



## **An Alternative Approach to Islamic Finance**

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At the second Islamic Finance and Trade Conference held on the 28th and 29th October 2008 in London, strong calls were made for radically reshaping the world's financial architecture, both by Muslims and non-Muslims. Anne Pettifor, executive director of Advocacy International, a consulting firm that works with low income country governments and organisations to promote positive development, investment and environmental sustainability, demanded that conventional bankers follow Islamic financial ethics and prohibit interest. Five years ago, Pettifor argued that "the next seismic debt crisis would be in America, not Argentina."

Islamic economics emphasises the importance of distribution of wealth. In sharp contrast, our financial system with banks at the epicentre, promotes hoarding of wealth. Even Islamic banks offer products that are shaped around their conventional banking counterparts. Assets and liabilities are priced off the yield curve and remain dependent on the term structure of interest rates.

This paper proposes an alternative framework for Islamic finance that strives to move from Shariah-compliant to Shariah-based. The model proposed herein, which better resembles fund management, suggests that an investment fund can be launched for every business a bank extends credit in, albeit on an equity participation basis.

A fund structure provides the fund manager with more flexibility with respect to asset liability management. That is, unlike a bank treasurer who is continuously plagued with maturity mismatches between short-term liabilities and long-term assets, a fund manager has more freedom to deploy capital in lucrative investments without nearly the same level of concern for liquidity or redemption.

This is simply because fund investors recognise that their capital is at risk and acknowledge that their investment horizon needs to be long term. Naturally, no fund manager can expect to increase assets under management (AuM) or even remain afloat for that matter without generating profits consistently.

Some Mudarabah or equity participation fund structures which can be used in place of traditional bank lending are described below. In this model, the fund manager acts as Mudarib and investors providing capital are Rab al maal. The Mudarib earns a management fee as a percentage of the profits (for example, 10%) of the Mudarabah. All profits are distributed to investors. However, administrative expenses related to setting up or operating the fund can be charged to investors.

### **Trade Financing Fund**

#### **Import partnership**

The trade financing fund enters into partnership agreements as the capital partner with entrepreneurs or companies to import goods for resale in the domestic market. The focus can be in industries and product segments that demonstrate high profitability and rapid inventory turnover.

#### **Agriculture partnership**

In view of the size and predominance of the agriculture sector in the Muslim world, it is only natural to address the Islamic financing needs of agri-businesses. The fund can enter into partnerships as the capital partner with large and small farmers to finance the production of crops, farming equipment and livestock.

#### **Agriculture Salam contracts**

The trading fund can make two-way markets in agricultural Salam contracts, selling Salam contracts to end-users and buying Salam contracts from producers. Profits will be distributed to the fund's investors on a monthly basis after administrative costs have been deducted.

### **Consumer Financing Fund**

#### **House finance facility**

The consumer financing fund can enter into 10-, 15- or 20-year co-ownership agreements using diminishing Musharakah mode of Islamic finance with property buyers as a method for providing Shariah-compliant



property financing to the consumer sector. This fund would also address the pressing need for income-oriented investment vehicles for Islamic investors.

#### **Car finance facility**

The fund can penetrate the consumer car finance market by entering into Salam contracts with leading automobile manufacturers for the advance purchase of fleets to be sold through dealers on a deferred payment basis. Manufacturers will have an incentive to enter into these types of agreements with the fund because they will receive payment in advance.

Using this leverage, the fund will negotiate a better price for purchasing the goods in bulk. The price benefit will then be transferred to dealers in the form of a sales commission in order to give them incentive to offer their clients the fund's deferred payment plan. The deferred payment plan will also be available through other distribution outlets.

#### **Durable goods finance facility**

The fund can capture market share in the consumer durable goods finance sector by entering into Istisna contracts with electronics and home appliance manufacturers for the purchase of goods to be sold through retail outlets on a deferred payment basis.

Manufacturers will have an incentive to enter into these types of agreements with the fund because they will receive payment immediately upon completion of the consigned goods.

Using this leverage, the fund can negotiate a better price for purchasing the goods in bulk. The price benefit will then be transferred to dealers in the form of a sales commission in order to give them an incentive to offer the fund's deferred payment plan to their clients. The deferred payment plan can also be made available to consumers through other distribution outlets.

#### **Venture Capital Fund**

##### **Education venture capital fund**

The education fund can enter into partnerships as the capital partner with educationists who have extensive administrative experience in establishing and operating profitable school systems.

A diminishing Musharakah structure can be employed over a 5-year period to recover the fund's investment and pass on ownership to the educationist-entrepreneurs.

##### **Islamic microenterprise fund**

The Islamic microenterprise fund can enter into partnerships as the capital partner with the poorest of the poor in rural areas of developing Muslim countries. Grameen Bank's replicable model can be adopted, albeit on a partnership basis.

#### **Real Estate Fund**

##### **Islamic real estate investment fund**

The Islamic real estate investment fund can invest in prime properties such as office buildings, residential complexes and shopping malls in both Muslim and non-Muslim countries in order to earn monthly rental income for the fund's investors.

The fund will also seek capital appreciation by entering into partnership agreements with leading property developers to finance selected development projects throughout the Muslim world.

#### **Commodity Trading Fund**

The commodity trading fund can take short-term strategic proprietary trading positions in major and liquid exotic currencies, metals and energies based on an analysis of global economic and political developments, commercial supply and demand, as well as international reserves and capital flows. Fund profits can be distributed to investors on a quarterly basis.

The banking community may be quick to point out the failure of Mudarabah funds in Pakistan. Mudarabah funds were envisioned to adopt a model similar to the one prescribed herein. However, former bankers,



when entrusted with this responsibility, were unable to think outside the realm of banking. Nor did Pakistani laws allow funds to purchase real assets.

Portfolio management, asset allocation, diversification and concentration whether in the context of exchange-listed securities or private equity were not frequently used concepts, much less strategies at the time.

The model for Islamic finance proposed herein is unquestionably more operationally intensive than conventional banking. It requires fund managers to develop a strong understanding of the industries they allocate funds to, much like sector analysts; it requires that they serve on boards of companies they partner with, much like venture capitalists; it requires due diligence, monitoring, risk management and auditing either directly or through third party consultants.

The fund manager will have to negotiate profit sharing ratios with businesses and entrepreneurs, which can be significantly more mind gruelling than agreeing on spreads over an inter-bank offered rate. Clearly, these requirements are much more onerous than extending credit based on collateral and/or creditworthiness.

However, the resources necessary for achieving this in an integrated fund model are readily available. For example, research analysts specialising in every industry (construction, autos, healthcare, technology and so on), who understand the nuts and bolts of their respective industries from the ground-up, can be hired as employees or consultants.

The events of the last few months have revealed the frailty of fractional reserve banking. While governments in developed and emerging markets alike have taken action individually and in concert to restore faith in the banking system, they have used other people's wealth to do so. The debt burden created in this process will have to be borne by future generations worldwide.

Considering that conventional banks have failed to live up to their reputation as icons of conservatism and wealth preservation, would it not be prudent for institutions engaged in Islamic finance to adopt an alternative model such as the one proposed herein, which on the surface may appear to be riskier than its conventional counterpart because of its partnership structure but, when executed with proper due diligence and risk management, may offer significantly better risk-adjusted returns.

The fund model for Islamic finance proposed herein eliminates many of the excesses for which Wall Street is widely criticised. Fund managers are rewarded for performance only and cannot rely on fees from assets under management to remain afloat.

Entrepreneurs are no longer burdened with debt if their business or invention fails. From the investor's perspective, the worst-case scenario involves the loss of his original risk capital, not an amount two or three times that. Profit or loss, wealth will have been distributed equitably.

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