A Word about Islamic Finance: Part I

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In this first of a two-part article, MASB staff explain what is Islamic finance, and share the behind-the-scenes thinking that led the MASB to subject Islamic financial institutions (IFIs) to Malaysian Financial Reporting Standards (MFRS) - a verbatim adoption of International Financial Reporting Standards (IFRS).

In the beginning

In the mid-20th century, nationalism was palpable throughout lands under Western colonial rule. But unique to Muslim-majority countries, the quest for independence was often couched in religious terms. Hence, rejection of the colonialists' political, social and economic systems was accompanied with a desire for perceived Islamic substitutes. It was under these circumstances that the idea of establishing economic practices that would comply with Islamic law, or Shariah, was born.

One early experiment with Shariah-compliant economic practices was the Mit Ghamr Savings Bank. Established in 1963 in the small town of Mit Ghamr in Egypt, the bank primarily accepted savings and deposits, which were invested in local businesses with profits channelled back to depositors. Interestingly, during its life the endeavour was merely called interest-free banking as the government of the day was wary of 'Islamic fundamentalism' and overt mention of Islamic tenets was carefully avoided.

In the ensuing decades, however, a newly affluent populace, enriched by oil-wealth and economic growth, became bolder in demanding for financial alternatives that would satisfy their heightened religious sentiments. Consequently, financial institutions and their regulatory bodies began to develop a multitude of products that would comply with Shariah.

From simple savings and loans, Islamic finance - as the industry came to be known – developed alternatives for many other modern financial products. To address the need for security and protection, an alternative to insurance called "takaful" was developed and offered by the General United Insurance Company of Sudan in 1968. The year 1975 saw the first commercial Islamic bank, Dubai Islamic Bank, as well as the supranational Islamic Development Bank. In 1990, the Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI) was established and registered in Bahrain the following year. Also in 1990, Shell Malaysia issued the first corporate *sukuk*, the Shariah-compliant answer to bonds.

Today there is an Islamic alternative for most conventional financial instruments, whether simple or sophisticated. Where there is not, it is usually due to a Shariah prohibition. However, proponents believe that far from being handicapped by Shariah, its rules serve to put Islamic finance in good stead and have largely shielded Islamic finance from the worst economic crisis since the Great Depression.

Prospering and multiplying

Islamic finance grew steadily through to the new millennium. Undoubtedly, Islamic financial institutions are dwarfed by conventional banks; Shariah-compliant banking assets total about USD 1 trillion[1], compared to USD 96 trillion[2] for the 1000 largest banks in the world. However, they have been experiencing much higher growth rates. While many banks are still suffering the adverse effects of the 2007 subprime mortgage crisis and the 2008 global financial crisis, Islamic banks are comparatively insulated (though, admittedly, not immune) from the aftershocks. Some attribute this to Shariah rules which prevented involvement with the repackaged toxic assets responsible for the crises. Regardless, the Islamic finance industry continues to prosper, with the top 500 global Islamic financial institutions growing at 21% per year[3].

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[1] Tan Sri Dr Zeti Akhtar Aziz, at the Islamic Financial Intelligence Summit (IFIS) 2011. 11 November 2011. Text of speech available at: http://www.bis.org/review/r111117e.pdf?frames=0

[2] Assets of the largest 1000 banks in 2009 taken from *Banking 2010, IFSL Research,* February 2010. Available at: http://www.thecityuk.com/media/2372/IFSL_Banking_2010.pdf

[3] Tan Sri Dr Zeti Akhtar Aziz, *ibid.*

In recent years, there have been calls for Islamic finance to move into new areas - both that have already been explored by conventional counterparts, such as hedging and liquidity management, as well as uncharted territory which would require not just replicating existing conventional products but innovating new modes of finance that are 'purely' based on Shariah. Many of the latter proposals seem to involve moving away from debt financing to equity financing, and away from deposit-taking to investment management.

Government economic policies also seem to encourage Islamic finance, as it allows access to untapped capital and creates new economic opportunities. In Malaysia, the Securities Commission (SC) and the central bank, Bank Negara Malaysia (BNM) have included Islamic finance sector as one of their targeted growth areas. BNM plans for Islamic finance to account for 40% of total financing by 2020[4] from the current 22%; and the SC's Capital Market Masterplan 2 (CMP2) noted that in addition to growing primary capital market products, the SC will also identify potential opportunities in middle and back-office functions related to the Islamic capital market.

Not being a moneylender, and charging no interest

Though many are aware of the existence of Islamic finance, few outside the industry are able to describe with certainty how it works and to what extent it is similar or different to conventional finance.

Firstly, Islamic financing is characterised by the use of trade contracts instead of loans. Charging interest on a loan principal is anathema, as lending is an act of benevolence in Islam. It is, however, perfectly acceptable to make gains on trading. In the Mit Ghamr example, the bank *invested* in local businesses, it did not give them *loans*. Returns to savers and depositors were accordingly share of profits, not interest. Other than direct investment, sales (*bai'*) and leases (*ijarah*) are also commonly used to achieve financing. An Islamic bank does not give out housing loans. The bank either buys the house then sells to the customer at a profit (a practice known as *murabahah*), or the bank leases the house to the customer over the period of financing, with either gradual sales over the lease or a sale at the end of the lease.

As for customer deposits, some are amounts entrusted for safe-keeping, *wadiah*, and the bank may give a gift, *hibah*, to the customer for letting it use the money. Others may be based on an agency principle,

[4] Tan Sri Dr Zeti Akhtar Aziz, at the launch of BNM Financial Sector Blueprint. 21 December 2011. Text of speech available at:

http://www.bnm.gov.my/index.php?ch=en_speech&pg=en_speech_all&ac=423

wakalah, where the bank appropriates an agency fee from the profit. *Mudarabah* splits profits between the bank and the customer according a pre-agreed ratio, but classically any loss is borne by the customer. Strictly going by this rule, a *mudarabah* deposit may not be a deposit at all; some consider *mudarabah* necessarily in the realm of investment management and not deposit-taking.

Secondly, the subject of trade must usually be a tangible item or a permitted intangible. Permitted, however, means different things to different Shariah scholars. Land and buildings are a universal favourite, possibly overexposing Islamic finance to the real estate sector. *Usufruct*, or the right-of-use, in a lease is also popular. Other intangibles such as patents, trademarks and copyrights can fall into a grey area depending on what underlies the intangible. Trading in debt, or *bai' al dayn*, though routine in the conventional sphere (e.g. in factoring, collateralised debt obligations), is a point of contention amongst Shariah scholars; exceptions do exist and in Malaysia a sale of debt may be allowed, for example, in the sale of home loans to the national mortgage corporation. And, obviously, trade related to a prohibited item (e.g. alcohol, tobacco, gaming) would not be permitted.

This leads to the third point of difference: the level of religious supervision. While most major religions have something to say about money, none of their adherents have developed faith-based finance to the extent that Muslims have. This is largely attributable to the Muslim mind-set which must consider the religious implication of every aspect of their lives, even those that seem profane to others, such as banking. Hence, the average Islamic bank would have a panel of Shariah experts to vet through the structure of its products and a Shariah board to endorse them and attest in its annual report to what extent the bank has complied with Shariah. In well-regulated markets, bank regulators or supervisors would also have their own Shariah councils.

Although Islamic and conventional finance greatly differ in philosophy and in legal form, the former is often structured to provide the same economic effect as the latter. Hence, an Islamic bank customer is likely to incur roughly the same cash flows as someone with an otherwise similar conventional loan. This is especially true in jurisdictions where there is an incentive or compulsion to maintain parity with conventional banking.

Speaking the truth

Because Islamic finance takes on contractual forms that are different from conventional finance, there are those who believe different accounting standards would be required; for only then can the legal reality be conveyed to the reader of the financial statement. AAOIFI is the foremost advocate of separate Islamic accounting standards. Its stated approach is to accept generally accepted accounting principles except where it believes there is a conflict with Shariah. For the most part, this means that AAOIFI readily embraces innocuous concepts such as timeliness, reliability and understandability. But, historically, AAOIFI has been less welcoming to two key concepts in IFRS: substance over form and time value of money.

Accordingly, a financial statement prepared in accordance with AAOIFI standards can yield vastly different results from an IFRS-compliant one. Take, for example, the sale of a house by a bank to a customer. Let us say in 2001 a bank buys a house at RM500,000 and sells it to the customer at RM696,650. The customer will pay in monthly instalments over a period of 10 years. If the overall economic objective was ignored and only the legal contract considered, it could be said that this is a sale of goods where the gross profit is RM196,650. However, it would be most unusual for a bank to immediately report a RM196,650 profit.

AAOIFI appears to agree that recognition of profit is related to the repayment period, and under its Financial Accounting Standard (FAS) No. 2, *Murabaha and Murabaha to the Purchase Orderer*, the profit of RM196,650 would either be recognised proportionately over the repayment period or, in a departure from the accruals concept, as and when instalments are received.

Crucially, AAOIFI does not seem to acknowledge that the profit represents a financing element that is related to a principal disbursement. AAOIFI's requirement for proportionate allocation is often taken by stakeholders to mean a simple arithmetic division of total profit over the number of instalments during the repayment period. This is because FAS 2 was prepared in accordance with AAOIFI's original conceptual framework, which propounded that "money does not have a time-value". Hence, AAOIFI does not require the pattern of profit recognition to be related to the amount of principal outstanding.

The concept of time value of money is, conversely, central to IFRS requirements for recognition of a financing element. Under IAS 18, *Revenue*, when there is a difference between the fair value (i.e. RM500,000) and the nominal amount of consideration (i.e. RM696,650) the difference (i.e. RM196,650) is recognised as interest revenue (or 'financing' revenue, for the squeamish) using the effective interest method under IAS 39, *Financial Instruments: Recognition & Measurement*. The effective interest method amortises the cost of the financial asset (i.e. RM500,000) and allocates the interest income (i.e. RM196,650) over the relevant period (i.e. 10 years), based on the effective interest rate (which, using a calculator, comes to about 7%).

The table below provides an example of how different the pattern of income recognition can be under AAOIFI and IFRS. To further illustrate how even within AAOFI standards there may be differing outcomes, the table shows both AAOIFI recognition based on proportionate allocation and recognition based on actual receipts, given the scenario that the customer misses an instalment in 2003 but pays-up in 2004.

Recognition and measurement of income for Murabahah home financing

In 2001, a bank buys a house at RM500,000 and sells it to the customer at RM696,650. The customer pays in monthly instalments over a period of 10 years. In 2003, the customer misses an instalment but pays the amount in 2004. Below are the possible ways that the bank could recognise and measure income over the 10 years.

	Under AAOIFI standards		**Under IFRS**
Relevant paragraph(s)	FAS 2, paragraph 2/4/2 (a)	FAS 2, paragraph 2/4/2 (b)	IAS 18, paragraphs 11, 29, 30 IAS 39, paragraphs 9, AG5-AG8
Requirement	Proportionate allocation of profits over period of credit	Profits recognised as and when instalments are received	Difference between fair value and nominal amount of consideration recognised as interest revenue … in accordance with IAS 39
	RM	**RM**	**RM**
2001	19,665	19,665	33,866
2002	19,665	19,665	31,278
2003	19,665	18,026	28,503
2004	19,665	21,304	25,527
2005	19,665	19,665	22,337
2006	19,665	19,665	18,915
2007	19,665	19,665	15,247
2008	19,665	19,665	11,313
2009	19,665	19,665	7,094
2010	19,665	19,665	2,571
Total profit / interest income	**196,650**	**196,650**	**196,650**

So, which is the true and fair representation of such an income stream? Like the story of the blind men touching different parts of an elephant, how the elephant truly looks like depends on whom you ask. AAOIFI advocates would argue that its measurement requirement is true to the trading nature of *murabahah*. The pro-IFRS camp would counter-argue that measurement based on the effective interest rate reflects the true substance of the sale, which is financing.

Faced with such a conundrum, MASB sought the opinions of the Shariah advisory councils of both the central bank, Bank Negara Malaysia (BNM) and the Securities Commission of Malaysia (SCM). In a meeting in October 2007, BNM's Shariah Advisory Council, with SCM representatives in attendance, ruled that it was permissible to apply generally accepted accounting principles to Islamic transactions, which included the principles of accruals, substance over form, time value of money, and recognition based on the probability of a transaction occurring[5]. In short, there is generally no Shariah restriction to applying MASB approved accounting standards to Islamic financial transactions. Consequently, in September 2009, MASB issued a statement of principles (SOP) entitled SOP ***i***-1, *Financial Reporting from an Islamic Perspective* to confirm that MASB approved accounting standards shall apply to Shariah compliant transactions, unless there is a Shariah prohibition.

The MASB respects AAOIFI's point of view, but does not share it. In MASB's opinion, information on the economic effect is as valuable as, if not more than, information on the legal contractual form. Despite their contractual differences, many Islamic finance products are meant to replicate the economic effect of conventional products. Thus the MASB is more congenial to IFRS recognition and measurement bases which emphasise the economic substance of transactions. The MASB understands that the form of contract is also important from an Islamic perspective, and hence also encourages appropriate disclosures (which may include disclosures recommended by AAOIFI) to highlight adherence or departure from Shariah and to differentiate between Shariah-compliant and conventional contracts that are recognised and measured in a similar manner.

Additionally, the MASB found that the Islamic accounting standards available, namely those issued by AAOIFI, were designed for specific uses of limited types of contracts. They were not broad enough to deal with Malaysian products which used an amalgam of contracts to achieve a single economic objective, and which sometimes used controversial contracts. For example, in the early 2000s Malaysian Islamic banks often used *bai inah*, a form of sale-and-buyback, to structure various products such as personal financing and credit cards; despite its common use in Malaysia, AAOIFI accounting standards ignore *bai inah* because its Shariah board deems it an impermissible transaction.

It also became evident that having separate Islamic standards could create undesirable opportunities for arbitrage and abuse. AAOIFI standards allow ample leeway for pushing items off balance sheet. For example, a lessee that would otherwise have to recognise lease obligations because it met the criteria for a

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[5] Bank Negara Malaysia. *Resolusi Syariah dalam Kewangan Islam*, 2nd edition. October 2010. [In Malay] p.192-196.

finance lease under IFRS could conceivably understate its liabilities by availing itself to AAOIFI FAS No.8, *Ijarah and Ijarah Muntahia Bittamleek*, which requires all *ijarah* to be treated as operating leases and not recognise a lease liability.

Thus, it is for these reasons that when the IFRS-compliant Malaysian Financial Reporting Standards (MFRS) came into effect on 1 January 2012, no exemption was made for Islamic financial institutions.