerned enough to launch studies of their domestic institutions' exposure. It is certainly an area which needs greater scrutiny – in fact, because the real-estate assets which banks are financing continue to be owned by their clients, much Islamic bank exposure to real estate risk may not appear on the sector's balance sheets.

Operational risk

Islamic banking products can involve a number of separate contracts, giving rise to additional legal risks.

> Each step takes time and involves a fresh contractual agreement, magnifying the scope for disagreements and complications.

For example, in the case of a murabaha transaction, the bank has to buy an item and then sell it on under different payment terms – each step takes time and involves a fresh contractual agreement, magnifying the scope for disagreements and complications. In an istisna transaction – for example, when financing a construction project – the bank assumes the role of the contractor but has to sub-contract the actual building work out to a third party. If the builder fails to perform or defaults, it is the bank which bears much of the legal risk.

Islamic banks also have to face thorny operational risks associated with the administration of their business – paperwork and book-keeping, in other words. In principle, these risks are no different to those faced by conventional banks. In practice, they are made more taxing by the contractual complexity of Shariah-compliant transactions: there are more contracts to manage and more risk of documents being mislaid; the wrong contract could be used, or the wrong terms applied. Tying all of this paperwork into a coherent system which allows banks to reconcile their accounts, and aggregate and report their risks, is also more difficult. It's not impossible, of course – but it requires a watchful eye and drains more time and energy.

Fiduciary and reputational risk

Shariah compliance is all-important to an Islamic bank and to its customers.

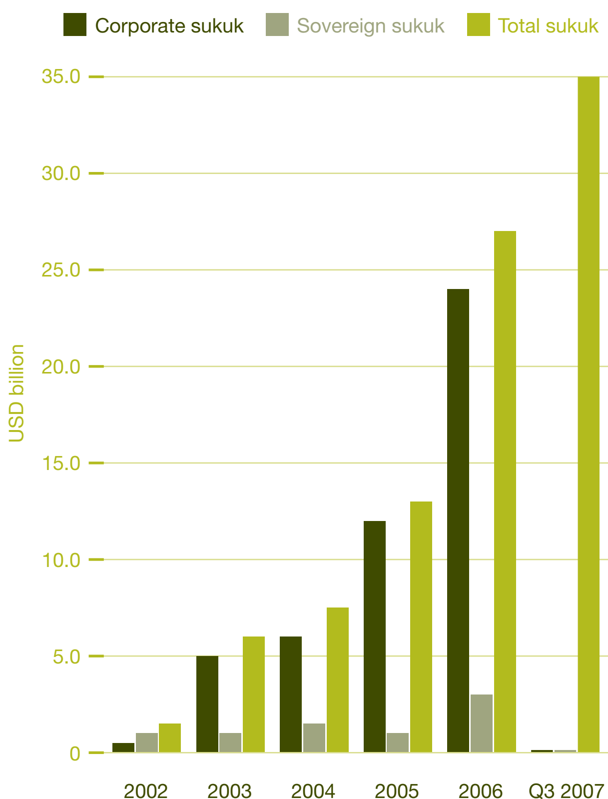
In theory, the bank's Shariah board should ensure that all of its products and transactions are compliant – at least, that is certainly the customers' expectation. But interpretations of Shariah vary from one school of thought to another, and from one scholar to the next. More to the point (as illustrated in the story of the failed hotel construction financing) Islamic banks will occasionally find themselves in a position in which a commercial opportunity falls foul of a Shariah board's fatwa, and may then seek to address the scholars' concerns by tweaking or restructuring the deal. Sometimes the judgements turn on very subtle distinctions. Through seeking to get business done, banks may find themselves sailing closer to the wind than is advisable and it's conceivable that a bank may at some point have its adherence to Shariah questioned – an event which could inflict devastating reputational damage, thanks to the sensitivity that Islamic banks have to customer behaviour and liquidity risk.

Alternatively, a class of product may run into the same problems – as happened with one of the Islamic banking industry's biggest success stories, the market for sukuk. This market saw issuance of over $35 billion globally in 2007[4] (see graph) but stalled temporarily after questions were raised about Shariah compliance at the end of that year.

Many of the sukuk behind the market's recent growth have been linked to underlying ijarah, mudharaba and musharaka transactions. In the case of an ijarah sukuk, a company or sovereign entity seeking finance would transfer an asset into a special-purpose vehicle (SPV). The SPV, by issuing certificates, raises funds which are used to buy the asset from the company, thereby providing the company with the finance it needs. Investors are paid by renting the asset back to the company, generating a stream of lease income which is paid to the certificate holders. At the end of the transaction, the company buys back the asset, paying off the SPV. Unlike a conventional securitisation, the risk associated with the transaction does not stem from the performance of the asset in question, but from the ability of the company to buy back the asset – it is, in essence, a counterparty risk.

[4] Standard & Poor's, 'The Sukuk market continues to soar and diversify, held aloft by huge financing needs', March 2008.

Issuance of Islamic securities



Source: ABC Investments, 'Islamic Financial Services Sector Report', December 2007.

These transactions had been declared halal, but on closer inspection, scholars like Sheikh Taqi Usmani – chairman of AAOIFI's Shariah board – have begun questioning whether mudharaba and musharaka bonds should have been considered Shariah-compliant.[5] The objection is with the buy-back of the asset at the end of the transaction's life – which most sukuk contracts had done at a fixed price. Scholars argue that a Shariah-compliant sukuk should require that the asset is bought back at a fair market value, meaning that the company might have to pay more – or less – money to get the asset back than they received for its sale. Because investors and issuers are reluctant to transact on those terms, the sukuk market for mudharaba and musharaka transactions has stalled. Ijarah sukuk have been able to continue,[6] because the underlying ijarah transactions already incorporate the buy-back mechanism which caused controversy for other types of sukuk – it's not a feature of the sukuk structure itself.

It's important to note that scholars have not tried to reverse their halal judgements – the bonds issued so far all remain technically Shariah-compliant. Instead Sheikh Taqi Usmani's comments were intended more as a warning to banks not to use structural features of financial products to disguise the fact that a transaction is not all it should be. This kind of friction between scholars and banks could become more common as Islamic banking products become more sophisticated.

[5] *International Herald Tribune,* 'Booming Islamic bond market embroiled in debate over religious compliance', January 2008.

[6] Statement issued by AAOFI's Shariah board, February 2008.

Capital management and Basel II

Risk and capital are the twin hearts of Basel II. The new framework is supposed to result in more accurate assessments of risk by banks, which then produce a more dynamic, sensitive regulatory capital requirement.

It is not easy to apply this model to Islamic banks. First, because Islamic banks can raise much of their funds through mudharaba accounts, it's not easy to work out how much equity a bank has, nor who bears the risk – the account-holders or the bank itself. Many Islamic banks have argued that the funds raised in this way should be seen as a form of equity because of the loss-bearing contracts on which they are based. As discussed above, however, the banks' sensitivity to liquidity risk means that most would accept losses themselves rather than pass them on to their customers.

The second obstacle is the fact that Islamic banks' risk profile may not be well reflected by the Basel II taxonomy – market, credit and operational risks are all measured according to the specific rules of Pillar I, but other risks which are important to Islamic banks, such as liquidity risk, concentration risk and fiduciary risk, are all approached more subjectively under Pillar II. Here, banks are required to articulate their approach to capital management and its allocation across businesses and risk types, subject to a regulatory review of the approach's effectiveness – which in turn will determine the supervisory approach taken.

As things stand, there is broad consensus on the part of Islamic bank regulators on how these risks should be assessed for capital adequacy purposes. The Islamic Financial Standards Board (IFSB) has developed a framework based on Basel II which provides the industry with a strong platform for the development of new national regulatory capital frameworks. Still, most national regulators will find this challenging to some degree. The banks themselves will find it hard to produce robust numbers, particularly for Pillar II risks.

Even more traditional risk types, like market and credit, come with thorny issues for the Islamic bank. Both require a wealth of historical data which the still-young Islamic sector simply does not have. As an example, banks that want to use the more advanced approaches to credit risk in Basel II have to be able to calculate a default probability for each of its counterparties. These calculations are based on years of data for other counterparties. In the absence of this kind of data, Islamic banks have been known to turn to conventional bank data as a proxy – but Islamic financial products do not have the same definition of default as a conventional product, making it difficult to apply this proxy information.

Rather than being forced to play follow-the-leader — regulators of Islamic banks could now help to set the agenda.

These issues could be even more acute for conventional banks that also offer Islamic banking, because their capital requirements will be set by a non-Islamic regulator which might not fully understand the complexities involved.

As noted above, national regulators are working to build on the Basel II guidance issued by the IFSB. Most are still assessing their implementation options. In theory, those options ought to be fairly limited – Basel II is supposed to be a uniform global regulatory standard which provides a level playing field for all banks within the framework, regardless of where they are domiciled. In practice, the credit crisis seems likely to produce so much regulatory change that regulatory capital standards may be in a state of flux for some years to come. It's not inconceivable that – rather than being forced to play follow-the-leader – regulators of Islamic banks could now help to set the agenda.

What the future holds for risk management in Islamic banking

This paper started by observing that if Islamic banks aspire to a more significant role in the financial system they will need to demonstrate to customers and conventional bank counterparties alike that they appreciate their risks and know how to manage them. That's true – but it can't be done by cutting and pasting risk management concepts and practices from conventional banks.

There is no exemplar for Islamic banks to follow. Risk practices within the conventional banking system are currently under intense scrutiny – no one should be rushing to emulate those practices until the lessons of the crisis have been thoroughly digested. More pertinently, many of the risks discussed in this paper are either particular to Islamic banks or have some special feature thanks to the unique nature of Islamic finance.

The sector needs to focus on strong management, robust governance and also transparency, which has the potential to address a number of Islamic banks' most pressing exposures. The issues of displaced commercial risk, real estate concentration and fiduciary risk all arise, to some extent, from the complex nature of Islamic banking relationships and products, and the tensions between Shariah-compliant form and substance.

Islamic banks could also be helped by consistency of Shariah interpretation. Uniformity would enable banks to act more confidently and seize opportunities more quickly. This may seem a distant prospect given the divergent Shariah judgements that currently exist, but the benefits could be considerable – and the arguments in favour of standardisation can be expected to grow.

Uniformity would enable banks to act more confidently and seize opportunities more quickly.

How PricewaterhouseCoopers can help

Risk management is an issue which no bank can ignore – and Islamic banks have a pressing need to establish risk management credibility as they move into the mainstream of the financial system.

As this paper illustrates, the sector needs to confront a considerable range of issues – from displaced commercial risk to liquidity risk, and from real estate risk to operational, fiduciary and reputational risk. PricewaterhouseCoopers has the breadth and depth of talent to help our clients with all of these challenges, offering diagnostic assessments, the development of new risk standards and frameworks, and implementation assistance as well as guidance on Basel II and regulatory policy.

Our team of Islamic finance and risk management specialists has wide experience of helping both Islamic banking clients and the Islamic subsidiaries of conventional banks in Malaysia, Dubai, Bahrain, the UK and elsewhere. Our track record includes risk management work at the strategic level – on market opportunities, acquisition due diligence and valuations, for example. We have helped clients implement the IFSB's Basel II-based capital adequacy standards, and to assess the different capital impacts of the various Basel II approaches. Other clients have engaged us to review their credit policies for all Shariah-compliant products, or to update their investment procedures and policies. In some cases, clients engaged PricewaterhouseCoopers to perform a top-to-toe overhaul of all their existing risk policies.

We also have a close relationship with AAOIFI and the IFSB, including relationships with technical working parties, and can keep our clients up to date on the impact that accounting and regulatory changes will have on them and their competitors.

PricewaterhouseCoopers is committed to bringing the best knowledge to financial services organisations across its global network. We resource projects with specialists from local offices and the wider PricewaterhouseCoopers network firms to best match the needs of our clients. This ensures that organisations obtain local expertise and the benefit of our market-leading risk management expertise from across the globe.

Appendix

An Islamic finance primer

Islamic banks play the same role in the economy as conventional banks. They act as a conduit for funds, allowing savers and investors to earn a return on their capital; they disburse credit and arrange financing. For conventional banks, these core activities are based on the receipt or payment of interest to compensate for the various risks involved. Shariah, however, prohibits the use of interest (riba). Speculation (maisir) is not allowed, and nor is ambiguity or general uncertainty (gharar). Trade in commodities that are repugnant to the Islamic faith, such as alcohol or pork, must also be avoided. As a result, there is a demand from devout Muslims for Shariah-compliant banks and banking products.

To assure customers of Shariah compliance, Islamic banks typically employ a board made up of Islamic scholars. The launch of a new product or the closing of a deal is conditional upon the board's ruling, or fatwa. Some conventional banks also have Islamic banking subsidiaries or offer Shariah-compliant products, having either their own Shariah board or turning to other Shariah advisers to offer judgements on what is allowed (halal). Fatwas can vary from one board to the next depending on the familiarity that Shariah scholars have with banking products, the pragmatism of the board and because of variations between the different strands of Islam.

Islamic banking products – an overview

The prohibition of riba, maisir and gharar has forced Islamic banks to be creative, giving rise to a suite of product types which, in functional terms, have direct equivalents in conventional banking but which often have a starkly different risk profile. As a rule, Islamic banking products seek to share risks and profits between the bank and its client, making transactions more like partnerships or joint investments in which both counterparties have a shared, long-term interest. Purely financial contracts do not exist – there will always be an underlying asset. Returns are determined by agreeing a profit share in advance – which may be periodically adjusted – rather than an interest rate.

The following list of Islamic banking products is not exhaustive. It focuses on the types of transaction which are mentioned in this paper:

Mudharaba: customers place funds with the bank which are invested in a variety of assets. Profits are shared between the bank and the customer. Contractually, losses are supposed to be borne by the customer alone although, for commercial reasons, banks are often unwilling to pass the losses along. Superficially, the product resembles a conventional savings or term deposit account. However, because the customer is (in principle if not in practice) exposed to the risk of under-performance in the underlying assets rather than to the bank as counterparty, these arrangements are more like an investment management relationship.

In a restricted mudharaba account, the bank creates different pools of assets for its various classes of clients to allow variability in risks, maturities and profitability to match client risk/return appetite. Unrestricted mudharaba accounts freely commingle the bank's own equity with customers' funds and can be invested as the bank sees fit.

Wakala: as in a mudharaba contract, customers place funds with the bank – but here the relationship is more like a straightforward custody arrangement, in which the bank has the discretion to pay a return but no obligation to do so.

Musharaka: resembling a private equity transaction, the bank provides finance to a project in return for an equity stake. The bank may or may not play a management role. Losses are shared in strict proportion to the size of the capital contribution, while profits are shared according to a pre-agreed ratio.

Sukuk: analogous to an asset-backed securitisation, sukuk entitle investors to a share of the profits earned by a pool of underlying transactions which are held in trust by a special-purpose vehicle (SPV). The sukuk originator will transfer exposure to the underlying assets to the SPV by entering into a mudharaba, musharaka or ijarah contract.

Murabaha: a form of financing often used to finance asset purchases or for consumer loans. The bank buys an item and then sells it to its client at a higher price with deferred repayment terms. The interest that would ordinarily be paid by the client in a conventional loan – and which would constitute the bank's profit – is replaced by the difference between the purchase and the sale price.

Istisna: a form of financing which works on the same principle as murabaha, with the important exception that the item being purchased does not yet exist. It is typically used for project or construction financing.

Ijarah: the equivalent of a leasing transaction. In Islamic finance, the owner of the leased asset must retain some of the risks and rewards of ownership. A pure operating lease should normally be acceptable under Shariah. Leases classified as finance leases for accounting purposes may or may not be acceptable under Shariah depending upon their precise terms and the views of the scholars giving the Shariah opinion.

Contacts

If you would like to discuss any aspect of the issues raised in this paper, please speak to your usual contact at PricewaterhouseCoopers or any of those listed:

Our specialist risk management team:

Cameron Evans
Director
PricewaterhouseCoopers (Thailand)
Telephone: +66 (0) 2344 1185
E-mail: cameron.evans@th.pwc.com

Prathit Harish
Partner
PricewaterhouseCoopers (Dubai)
Telephone: +971 (4) 304 3330
E-mail: prathit.harish@ae.pwc.com

Charles Ilako
Partner
PricewaterhouseCoopers (UK)
Telephone: +44 (0) 20 7804 2103
E-mail: charles.ilako@uk.pwc.com

Our global Islamic finance leadership team:

Mohammad Faiz Azmi
Global Islamic Finance Leader
PricewaterhouseCoopers (Malaysia)
Telephone: +6 (03) 2173 0867
E-mail: mohammad.faiz.azmi@my.pwc.com

Mohammed Amin
Partner
PricewaterhouseCoopers (UK)
Telephone: +44 (0) 20 7804 6703
E-mail: mohammed.amin@uk.pwc.com

Ashruff Jamall
Partner
PricewaterhouseCoopers (Dubai)
Telephone: +971 (4) 304 3105
E-mail: ashruff.jamall@ae.pwc.com

Madhukar Shenoy
Partner
PricewaterhouseCoopers (Bahrain)
Telephone: +973 1754 0554 Ext. 330
E-mail: madhukar.shenoy@bh.pwc.com

PricewaterhouseCoopers provides industry-focused assurance, tax, and advisory services to build public trust and enhance value for its clients and their stakeholders. More than 155,000 people in 153 countries across our network share their thinking, experience and solutions to develop fresh perspectives and practical advice.

"PricewaterhouseCoopers" refers to the network of member firms of PricewaterhouseCoopers International Limited, each of which is a separate and independent legal entity.

This paper is produced by experts in their particular field at PricewaterhouseCoopers, to review important issues affecting the financial services industry. It has been prepared for general guidance on matters of interest only, and is not intended to provide specific advice on any matter, nor is it intended to be comprehensive. No representation or warranty (express or implied) is given as to the accuracy or completeness of the information contained in this publication, and, to the extent permitted by law, PricewaterhouseCoopers firms do not accept or assume any liability, responsibility or duty of care for any consequences of you or anyone else acting, or refraining to act, in reliance on the information contained in this publication or for any decision based on it. If specific advice is required, or if you wish to receive further information on any matters referred to in this paper, please speak with your usual contact at PricewaterhouseCoopers or those listed in this publication.

For more information on the PricewaterhouseCoopers Global Financial Services Islamic Finance programme, please contact Áine Bryn at PricewaterhouseCoopers (UK), Marketing Director, Global Financial Services, on +44 (0) 20 7212 8839 or at aine.bryn@uk.pwc.com

For additional copies, please contact Maya Bhatti at PricewaterhouseCoopers (UK) on +44 (0) 20 7213 2302 or at maya.bhatti@uk.pwc.com

pwc.com

© 2008 PricewaterhouseCoopers. All rights reserved. 'PricewaterhouseCoopers' refers to the network of member firms of PricewaterhouseCoopers International Limited, each of which is a separate and independent legal entity.