

Islamic Investment Banking

The assets of Islamic financial institutions now top the \$250bn mark. That is more than a 50-fold increase since 1982. Most of the large Western financial institutions, following the example of Citibank, have their own Islamic subsidiaries or, at the very least, Islamic "windows" or products aimed at their Islamic clientele. As proof of how many companies are compatible with Islamic law - and not just from within the Muslim world - there is now even a Dow Jones Islamic market index.

This may seem strange. We often hear it said that Islam is incompatible with the new world order that emerged with the end of the cold war¹. How can practices rooted in the Middle Ages thrive in the age of technology-driven global finance? Or institutions that are suspicious of interest operate within a global, interest-based financial system? And how can Islamic finance, often considered a facet of political Islam, experience its most rapid growth just as that same political Islam is on the wane²?

Modern Islamic finance began in the early 1970s at the intersection of two important developments in the Muslim world: the rise of pan-Islamism and the oil boom. The 1967 Six Day war marked the end of the secular pan-Arab Nasserite movement and the start of the regional dominance of Saudi Arabia under a pan-Islamic banner³. With the start of the Organisation of the Islamic Countries movement (OIC) in 1970, the idea of updating traditional Islamic banking soon became part of the agenda. It was something that had preoccupied Islamic scholars, particularly in Pakistan, for a number of years.

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ISLAMIC INVESTMENT BANKING

Islamic banking and financial institutions grew along with political Islam: it declined, they did not. In fact, Islamic finance is now a confident part of the new global world of venture capital, ethical investment and profit-and-loss sharing.

...Ibrahim Warde
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The Equity / Asset ratio of Islamic banks stands at 13.10 per cent compared to 11.30 per cent for conventional banks in the GCC region. This indicates underutilization of capital and provides a large scope for taking on additional risk on the balance sheet

Research institutes focusing on Islamic economics and finance began to spread throughout the Muslim world. In 1974 the OIC summit in Lahore voted, after oil prices quadrupled, to create the inter-governmental Islamic Development Bank (IDB). Based in Jeddah, this became the cornerstone of a new banking system inspired by religious principles. In 1975 the Dubai Islamic Bank - the first modern, non-governmental Islamic bank - was opened. In 1979 Pakistan became the first country to embark on a full Islamisation of its banking sector; and Sudan and Iran followed suit in 1983.

The first paradigm of modern Islamic banking was established in those years. Islamic jurists reinterpreted a rich legal but pre-capitalist tradition to suit the requirements of the modern era. There was a central problem: although commerce had always been central to the Islamic tradition (the Prophet Muhammad was himself a merchant), profits from pure finance were viewed with suspicion. The Koran says, for example, that despite their superficial resemblance, profits from commerce are fundamentally different from those generated by money-lending (sura 2, verse 275). More specifically, Islam prohibits *riba*. Though the term literally means "increase", it has been variously interpreted: sometimes as usury (or excessive interest), more often as any kind of interest. The majority of Islamic scholars still equate *riba* with interest, even though major scholars - including the current head of Egypt's Al-Azhar, one of Islam's oldest and most prestigious centres of learning - have condoned the use of certain forms of interest.

Pricing time

Islamic scholars accepted that time must be priced, but objected to the fixed, pre-determined aspects of interest-based lending with its inherent risk of lender exploiting borrower⁴. In the early days of Islam, the dominant form of finance consisted in a partnership between lender and borrower, based on the fair sharing of both profits and losses - a logic similar to today's venture capital where financiers link their fate to the firms in which they invest. For instance, in medieval Arabia, wealthy merchants financing the caravan trade would share in the profits of a successful operation, but could also lose all or part of their investment if the merchandise was stolen, lost or sold for less than its cost.

A distinctive feature of Islamic banking was to be its focus on developmental and social goals. Profit-and-loss-sharing (PLS), or partnership finance, with its focus on cash-poor but promising entrepreneurs, held more economic potential than conventional, collateral-based lending, which favours established businesses. Islamic finance also promised to benefit local communities and draw into the banking system people who had shunned *riba*-based finance. In addition, banks were to contribute to, as well as manage, *zakat* funds⁵ earmarked for a variety of charitable and social purposes.

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The first Islamic banks were committed to partnership finance – *mudaraba* (commenda partnership) and *musharaka* (joint venture) – though most of their operations consisted of cost-plus operations such as *murabaha*, where the bank would purchase the goods needed by the borrower, then resell them to the borrower at a profit. Remuneration of deposits (current, saving or investment accounts) was based on a profit-and-loss sharing logic: investment accounts were remunerated based on the performance of specific investments by the bank; and holders of savings accounts shared in the bank's overall profits.

After a few years Islamic finance began to look like no more than an exercise in semantics: Islamic banks were really no different from conventional banks, except in the euphemisms they used to disguise interest. Forays into profit-and-loss sharing were disappointing, and often abandoned. The image of Islamic banks was also tainted by the failure of Islamic Money Management Companies (IMMCs) in Egypt in 1988 and by scandals such as the BCCI (Bank of Credit and Commerce International) collapse in 1991. People dismissed Islamic finance as a passing fad associated with the oil boom.

In reality, it was on the cusp of a major boom. Deregulation and technological change had produced a major readjustment in international finance. And the Islamic world had been transformed by new political, economic and demographic circumstances (the impact of the Iranian revolution, the Gulf war, the collapse of the Soviet Union, the emergence of new Islamic states, a changing oil market, the rise of Asian tigers, a growing Islamic presence in the West, the emergence of new Islamic middle classes).

The traditional world of finance, dominated by commercial, interest-based banking, could raise potentially troublesome theological issues. But Islamic finance thrived in the new world, with its downgrading of interest income, financial innovation and blurring of distinctions between commercial banking and other areas of finance. The downgrading of interest (and the concomitant rise of fees as a major source of revenue for financial institutions) allowed Islamic bankers to sidestep the controversial *riba* issue. Deregulation fostered the creation of tailor-made Islamic products. Until the 1970s financial institutions could sell only a narrow range of financial products. With the lifting of constraints on products that could be devised to suit every need, religious or not, Islamic products could be created. For example, the process of slicing and splicing makes it possible to split the interest and principal components of a bond, and sell them separately.

Pure-play Islamic Banks and financial institutions manage over \$250 billion of assets and a further \$200-300 billion is managed by the Islamic windows and subsidiaries of international banks.

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The GCC region has been the hotbed of activity as far as the Islamic Banking industry is concerned, where 41 Islamic financial institutions are currently operating in the GCC countries (of which 18 are banks). Qatar and Bahrain are the leaders and hold a 70 per cent share of the assets, while the UAE accounts for 19 per cent of assets. The growth in assets is estimated at 15 per cent and expected to remain so for several reasons.

- ◆ The growth in overall wealth in the Middle East.
- ◆ Growing awareness about the Islamic products.
- ◆ Islamic products are becoming more competitive compared to conventional products.
- ◆ Wider availability and variety of Islamic financial products.

Moralising finance

At the ideological level, the Islamist critique of statism converged with the emerging "Washington consensus". The Islamic commitment to private property, free enterprise and the sanctity of contracts meshed with the emphasis on privatisation, deregulation and the rule of law. The reliance on zakat and other religiously-based redistribution schemes matched increased preference, since the Thatcher-Reagan years, for the downsizing of the welfare state. In many countries, Islam became a tool for entrepreneurs seeking to get around restrictive regulation, and the best excuse to disengage the state from the economy. Malaysia and Bahrain used Islam as a tool of financial modernisation - essentially as a way of countering the rentier inclinations of the private sector and the anti-competitive leanings of entrenched elites who benefited from the status quo. *The Financial Times* noted that Islamic institutions are now often at the forefront of innovation and dynamism.

Perhaps the main impetus behind the current boom in Islamic finance lies in the excesses of global finance⁶. Just as current business excesses have spawned a preoccupation with ethics, the amorality of contemporary finance has generated an interest in "moralising" finance. And whereas Western or Judeo-Christian finance has become thoroughly secularised (the religious origin of many financial institutions has long receded from people's minds), the idea of Islamic finance was bound, at a time of rising pietism⁸, to strike a chord. Islam has a positive view of economic activities, while providing for a strict ethical framework; and Islamic finance offers a fruitful compromise between finance and ethics.

This explains the current tendency to focus on the spirit, or "moral economy", of Islam. In contrast to the 1970s, when literal, legalistic and scholastic interpretations dominated, the *ijtihad* (interpretation) now underway focuses on making modern financial instruments compatible with Islamic principles. The modernist slant disavows the view that whatever did not exist in the early days of Islam is necessarily un-Islamic. Challenging common perceptions that Islam is rigid and fossilised, it emphasises those adaptive mechanisms - such as departures from tradition for reasons of local custom (*ʿurf*), public interest (*maslaha*) or necessity (*darura*) - that have allowed the religion to thrive on every continent for 14 centuries.

Whereas the early years of Islamic finance were dominated by oil-producing Arab states (primarily Saudi Arabia), and to a lesser extent Egypt and Pakistan, the new paradigm reflects the diversity of the Islamic world. A wide range of Islamic products is now available in at least 75 countries. Even countries that have Islamised their entire financial systems have done so under different circumstances and in vastly different ways. In addition, much innovation and scholarship now originates within Muslim minorities outside the Islamic world.

Today the fastest growing segments of the industry are outside traditional banking products and in areas of finance that were either initially dismissed as unacceptable to Islam (such as insurance or *takaful*) or that barely existed in the 1970s (such as micro-lending and Islamic mutual funds). Funds invested in stocks acceptable to Islam (shunning unethical or highly-indebted firms, or engaged in gambling, alcohol sales and other prohibited activities) are increasingly popular, just like their "socially-responsible" secular counterparts. Islamic finance still faces a host of challenges (strategic, economic, regulatory, political, religious), but the current boom does not seem likely to abate.

¹Samuel Huntington, *The Clash of Civilizations and the Remaking of World Order*, Simon and Schuster Touchstone, New York, 1997, p 211.

²See for example Olivier Roy, *L'Échec de l'Islam politique*, Seuil, Paris, 1992.

³Edward Mortimer, *Faith and Power: The Politics of Islam*, Faber & Faber, London, 1982, pp 177-220.

⁴Until recently, the Christian and Judaic traditions had comparable misgivings about interest. See Rodney Wilson, *Economics, Ethics and Religion: Jewish, Christian and Muslim Economic Thought*, New York University Press, 1997.

⁵Zakat, or almsgiving, is one of the five pillars of Islam. The others are the profession of faith, daily prayers, fasting during Ramadan, and for those who can afford it, a pilgrimage to Mecca.

⁶Roula Khalaf, "Dynamism is held back by state control: As family dynasties stifle creativity in most of the industry, the Islamic sector is showing signs of the greatest vibrancy", *Financial Times*, 11 April 2000.

⁸Yahya Sadowski "Just' a Religion: For the Tablighi Jama'at, Islam is not totalitarian," *The Brookings Review*, summer 1996, vol 14 no.3, pp 34-35.

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Boca Comm: Our Progress

- 1981 Initiation of operations by the founding partners of the firm, simultaneously in USA and France
- 1980s Advisory role to IBM in personal computer R&D (France) and fabrication (Boca Raton Florida USA)
- Advisory and execution roles in AT&T's East Africa intercontinental telecommunications deployments (Kenya, Uganda, Sudan, Zimbabwe)
- 1990s Development of structured due diligence methodologies for engagement support of 'Big 6' (Andersen, Coopers, Deloitte, Ernst, KPMG, Price) privatization client valuations in emerging markets (Asia, Australia, Europe, Americas)
- Emerging market support worldwide to nascent USA-and UK-based LBO firms
- First government advisory services contract with City of Tampa Florida, followed rapidly by consultative engagements arranged by The Interamerican Development Bank and The World Bank—in Guyana, Argentina, Panama; then throughout Central & South America
- Internal Boca Comm IT and telecom systems relocated to Internet backbones
- 2000s Restructuring, realignment, outsourcing of the firm's service delivery model processes
- Formation of pure financial advisory services practice group concentration
- Development and implementation of risk mitigation strategies and tools specific for emerging market finance solutions
- Incorporation of Islamic finance strategies



Boca Comm

GLOBAL BUSINESS SERVICES

About Boca Comm

Boca Comm identifies, structures and executes diverse and innovative public and private market transactions for corporations, financial institutions and governments. Transactions include mergers, acquisitions, divestitures, the issuance of equity or debt capital, or a combination of these. We specialize in small- and middle- market private transactions across most sectors, concentrating in challenging or emerging markets worldwide.

Boca Comm Presence

- Every continent of the globe
- 45 Global Markets
- 600 Firm-wide Staff and Affiliates

Boca Comm seeks to provide our clients with the broadest possible range of opportunities from around the world. Our global relationships, coupled with our unique understanding of local economies, industries and cultures, help us consistently deliver high quality advice and service time and again.