Islamic Financial Instruments
-A vision for the future-

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Outline

1. Why Islamic Finance has become popular?
2. Main Islamic Financial Instruments: Banking
3. Main Islamic Financial Instruments: Capital Markets
4. The future vision
Don’t Forget

We are trying to play football in a basketball field.
Why Islamic Finance has become popular?

Global Financial Crisis lessons

1. **Global Economic and Financial System** has several vital problems.

2. People do not always behave rationally.
Global Economic and Financial System

Problems

i. Loans Without Advance Payment
   • Infinite Leverage
   • No Stake in the Game
   • Household Debt
     – 1980: 48% of GDP
     – 2008: 99% of GDP

USA Household Debt/GDP

1. Why Islamic Finance Has Become So Popular?
1. Why Islamic Finance Has Become So Popular?
ii. Deregulation and Financial Innovation
   – N.I.N.J.A. Mortgages: No income, no job or assets.

   Chuck Prince: «As long as the music is playing, you’ve got to get up and dance. We’re still dancing»

iii. Injustice and Inequality
Result

- The total value of homes in USA
  - 2006: 22.7 trilyon $,
  - 2011: 16 trilyon $ (-% 29.7)
- Extreme decline in values of bonds and bankruptcy of those real estates.
- L. Brothers, B. Stearns and Merrill Lynch Fannie Mae, Freddie Mac, AIG.
Economic Center of Gravity Moves to Asia
“The Great Credit Crisis has cast into doubt much of what we thought we knew about economics”

*B. Eichengreen, UC Berkeley*

“Most work in macroeconomics in the past 30 years has been useless at best and harmful at worst.”

*2008 Nobel Economy Prize Winner Paul Krugman*
2. Are People Rational? Example-1

• Which one do you prefer?
  $50,000 at where people win $25,000?  
or  
  $100,000 at where people win $200,000?
• People do not always behave rationally.
• Risk is more than an intellectual activity.
• It is a profoundly physical experience
• Example-2: Greed
  – “If the human has two valleys of full of goods, he would be willing to have the third.”
  [Prophet Muhammad]
Are People Irrational?

- Monetary gains activate mesial prefrontal cortex in brain. (Breiter, Kahneman 2001)

- Which is the area of brain that is activated by narcotics. (Addiction and Capitalism)
Searching for Alternatives

• Islamic Finance/Economy suggests very relevant arguments on these two issues.

Behavioral Finance

• People can make mistakes which can affect their financial decisions.
Key Features of Islamic Finance

• **Main Principal**: Funding of real economy
• Being asset backed *(secured debt)*
• Precluding leverage
• Sharing of profit and loss
• Prohibition of gambling and alcohol etc.
• Ethic and fair transactions
• Preservation of social justice etc...
Interest and Profit Share

• Interest is banned by many verses of the Quran: Bakara, 2/275

• Interest is banned by both the old and the new Testament.
• E.g. (Luke, 6/34). But interest was officially legalized in Geneva, 1574.

• Question: What is interest?
  • Can interest be at the same level with inflation?
• Islam offers partnership instead of interest.
• What is profit share?
Global Islamic Finance Asset Size

Global Islamic Finance Assets Growth Trend (2009-2013)
Source: KFH Research Limited

2009-2013 CAGR = 16.94%

USD bil
- 2009
- 2010
- 2011
- 2012
- 2013
- 2014F

2.09 tln
Global Islamic Finance Asset Distribution

- Others: 108
- MENA (ex. GCC): 720
- GCC: 666
- Asia: 288
- Sub-Saharan Africa: 18.0
IF INSTRUMENTS IN BANKING
Conventional Banks

Key Highlights
- Deposits are loans to the Bank as debt
- Assets are invested in fixed-income securities and loans
- Bank has fixed obligations on deposits but uncertainty on assets returns
- Bank is exposed to assets and liabilities mismatch risk
Islamic Banking

Key Highlights

- Depositors are investors rather than lenders
- Risk Sharing through Profit and loss sharing.
- Assets and Liabilities are matched.
- Ethical and socially responsible assets
Market Size in Various Countries

Source: Central banks and regulatory authorities, individual institutions, Bloomberg, Zawya, corporate communications, The Banker, KFHR
The Profit Margins and Interest Rates in Turkey

Deposit Rates

% of Deposit Rates from 2005 to 2013 for IF Banks and Conventional Banks.
Average Deposit Rates Difference:
IF Banks-Conventional
Murabahah

• Most Common Instrument: Murabaha
• Murabaha: Sale on profit.

• The difference from the Credit is
  • The money is not lent to the customer.
• New Trend: Buying with waqalat
Example: Murabahah

• The Bank buys a car for 20,000 TL for her customer.
• It sells it to her for 21,324 to be paid in 12 installments. (%1 monthly for 12 months)

<table>
<thead>
<tr>
<th>Months</th>
<th>Balance</th>
<th>Payment</th>
<th>Profit</th>
<th>Amortisation</th>
<th>Remaining loan Balance</th>
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<td>1,777</td>
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<td>1,777</td>
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<td>15,222</td>
<td>1,777</td>
<td>152</td>
<td>1,625</td>
<td>13,597</td>
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<td>1,777</td>
<td>136</td>
<td>1,641</td>
<td>11,956</td>
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<td>11,956</td>
<td>1,777</td>
<td>120</td>
<td>1,657</td>
<td>10,298</td>
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<td>10,298</td>
<td>1,777</td>
<td>103</td>
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<td>8,624</td>
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<td>86</td>
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<td>Nov.</td>
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<td>1,777</td>
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<td>1,742</td>
<td>1,759</td>
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<td>Dec.</td>
<td>1,759</td>
<td>1,777</td>
<td>18</td>
<td>1,759</td>
<td>0</td>
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<tr>
<td>Total</td>
<td>21,324</td>
<td></td>
<td></td>
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</tr>
</tbody>
</table>

• Excel: PMT(...)
Joint venture partnership. Two or more parties contribute capital to a business and participate with the related profits and losses. The capital need not be money only.
Musharakah

Joint venture partnership. Two or more parties contribute capital to a business and participate with the related profits and losses. The capital need not be money only.

1. **Consecutive musharaka**: Each partner can keep its share in the partnership until the very end of the joint venture, project, or business.

2. **Diminishing musharaka**: One partner is allowed to buy the other partner’s share of equity step by step until the whole equity of the other partner is transferred.
Example: Musharakah

• Erdem ltd is willing to make a business.
  – The business is worth 5m TL
  – The company has 2 m TL
  – The company does not have an expertise on the field.

• The Bank provides Erdem ltd. with 3 m TL and an expertise.
Mudarabah

An economic agent with capital develops a partnership with an entrepreneur with an agreement to share the profits.
Ijara (Leasing)

Ijara is a sale of the usufruct (the right to use the object) for a specific period of time.
Bay’al-salam

- The buyer pays the seller the full negotiated price of a specific product which the seller promises to deliver at a specified future date.
- Similar to forward contracts
- But the payment is made at the deal date
Islamic Finance: Capital Markets
The Difference btw Banking and Capital Markets

• Banking is for short term partnerships
• Capital Markets is for long term partnerships
Capital Markets: Equities

Indicies

- Adana Çimento
- Akçansa
- Aksa
- Albaraka Türk
- Alkım Alkali Kimya
- Aygaz
- Bankasya
- Bim Mağazalar
- Bursa Çimento
- Çimsa
- Enka İnşaat
- Ford Otosan
- Good-Year

- İndeks Bilgisayar
- Kartonsan
- Konya Çimento
- Mardin Çimento
- Nuh Çimento
- Park Elektrik
- Pegasus
- Petkim
- Pınar Entegre
- Pınar Süt
- Soda Sanayii
- Teknosa İç ve
- Tümösan
- Türk Hava Yolları
- Türk Traktör
- Turkcell
- Ülker
• Sakk (Arabic): certificate
• Instead of only debt based instruments
  – Asset-based Long-term partnership
• The investor shares the asset.
• Even there numerous sukuk types two are of common
  – Mudarabah
  – Ijarah
• Sukuk can be issued based on the future income flow.
Sukuk

Funds Mobilizing Entity

Pool of Assets (Ijarah/Lease)

Credit Enhancement

Special purpose Mudarabah “SPM”/“SPV”

Servicing

Invesors

SPM Balance Sheet

<table>
<thead>
<tr>
<th>Assets</th>
<th>Liabilities</th>
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</thead>
<tbody>
<tr>
<td>Ijara Assets (Leases)</td>
<td>Sukuk</td>
</tr>
</tbody>
</table>
- The Turkish Treasury wants to buy a building worth 1 million TL to work. An SPM collects money from its 50,000 investors each of which invests 20 TL.
- The SPM buys the building and rents it to Treasury for 10 years for 12500 TL. So each investor will receive 0.25 TL (coupon) each month.
- At the end of 120 month the investors will receive the principal 20 TL.
- The rate is 2.5% monthly. RATE(....) in Excel
The Sukuk Payments
• With the exception of Murabahah certificate, all sukuk types are Shariah compatible for trading in the secondary market.

• Sukuk issued against a pool consisting of cash or debt like instruments cannot be traded in the secondary market.
Global Sukuk Issuances (2012 – US Dollars)
Challenges

• Murabahah and wakala issue

• Are credit cards ok in IF?

• 20 prominent scholars holds %55 of all memberships of shariah boards.

• Two most popular scholar has 85 memberships in boards.
• IF has not encountered a global crisis yet.
• IF needs more research
• Education and financial awareness in necessary
World Bank Global Islamic Finance Development Center

Main Functions of the Center

- Research & Knowledge
- Standard Setting & Regulation
- Innovation

Main Areas of Interest

- Global Islamic Finance Report
- Global Islamic Finance Database
- Islamic Capital Markets
- Islamic Banking
- Islamic Finance and Economic Development
IF investors and Other Investors in Turkey (Çörtük and Erdem 2014)

<table>
<thead>
<tr>
<th></th>
<th>All individual Investors</th>
<th>Real IF Investors</th>
<th>Real Conventional Investors</th>
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</thead>
<tbody>
<tr>
<td>n</td>
<td>855,303</td>
<td>28,413</td>
<td>826,890</td>
</tr>
<tr>
<td>Holdings(%)</td>
<td>100%</td>
<td>4.55%</td>
<td>95.45%</td>
</tr>
</tbody>
</table>
Risk Appetite of IF investors and Other Investors in Turkey (Çörtük and Erdem 2014)
Further Readings

• An Introduction to Islamic Finance, Theory and Practice by Zamir Iqbal and Abbas Mirakhor, Wiley
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