SHARED RISK & REWARD

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TUNISIA EXPLORES ISLAMIC FINANCE, SUKUK

Tunisia has set up a working group to study how to facilitate Islamic finance in the country. While there are a number of priorities likely competing for attention of the government, it is good to see that the working group is being set up and also is not being done in a way that is designed to inhibit conventional finance. A post-revolutionary country cannot be too picky about where it receives finance and I think it would be inadvisable to look to Sudan or Iran for example (both countries, at least nominally, have entirely Islamized their financial systems). Tunisia is very sensibly looking towards Malaysia and Bahrain, as well as recent entrants to Islamic finance like Oman and Jordan.

According to the OECD (pdf report), Tunisia is relatively well suited in terms of its economy to try and attract Islamic finance as a way to add diversification to the economy (unlike its neighbor Libya), given its ties to Europe and links with GCC countries like the UAE, Qatar and Bahrain. To be honest, when I started looking for information on Tunisia's economy, I expected it to resemble Eastern Europe after the fall of the Iron Curtain with a large public sector trying to shift its focus towards Europe (the transition from communism to capitalism was the subject of my thesis in college).

However, if there is any comparison with Eastern Europe, the most apt comparisons would be to the Czech Republic or Slovenia, and the Baltic countries, which (after an immediate severe decline in the economy) were able to more readily re-orient their economies and political systems to look west instead of east. For Tunisia, the adjustment should be easier since it had already shifted towards Europe and away from the large public sector that Libya was left with after the fall of Qaddafi.

Returning to the subject of Islamic finance in Tunisia, there will likely be a significant learning curve, since Islamic finance was absent under Ben Ali. However, the private sector is better developed than, for example, in Libya, which should provide more destinations for finance directed through Islamic financial institutions in the country into real economic activity, which is supposed to be the raison d'etre for Islamic finance.

The priority in Tunisia for Islamic finance is not likely to be the private sector since the country is estimated for see its budget deficit rise from 4% in 2011 to 6% in 2012. The priority is likely to be a sovereign sukuk to fill the budget gap. Finance Ministry's director-general Chaker Soltani noted: "Before issuing Islamic bonds, or sukuk, we must put a law in place". He admitted that a sukuk issue would be unlikely to come in 2012.

One the legislation is in place for Islamic finance and the first sukuk is issued by the government, the question will be whether there is significant enough demand for Islamic banking services. With a population of just 10 million people and an established conventional banking sector, Islamic banks will have a lot of competition on their hands for a small population. However, on the plus side (for comparison sake), the UAE (which has many retail Islamic banks) has a population of only 7.5 million.

There are certainly international Islamic banking companies eyeing the market. For example, the working group includes Bahrain-based Al Baraka Banking Group. For a country like Tunisia without a history of Islamic banking, the first movers will likely be companies like Al Baraka, who can bring in their experience in other countries to develop the Islamic banking industry. Once they become established, *de novo* Islamic banks or Islamic windows of conventional Tunisian banks (or windows of global banks) will follow.

This is a long road for Tunisia, and while a moderately Islamist government would probably prefer to jump start the Islamic finance sector more rapidly at the expense of conventional banks, this would be unwise. Having a working group lay a solid framework using international lessons (which is the approach they seem to be taking) will not immediately bear fruit, but it will be more successful in the long run. The worst case would be for the Islamic finance market to quickly grow domestically which would likely lead to failures (and perhaps a few fraudulent schemes by unsavory players looking for a quick buck) which would dampen interest among the public for Islamic finance. That would be a shame. Just head east to Egypt for examples of how the failure of so-called Shari'ah-compliant financial institutions can hurt the prospects for future developments.

Updates from the Americas

Last weekend, I had the pleasure of speaking at the Islamic Finance Conference: East Coast organized by students at the University of Maryland in College Park. I would like to thank them for putting together an interesting day of speakers with much less commercialism/sales pitch-ism than many other conferences I have attended.

My presentation, which is available on my website now (I believe my talk will be available on the conference's website shortly) was on the potential for Islamic microfinance to expand into providing financing for cleaner and/or renewable energy financing, particularly in rural areas. Feedback is welcome from newsletter subscribers, many of whom have been working in Islamic finance for many more years than my 5½ years.

Website update

This weekend I was able to finish uploading the back issues of the newsletter to the Sharing Risk website. I started writing the newsletter back in May 2010, so there are quite a few issues that I have addressed over the nearly two years I have been writing the newsletter. If you go to the website, the newsletters are arranged by month under "Newsletters". There is not a search feature on the website, but to search for a specific issue, you can always go to Google and enter your search followed by "site:www.sharingrisk.org".

Thanks to all the subscribers for the providing feedback on previous issues, and I look forward to more feedback now that the back issues are available on the website. Please feel free to forward on this newsletter to others who might be interested. They can subscribe either on the blog or by emailing me.

Until next week,
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FROM THE BLOG…

SATURDAY (Mar. 17)

Khazanah Sukuk

The first convertible sukuk in 2 years was issued by Khazanah Nasional at a yield to maturity of -0.5% and no periodic payments. The conversion premium into shares of Chinese retailer Parkson Retail Group) for the sukuk was 30%. Based on today's price of Parkson, was last time the conversion price was seen was at the beginning of 2011. The sukuk was 3.4 times oversubscribed and priced at the lower end of the expected range.

Khazanah has issued a few convertible sukuk to divest itself of several holdings including Telekom and well as an exchangeable sukuk for PLUS, a company which operates highways in Malaysia (Khazanah also issued a renminbi-denominated sukuk last year). Both of those sukuk were issued pre-financial crisis (2006 and 2007, respectively). The pricing for the sukuk and the level of interest (from the oversubscription) indicates that the Malaysian sukuk market (at least those from companies connected to the government) continues to be robust.

WEDNESDAY (Mar. 14)

Could trade finance provide a place for murabaha in "authentic" Islamic finance?

The executive director of the Monetary Authority of Singapore, Tai Boon Leong, gave a speech at the Islamic Finance News Roadshow Singapore in which he suggested that Islamic banks become more involved in trade finance, noting the withdrawal of European banks due to the debt crisis. He said:

"Islamic finance players should however explore new growth areas which adhere to Shariah principles. One such possibility is trade finance. Globally, trade finance is facing funding pressures as European banks, who have been traditionally strong in this sector, continue to deleverage and adjust to the requirements of Basel III. Given Islamic finance's emphasis on supporting tangible, real economic activities, trade finance is a business segment which fits well with Shariah principles and business model."

I am not extremely knowledgeable about trade finance (I am not a banker), but from what a few minutes of informal research, the forms of trade finance mostly revolve around factoring trade receivables (i.e. extending credit based on goods being transported internationally) and trade credit insurance. The roots of Islamic finance are based in trading, since many of the countries in the Middle East where Islam began were based on trading and much of the spread of Islam occurred along trade routes.

Murabaha has attracted a lot of criticism because of its similarity with conventional finance and also because it is being used to synthesize loans that mimic conventional loans. However, where applied to trade finance, the main points of criticism fall away. In a trade finance loan, the buyer in one country wants to sell goods to a seller in another but wants to get paid now and not bear the risk associated with dealing with a buyer in another country, as well as the time it will take to get paid. The seller does not want to pay in advance because it would be difficult to recover funds paid if the goods aren't delivered. A bank can serve as a trusted intermediary that takes the credit risk from the seller and facilitates the desire by the buyer to make payment on delivery.

The trade finance company can buy the good from the seller and take legal ownership of the good and then, at the same time, sell the asset to the buyer and transfer legal ownership of the good to the buyer, but with payment due in the future with a markup on the anticipated delivery date. The transfer of ownership shifts the risk of loss to the buyer, but removes the risk of fraud by the seller, and in return, the bank remains focused on the credit risk where banks are specialists.

The transaction offers value to both buyer and seller, and facilitates the exchange of a real asset that is in demand (in contrast to many murabaha which use an asset only to facilitate the extension of credit). Perhaps it is too boring of a transaction to attract much attention and it already occurs with regularity, but with the controversies around some murabaha transactions like the Goldman Sachs sukuk, it would be to the industry's benefit if transactions like this were mentioned as demonstrating the usefulness of murabaha to counter the widely held idea that most murabaha transactions are done as a way of replicating a conventional financial institution, and do not involve buying and selling an asset that is actually demanded. It is, instead, a transaction that would facilitate the economic activity between a buyer and seller that they would not (unless they turned to conventional finance) be willing to undertake without the Islamic bank.

Transparency vs. the OCIS-SC closed-door forum

The Oxford Center for Islamic Studies and Malaysia's Securities Commission held a closed-door forum on "Solutions for Liquidity Management" earlier this week. While I have no problem with a closed door meeting, I am a bit mystified trying to read the SC press release to figure out what they were talking about (there is no press release that I could find from the OCIS). I am not sure why a press release was issued that contains few details that would be useful to people following the industry.

There were really only 2 paragraphs of substance:

> "While sukuk issuances have generally been successful in terms of primary subscription, "the lack of secondary trading - due perhaps to the scarcity of supply; lack of infrastructure; trading mechanisms that are not globally accepted; or unresolved issues over valuations - have all led to investors holding on to the "buy-and-hold" attitude of the instruments until maturity" observed HRH Raja Nazrin."

I have discussed the liquidity challenges in sukuk secondary markets many times. I think that all of the reasons cited are valid, but I think the most problematic for investors is the lack of supply, so that it becomes hard to replace a sukuk sold in the secondary market with another (either in the primary or secondary market). There has to have been some interesting discussion in the forum on the differences in liquidity between Malaysia and the GCC (and beyond) that would not be too sensitive to release to the public, that could have offered as the basis for constructive discussion around what can be done to help the secondary markets develop. Alas, there was nothing beyond the well-known issues for the sukuk markets. The press release continues a bit later discussing a bill in Malaysia being developed by the SC to expand the investment opportunities for funds.

> "This bill will pave the way for Shariah funds to directly invest into income generating assets and businesses. The bill also proposes the creation of business trusts, a trust vehicle, to accommodate the ownership of businesses or assets, giving investors direct exposure to the real economy. More importantly, these initiatives are consistent with maqasid al shari'ah. This bill has strong roots in the exchange of visionary ideas and perspectives from the inaugural SC-OCIS Roundtable of 2010" added Tan Sri Zarinah."

Here, the release is a bit more forthcoming suggesting the idea to allow more direct ownership of businesses through trusts that give investors "direct exposure to the real economy". However, this does not appear--from the discussion in the press release--to be a new idea. Islamic funds already have direct exposure to the real economy through equity ownership in businesses, or through debt-based sukuk that use of trusts (SPVs), both of which are also "consistent with maqasid al shari’ah". A more direct discussion of the bill and how it differs from what is already in existence would help spur discussion, again without revealing any of the sensitive discussions that happened behind closed doors.

Transparency is a good thing. While it does not have to be universal--it shouldn't always be--press releases that say little about closed-door forums is not particularly useful for anyone involved. For example, I will never get the time back the time I spent trying to squeeze water from the rock that this press release.