



MANHATTAN COLLEGE

Is There Really a Threat of Shariah In the Financial Industry: A Comparison Between Conventional and Islamic Investment Vehicles

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Motivation

- Islamic faith and investment advising
 - * Muslim
 - * Debt-free (without paying interest)
 - * Not earning (directly) from interest
- Misunderstandings of Islam & Muslims by:
 - * Media
 - * Fear of Shariah
 - * Skepticism of non-Muslims

Bridge the gap between two worlds and give peace a chance.

Study Purpose

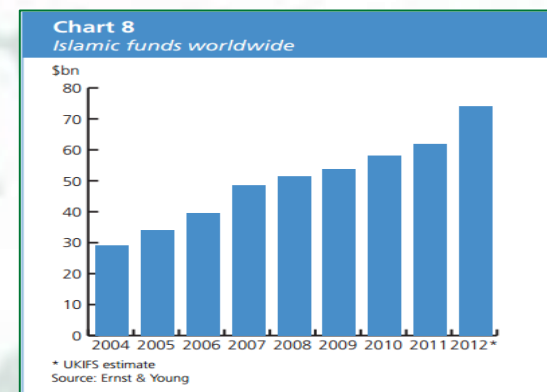
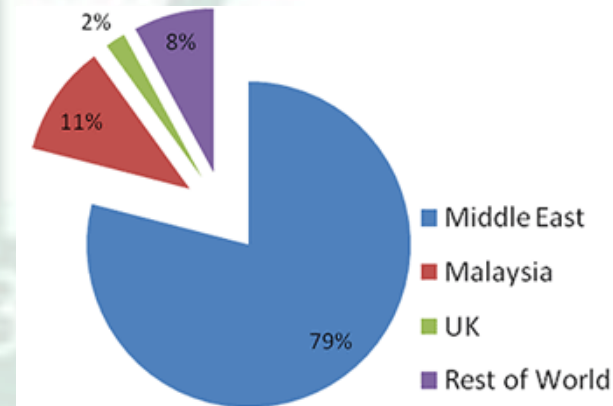
- Ideally, conventional finance focuses on maximizing profit that exceeds a certain risk-free rate.
- In Islamic finance, interest is prohibited but there are still investment vehicles that are Shariah-compliant.
- The purpose of this study is to demonstrate the similarities of the two in hopes of bringing about a better understanding of the field of Islamic finance.

What is Islamic Finance?

- Contracts between two parties
- Brought up with the teachings of the Qu'ran & Hadith
- Act in the best interest of the customers and society as a whole - no exploitation and no deception
- Typical companies are those with little/no debt on their books, high current ratios and low debt/equity ratios that are not involved in weapons manufacturing, pornography, gambling, alcohol, and pork products.
- So what makes finance Islamic?
 - Compassion
 - Interest-free
 - Gambling-free
 - Socially responsible

Islamic Finance

- Used in different countries
 - Malaysia
 - Bahrain
 - Indonesia
- Markets are growing
 - Sukuk
 - Home ownership
- In 2013, it was valued at over \$130 billion (swift.com)
- Used in non-Muslim countries
 - DJ Islamic Index
 - Amana Growth & Income mutual funds



(Source:

www.swift.com
Karasik, Wehrey,
2007)

Islamic Banks in the UK

(taken from THECITYUK)

Fully Sharia compliant

Bank of London and The Middle East

European Islamic Investment Bank

Gatehouse Bank

Islamic Bank of Britain

QIB UK

Abu Dhabi Islamic Bank

Islamic windows

ABC International Bank

Ahli United Bank

Bank of Ireland

Barclays

BNP Paribas

Bristol & West

Citi Group

Deutsche Bank

Europe Arab Bank

IBJ International London

J Aron & Co.

Lloyds Banking Group

Royal Bank of Scotland

Standard Chartered

UBS

United National Bank

Western Countries with Islamic Banks

Number of Banks (source: The Banker)

UK 22

US 10

Australia 4

Switzerland 4

France 3

Canada 1

Cayman Islands 1

Germany 1

Ireland 1

Luxembourg 1

Russia 1

Conventional v. Islamic Finance

- Islamic – Shared risk, investment in primarily common shares, risk averse in trading (no short-selling, buying on margin), no interest-based transactions
- Conventional – Interest based loans, speculation futures, short-selling and buying on margin



Conventional Finance

- Great recession is over even though many Americans feel differently.
- Spirituality does not always hold much of an influence therefore, pragmatism is more implied as opposed to dogmatism.
- Returns are phenomenal and come with a chance of reaping infinite profit but so, too, are the risks

Source: Loanstreet, 2013
Washington Post.com, 2014

Common Ground

- A few of the widely used investment vehicles that are commonly used by both a Muslim & non-Muslim investor are:
 - Common Stocks – direct ownership of a portion of a company (Ross - Investopedia.com)
 - Interest is prohibited in Islam but profit (from trade) is permissible (Quran 2:275)
 - Options – covered calls & puts
 - Life Insurance (Qatar Islamic Insurance, 2012)
 - Bonds?
 - Zero coupon bonds (no interest paid)
 - Revenue generating bonds and sukuk
 - Equipment trust certificates (Muhammad Akram Khan, 2004)



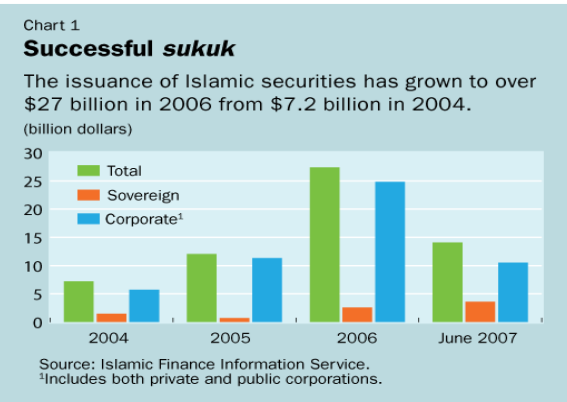
Sukuk Bonds

Ideally

- Asset-backed bonds that are investments vehicles but the owner of the security has legal recourse to the hard asset.
- Sukuk holders are owners as opposed to creditors
- Owners are paid from the asset's cash flow

Realistically

- No rights over assets
- Sukuk holders are creditors and are paid a fixed guaranteed return on their initial investment
- As much as 85% of these bonds are not asset-backed



Similar or Different?

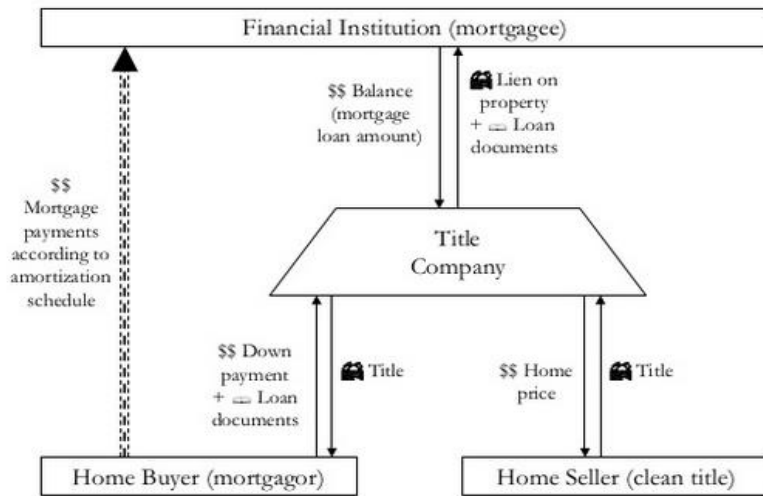


Fig. 1.1. Home Mortgage Transaction

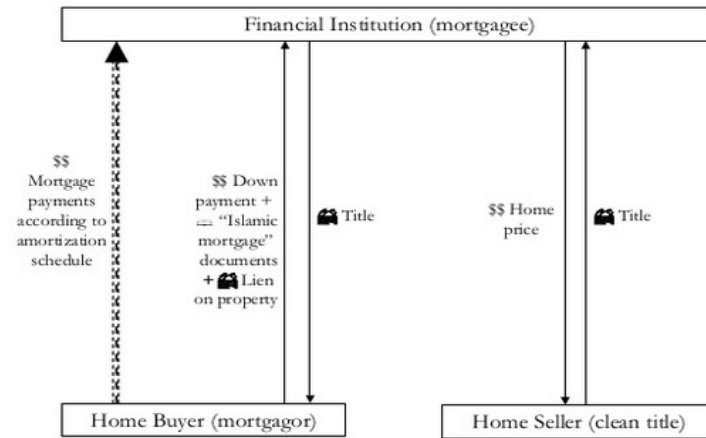


Fig. 1.3. *Mubaha* Alternative for Home Finance

Islamic finance has “done little more than mimic conventional financial products less efficiently...thus increasing rather than reducing social and financial risks (El-Gamal, 2006).”

Support for Bonds in Islamic Finance

- Since 2008, many investors are seeking to preserve their capital
- Yet Muslim investors would also like to invest but do not wish to risk their capital in common stocks.
- Quranic verse - “And if the debtor is in straitened circumstances, then (let there be) postponement to (the time of) ease; and that ye remit the debt as almsgiving would be better for you if ye did not know (2:280).”
- Hadith - “The Prophet Muhammed owed me some money and he repaid it and gave me more than what was due.” (Bukhari Vol. 1, Book 8, #434)
- So, loaning (through a bond) can be acceptable since what is important is that the issuer repay the principal. But, if a little extra paid, so be it....

Is there a difference? Not really.

- Common risks: business, inflation, and credit risk
- Common vehicles: common shares and (certain) mutual funds

Limitations in Islamic finance

- Types of businesses (no weapons, pornography, exploitation, pork, alcohol, gambling, etc.)
- Avoidance of significant speculation (no short selling, margin purchases)
- High liquidity requirements to avoid borrowing and paying interest

Advantage – the risk of default in payment is reduced

Conclusion

- More and more financial institutions are starting to adopt Islamic finance
- Conventional Banks are beginning to launch Islamic bonds
- This will promote growth as Islamic Finance continues to make its way into the mainstream market
- This work should inspire people from all walks of life to come together and focus on the similarities between the two systems thereby encouraging collaboration.
- With the help of conventional financial customs and the ethical benefits associated with Islamic finance, these two systems should flourish together.

Questions?

