Tatagroprombank

Talk on Islamic Finance

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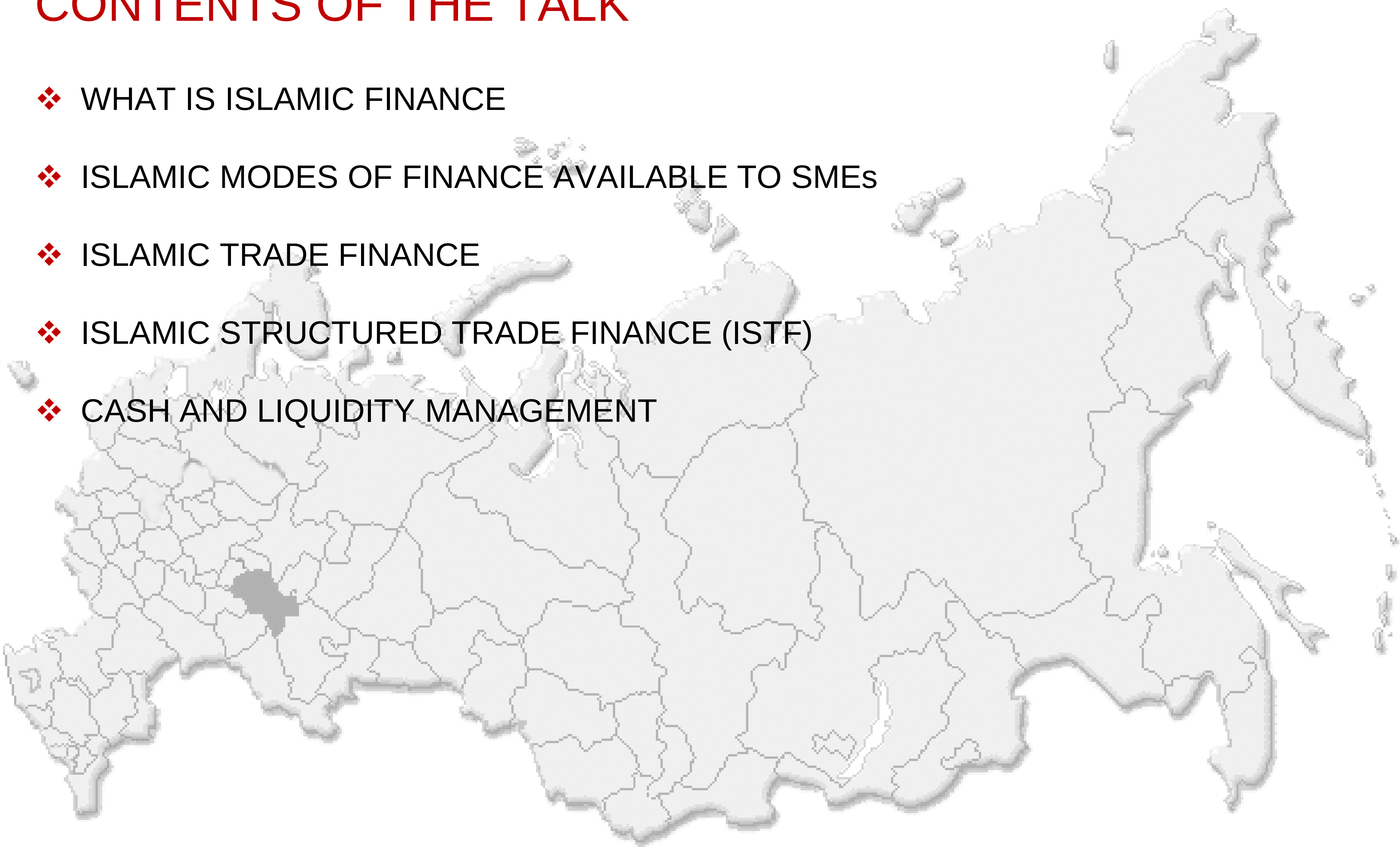

WHAT IS ISLAMIC FINANCE

ISLAMIC MODES OF FINANCE AVAILABLE TO SMEs

- In Malaysia, SMEs are considering Islamic financing due to the following reasons:
  - → Multiple products to cater for SME's working capital and capital expenditure requirements.
  - → Available options for fixed and floating rate financing for better management of SME's cash flow.
  - → Tax incentive and discount on stamp duty.
  - → Competitive structure and pricing as compared to conventional facility.
  - → Government support for Islamic financing/ banking- schemes & incentives.

- For short-term trade finance:
  - → Letter of Credit-i
  - → Trade working capital financing-i (Murabahah)
  - → Accepted bills-i (Murabahah and Bai' Dayn)
  - → Bills of exchange purchased-i (Bai' Dayn)
  - → Export credit refinancing-i
  - → Shipping guarantee-i
  - → Bank guarantee-i (Kafalah i.e. guarantee or surety given by one party to discharge the liability of a third party in the case of default)

ISLAMIC MODES OF FINANCE AVAILABLE TO SMEs

- Working capital financing:
  - → Cashline-I (*Tawarruq*)

- Medium and long-term financing:
  - → Ijarah Thumma Bai- hire purchase facility for equipment/ machineries/ vehicles
  - → Ijarah-i- Leasing facility for plant/ equipment/ machineries/ vehicles
  - → Bai Bithaman Ajil (asset or property/ building financing)
  - → Business financing-i (term financing for operation or capital expenditure requirements) – *Tawarruq*

- Sukuk and Islamic finanicing to SMEs:
  - → In August 2012, SME Bank Bhd issued a total of RM500mln sukuk in two tranches of RM250mln each. This sukuk issue was part of an RM3bln government-guaranteed Islamic medium term notes programme
  - → The RM500mln sukuk deal was oversubscribed by 5.9 times. The 7-year sukuk was priced at 3.6% while the 10-year sukuk was priced at 3.69%. These profit rates represented spread of 28bps over the equivalent Malaysian government bonds. These yields were the lowest for a government-guaranteed issuance in 2012
  - → The SME Bank sukuk was based on wakalah, a structure that is widely accepted in Malaysia and globally.

ISLAMIC MODES OF FINANCE AVAILABLE TO SMEs

- The SME Bank with the cooperation of the Islamic Development Bank will provide RM200mln to the Halal Industry Fund to finance the working capital of participating SMEs. This will encourage the development of high-impact halal products for export

ISLAMIC TRADE FINANCE

- Islamic Trade Finance is based on standard documentary credit (Letter of Credit, Bills of Exchange, etc.) as regulated by the UCP 600:
  - → but made Shariah-compliant
  - → we have, for instance, standardized *murabaha* Letter of Credit, *musharaka* Letter of Credit and *wakala* Letter of Credit

- Although all the Islamic contractual relations are ausable the modes most widely used are the following three

- The **Islamic Trade Finance *Murabaha*** under which the bank will purchase the commodities from the supplier and then sell them to the beneficiary with a deferred payment arrangement, typically between 80 and 90 days
  - → the difference between the purchase price and the sale price is a reasonable markup added to the purchase price
  - → the *murabaha* remains the preferred trade-financing tool in all Muslim countries because careful drafting techniques and structuring methods can minimise the risks involved for the bank and make the proposition more attractive to investors
  - → some banks are introducing innovations lacing this tool with derivatives or options

ISLAMIC TRADE FINANCE

- The **Islamic Trade Finance Installment Sale** under which the bank will purchase the commodities on behalf of the beneficiary and transfer the ownership immediately upon delivery to the beneficiary
  - → this allows the beneficiary to provide the same asset as security
  - → the sale price will usually be paid in installments
  - → under this mode of financing, the beneficiary is required to furnish a government, bank or any other guarantee acceptable to the bank

- The **Islamic Trade Finance *Istisna'*** to promote trade in capital goods and enhance the production capacity:
  - → it is a contract for manufacturing goods and other assets in which the manufacturer, under mandate of the financier, agrees to provide the buyer with goods identified by description after they have been manufactured in conformity with the description within a certain time and pre-determined agreed price
  - → this mode enables the bank to finance working capital and therefore enhance production capacity

- In addition to these modes key stakeholders of the industry are working on importing more modes of financing such as *ijara* to finance service packages linked to the purchase of equipment, *wakalah* and *musharaka*

ISLAMIC TRADE FINANCE

- *Wakalah*, in particular, is gaining traction in South East Asia
  - → Under this scheme, a borrower requests a bank to open a LoC to finance the import of certain goods via another lender. The bank acts as an agent and not a financing institution, charging a commission for the service

- Under the *musharaka* scheme, a borrower and a bank set up a financing vehicle in which they share the equity, but also potentially share the loss. Shariah-compliant shipping guarantees are also available

- As there is a massive amount of short term liquidity in Islamic institutions that needs to be invested, Islamic trade finance by its short terms nature meets this need perfectly

ISLAMIC TRADE FINANCE

- There is no need to elaborate much on documentation needed for applying to ITF as it is pretty standard. It includes the following documents and information:

  → Beneficiary's name and complete contact information
  → Beneficiary's legal documents such as ceritificate of incorporation, commercial registration, Memorandum and Articles of Association, etc.
  → Beneficiary's audited annual reports or audited accounts for the most recent 3 to 5 years
  → Specifications of commodities to be imported
  → Source of supply of commodities
  → Financing amount requested and currency of denomination
  → Details of the guarantee/security offered
  → The proposed repayment period (tenor)

ISLAMIC TRADE FINANCE

- The leader in Shariah-compliant trade finance is the International Islamic Trade Finance Corporation (www.itfc-idb.org):
  - → the ITFC is the trade finance arm of the Islamic Development Bank Group and was formed to consolidate business that was formerly undertaken by various windows within the IDB Group.
  - → though ITF can be easily arranged by any bank, specific know-how and expertise is found within Standard Bank, Bank Maybank Islamic, HSBC Amanah, CITI and RHB

ISLAMIC STRUCTURED TRADE FINANCE (ISTF)

- Islamic Structured Trade Finance (ISTF) is an alternative mean of providing trade financing facility so as to overcome the difficulty of obtaining conventional payment guarantees in the form of government or central/commercial bank guarantees making it an effective financing solution in the developing markets. Its main features are :

  → the main security is a current asset, either a commodity (stored in the warehouse run by a collateral manager), a receivable in a secured collection account, escrow account or a combination of both

  → ISTF is an asset-backed financing allowing banks to retain title of goods till repayment, hence an off beneficiary's balance sheet financing which enhances the beneficiary's financial position

  → ISTF can be applied across part or all of the commodity trade value chain: from producer to processor (pre-export financing) to distributor, including traders who purchase and deliver commodities in the international and domestic markets (import / export financing)

  → ISTF is primarily based on performance risk and hence it is particularly well suited for companies doing business in what are considered higher risk markets and industries (emerging markets) or other companies trying to control their leverage level by applying for an off-balance sheet financing

ISLAMIC STRUCTURED TRADE FINANCE (ISTF)

- Unlike traditional financing, ISTF looks to the flow of the goods and their origins with repayment realized from the export and sale of commodities in preferably hard currency:

  → that is to say, the financier's risk assessment is primarily related to the company’s ability to perform - to produce and deliver commodities, even under unstable or uncertain political and financial circumstances

  → by focusing on the individual transaction structure and the company’s business performance capability, as opposed to their balance sheet, ISTF provides an alternative and cost effective financing tool to companies in the commodity arena, and to commodity producers and trading companies doing business in the developing markets

  → the value-added of ISTF solutions is their built-in ability to provide maximum security to all parties in a transaction - financier, producer and trader - essentially by converting payment and sovereign risk into performance risk that is carefully identified and mitigated by appropriate control tools, one of which is hiring a collateral manager

ISLAMIC STRUCTURED TRADE FINANCE (ISTF)

- Collateral management is a mean of securing physical commodities (subject of a loan/financing) that are taken under safe custody of a third party on behalf of the financier:
  - → a collateral management agreement (CMA) is formed among the financier, the beneficiary (or the owner of the commodities) and the collateral manager, a professional independent reputable company with experience in inspection, supervision, quality control, warehousing as well as/or in addition to freight forwarding/transport specialist
  - → collateral managers basically look after the collateralized commodity on behalf of the financier. Collateral management is basically the management of physical collateral (an asset) during several stages of the value chain. It is a third-party commitment accepted by the collateral taker (financier) to secure an obligation of the collateral provider (beneficiary)

CASH AND LIQUIDITY MANAGEMENT

- Islamic inter-bank markets exist though they are not very much developed:
  - → Funds are placed on the basis of *mudharabah* or *wakalah* contracts

- Another solution that is widely used is the commodity *murabahah* to manage short-term liquidity:
  - → Such transaction are carried out through international metals and commodities markets

- Organized *tawarruq* is approved and officially used in Malaysia to ease the issue of liquidity management faced by Islamic banks:
  - → liquidity risk is the potential loss to banks arising from their inability either to meet their obligation or to fund increases in asset

CASH AND LIQUIDITY MANAGEMENT

- The Association of Islamic Banking Institutions Malaysia (AIBIM) has launched in Sept 2009 the ‘Corporate Murabahah Master Agreement (CMMA)’ in a move to boost the Islamic money market:
  - → it is a standard document for deposit taking between financial institutions (Deposit Taking Entities or DTEs) and corporate customers (Deposit Placing Entities or DPEs). The latter intend to place their surplus funds with the DTEs
  - → the CMMA specifies *a common modus operandi* for Islamic financial institutions in accepting deposits via commodity *murābahah*
  - → the purchase by the bank, in its capacity as the agent of the customer, will be effected upon spot payment and immediate delivery by suppliers
  - → it helps eliminate the need for corporate customers to vet through each and every agreement proposed by different Islamic financial institutions on the same product
  - → it also provides certainty and standard methodology in ensuring principal and profit due to corporate depositors

CASH AND LIQUIDITY MANAGEMENT

- Similarly AIBIM has launched the' Interbank *Murābahah* Master Agreement (IMMA)' in 2009:
  - → it is a bilateral agreement between the Deposit-Placing Entity (DPE), or the principal and the Deposit-Taking Entity (DTE), or the agent
  - → as an agent, the bank will receive instructions from the principal to buy commodities from suppliers
  - → the purchase by the DTE or the bank would be effected upon spot payment and immediate delivery by suppliers
  - → upon conclusion of the commodity purchase by the bank on behalf of the principal, the bank may subsequently offer to purchase the commodities from the principal on a deferred cash payment basis, at an agreed sale price that takes into consideration the initial purchase price and the profit amount
  - → the sale would then be effected upon acceptance of the offer by the principal

CASH AND LIQUIDITY MANAGEMENT

- To implement the two agreements, Bursa Malaysia has launched in 2009 a trading platform called ‘*Suq al-Sila*‘’ or ‘Commodity Murabahah House’:
  - → the platform aims to facilitate Islamic financial transactions, particularly the application of commodity *murābahah* which is based on the principle of *tawarruq*
  - → the platform claims to provide *genuine commodity transactions* where possession and delivery of the commodity can take place without any hindrance, as opposed to the controversial practice of *tawarruq* using a platform like the London Metal Exchange (LME) in London

- Dubai Multi Commodities Centre (DMCC) has announced the inaugural Commodity Murabahah transaction on its DMCC Trade-flow platform