



LET'S TALK ABOUT...

FINANCIAL LEXICON EDITED BY THE SWISS ASSOCIATION OF ASSET MANAGERS

Sharia and Subprime

(Part Six) The latest achievement of the Islamic finance is the establishment of *sharia* compliant hedge funds. Of course the current phase is not favourable for these instruments, which are among the major actors, and victims, of the markets' debacle, being suffering huge liquidity crisis and having been obliged to block redemptions and postpone payments to their participants. However, the storm will be over some day, and such or similar products may be of interest in the investment arena again. Besides, many Western-style hedge funds have gained large market shares among investors in the Islamic areas too. However, their main features being high leverages, wide use of derivatives, diversified strategies such as short selling, overall speculative approaches, the "Islamic model" of an alternative fund is inevitably faced with regulations and limitations stemming from the *sharia*. We have already cited the prohibition of short selling, that is selling assets one does not hold, and similar exclusions apply to the derivative instruments as forms of betting on future events and trends, or as interest-related vehicles in some way. In debating the practice of short selling, it could be said that in terms of strict financial ethic it may be viewed as contrary to the principle of "economic usefulness" within Western environments too, despite the contrary opinion that short selling increases the market liquidity and trading opportunities. How may the Islamic finance overcome such prohibition ? While noting that the *sharia* allows to buy or sell goods at a previously agreed price and for postponed deliveries, the short selling transactions are replaced with contractual forms including partial down payments combined with optional choices for executing the transaction or not according to the asset's price evolution. Moreover, the Islamic hedge fund should have a low leverage and a range of investment choices in line with the *sharia*'s limits and principles as reviewed in our previous articles. *(the end)*GLT

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(Part Five) We have noted how the Islamic finance applies the principles and guidelines of *sharia* in evolving from the most traditional contracts to the modern investment products and vehicles: they include the equity sector, both through stock picking and mutual funds, and the bond sector, where it has been able to overcome one of the strictest rules, that is the prohibition of interest (*riba*). That has been possible thanks to the traditional but redefined *sukuk*, involving debt-credit rights and obligations, but always linked to a well defined asset or economic venture, according with the general Islamic principle that money is not an asset by itself, but just the measure for other tangible assets. Such basic principle, if duly applied in the Western financial environment, would have likely made it possible to avoid or at least limited the huge crisis which is still storming the financial markets and the economic scenarios. Debt trading, so diffused in the Western financial world through repackagings and securitizations, is actually not allowed according with the *sharia*. However, many *sukuk* being listed on exchanges and tradeable before expiration in secondary markets, and often carrying yields more or less linked to traditional monetary market benchmarks, has made them criticized or questioned by many traditional Islamic scholars. As an example comes the case of diverging opinions about Islamic financial matters between Arab authorities and Asia Islamic ones, as the ones in Malaysia or Singapore. The subject is becoming the more topic and virulent as many Islamic financial institutions are going to launch alternative instruments, such as the hedge funds, whose approaches are openly speculative, with high leverages, diversified strategies, short selling and so on, not to say about the large use of "market betting" instruments such as futures. All of those are not *sharia* compliant and even openly prohibited by its rules. Well then ? We will discuss that in our next article.

(to be continued) GLT

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(Part Four) While the equity sector is better placed in complying with the *sharia* dispositions and limitations, as it “naturally” includes the ideas of partnership and fair sharing of profits and losses, in the fixed income domain the question becomes some more difficult, due to the prohibition of interest (*riba*) in all its forms. The classical instrument of the Islamic finance we find in this area is the *sukuk* (also ethimologically linked to our term *cheque*), a word of Persian more than Arab origin, dating back from the Middle Age as the similar vehicles designed and used by the old Western bankers: it designates a formal document representative of monetary and financial rights and obligations, but strictly complying with the principles of *sharia*. In general terms, the main feature of a *sukuk* in comparison with a traditional Western bond is that its rights are not of a generic and speculative financial nature, but rather linked to trade operations, industrial projects and other ventures however strictly linked to the real economy. If a Western institution, both a governmental or corporate one, issues bonds or notes aimed at repaying other debts or pursuing financial and speculative objectives, that is not possible with *sukuk*, as their issues must be linked to well defined economic or trade projects. Whilst from the subprime crisis to its next follow ups in the credit area we have seen the transformation of debts in other debt instruments in order to spread them among many subjects and to reconvert and repackage them in different ways, the *sukuk* may only be a form of securitization for real and tangible assets instead of virtual ones, let alone debts. In other words we could say that while the classical bond is based on a lender-borrower relationship, which incorporate the right to principal at expiration, plus periodical interests, the *sukuk* tends to transform future monetary flows deriving from economic activities into current flows, entitling the holder to the partial ownership of a debt, identified assets, economic, industrial, as well as commercial ventures... However, since many *sukuk* actually replicate the features of traditional bonds, as they are listed and traded on a secondary market, and moreover their returns are often *de facto* linked to market benchmarks such as LIBOR, RIBOR and similar ones, they are criticised by some conservative Islamic scholars and authorities. *(to be followed)* GLT

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(Part Three) The debate about Islamic Banking and the current financial crisis, the main points of which we have previously discussed, actually shows many faces. If it is true that excesses of debt, high leverages, speculative approaches, issues of poorly or badly collateralized investment instruments, are particularly to be blamed for such crisis, then we can say that the basic principles of Islamic finance may be really viewed as “alternative” and able to have limited the consequences of the ongoing turmoils.

Prohibiting interest, as just money produced by other money, limiting debt and leverage, emphasizing the role of partnership and the sharing of returns and losses between involved parties, the need of real and tangible assets as collaterals, the productive roles of financial ventures more than just speculation, also excluding short selling, all of them may have given positive contributions to markets, whichever the ideological approach. But our reader may ask how the Islamic finance can work in complying the *sharia*, the fundamental law, given those limitations and that doctrinal mainframe. In the domain of equity, the question is easier, because the concept of equity itself – in the Western perspective too – include the principles of partnership and risk sharing. Once stated the banning of short selling and investing in prohibited sectors (as gambling, life insurance, pornography, alcohol,...) and high leveraged or too much speculative companies, the manager still has a wide range of opportunities to select, both through stock picking and via a *sharia*-compliant mutual fund. Besides many “ethical” funds have been designed with similar aims and operational guidelines within the Western financial environment too. In the fixed income area, that is bond issuing and similar interest-bearing products, the picture is some more complex due to the absolute prohibition of *riba*, a pre-defined rate of interest which be calculated on a sole financial basis. *(to be continued)* GLT

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(Part Two) The debate on traditional versus Islamic finances in relation to the current crisis stems from the foundations of the Islamic finance itself: prohibition of interest, less speculative approach, use of real assets as collaterals of debts, limits in leverage levels, prohibition of selling assets not held, that is prohibition of short selling.

Having such element strongly contributed in making the current crisis more exacerbated and disruptive, as daily chronicles still confirm, it may be useful to discuss some terms of the debate. All in all the procedures and goals of the Islamic banking and finance tend to be much more aimed at supporting real economic activities than speculative operations. Money may not come from money alone. The final return of an operation carried on in compliance with the *sharia* is then the sum of the earnings and losses which, after a certain period of time, result from traditional and typical contractual patterns such as *murabaha* (trade financing), *mudaraba* (a joint venture specifically aimed at sharing profits), *musharaka* (a partnership set in view of a defined operation or venture), *ijara* (*leasing*). Of course this is the more traditional face of the Islamic Finance. Several evolutions have taken place, in the area of issuing debt on the market and designing mutual investment instruments, which take the Islamic approach some closer to the Western one. Differences exist anyway, more or less evident, although some of such evolutions have fueled debates among the Islamic scholars in terms of their adherence with the precepts of *sharia*. Among the most debated matters in such financial-religious perspective is perhaps the launch of "Islamic" hedge funds. (*to be continued*) GLT

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(Part One) A debate is emerging on *media* about a peculiar side of the deep subprime-induced financial crisis, then widely spread to the credit market and its securitized instruments: the question is about the crisis itself face to the relative comparison of operational environments of “Western-traditional” and Islamic financial systems. Such debates often come to conclude that implementing Islamic financial principles would have avoided or reduced the dramatic consequences of the Western financial excesses and speculations. The question is pretty interesting and indeed relevant. It is perhaps worth reminding that the current deep and dramatic downturn, now affecting the real economies after rocking the financial markets, was greatly fueled by the design and diffusion of financial instruments which were not backed by any assets at all, but instead by debts, as well as by skyrocketing debt and leverage levels in general with very poor guarantees, if any. As for Islamic Banking and finance in general, we have already reviewed them some time ago: now we just remind that the Islamic finance is deeply rooted in the *sharia*, the set of religious-derived rules which apply to all areas of the Islamic communities’ life, from rituals to interpersonal relations, private behaviour and family life, politics and sciences, aesthetics and law, as well as economy, finance and trade, in more or less rigid, deep and extensive forms according to the different countries it applies. In very general terms we may point to some major elements which define Islamic finance: first of all the prohibition of interest in all its form, that is of money as sole gain on lent money; the principle of equity between the parties involved in a transaction, with no exploitation of one subject by the other, being it a person or an institution; the need of real assets as collateral to a credit, not being accepted virtual values, less than ever debts as backing the selling of other debts, as it has been the diffused case in Western markets before the collapse; the rigorous control of debt levels in relation to owned assets; the prohibition to sell assets if they are not really owned, so the prohibition of the very common financial strategy of short selling, which has created so many problems for the already derailed markets. *(to be continued)* GLT

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