SHARED RISK & REWARD

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Islamic financial institutions, like their conventional counterparts, depend on confidence from investors and market participants. When they lose this confidence it is next to impossible to regain it. Arcapita, the Bahraini Islamic private equity company now in Chapter 11 bankruptcy, appears to have ignored this basic lesson of finance.

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The lesson from Arcapita

There is an often repeated expression that when a bank has to try and convince the market of its solvency, it has already lost the battle. When banks lose the confidence of the market, its fate has already been written in stone. Finance runs on confidence and when that is lost, it is only a matter of time before the bank itself is lost.

When I began covering Arcapita for *The Islamic Globe*, my first article was about the potential for the company to restart its deal business with the acquisition of J. Jill, a women's apparel company in the U.S., which it acquired from a conventional private equity firm in a leveraged buyout (in April 2011). At the time, I gave Arcapita the benefit of the doubt and assumed that, while it was facing a murabaha coming due in a year, it had been just sidetracked from its primary business of buying and selling companies by the financial crisis.

Last fall, Arcapita saw the debt on J. Jill downgraded, which I also wrote about with a bit more urgency on the murabaha coming due the next spring (i.e. now). The debt deal was structured so that the debt covenants became more restrictive over time, but could be cured with equity injections from Arcapita and its investors. With several exits from its portfolio, Arcapita seemed to be taking advantage of the improving deal environment in the financial markets.

When J. Jill was downgraded again, it was February 2012 and the murabaha was coming due in months, I expected to see a cash build in the company in the September 2011 as a result of the portfolio company sales the previous year. However, the financial statements revealed a troubling lack of cash on hand as of September 30. As a result, I dug into the financial statements and portfolio holdings and, when *The Islamic Globe* suspended publication, I was hard at work determining why the murabaha was trading at around 60 cents on the dollar.

Since the September 2011 statements are the most recently filed financial statements and no information will be available through the bankruptcy filing until early May, I still have no more information of the company's cash position, but the bankruptcy filing revealed that the murabaha cannot be paid when due (it matured on Wednesday).

Arcapita requested the bankruptcy court approve continued payments for its employees and some creditors, and one of the funds that owns $88 million of the $1.1. billion murabaha objected on the grounds that Arcapita has "provided absolutely no visibility into the operations of these non-Debtors [their subsidiaries not included in the bankruptcy, including Arcapita, Inc., it's US operations], and to this date have refused to offer any assurances that the portfolio companies or their non-Debtor managers will not engage in transactions outside the ordinary course of business without the approval of this Court".

That creditor, Euroville S.ar.l (the hedge fund Fortelus) argued in an objection that Arcapita was asking to finance expenses more than what was "minimally necessary to "keep the lights on" including what it describes as "enormous operating expenses, lavish employee benefits and exorbitant rent obligations to an insider landlord".

These issues will be handled by the bankruptcy court (and one should not rely too heavily on statements from parties involved in the bankruptcy who may have their own motives), but the issue remains: when should an Islamic finance company announce defeat, rather than saying “Retreat, hell! We're not retreating, we're just advancing in a different direction.“

One of the primary objections by Fortelus is that Arcapita is retaining all of its employees, even though the company has made but one deal since the financial crisis (J. Jill) and is certainly not making any now (it has 191 employees it wishes to continue to pay, including executives (and their discretionary bonuses), down from 275 on June 30, 2011).

Despite the steadfastness shown by Arcapita’s management, it is clear that it (if not its business model) has failed. It acquired companies in leveraged buyouts just like conventional private equity firms. It also leveraged itself up with the murabaha, and also the unrestricted investment accounts it invested on behalf of investors into the companies it owned. It accelerated these activities in the years before the financial crisis when debt was cheap and companies were expensive (the murabaha was issued in 2007).

When credit becomes expensive and the investments made on margin drop in value, a firm exposed to both should recognize that it cannot fix the situation, not continue on the same path (Arcapita blamed the European financial crisis in late 2011 for its failure to roll over the murabaha). However, Arcapita became defensive, both to creditors and to reporters covering the company.

Islamic finance is not immune to failure and failure is a natural part of finance. The problem comes when institutions whose business model cannot accept this fact and try to either continue on as normal or deny there is a problem and attack those who raise questions. A failure to evolve and abandon failed businesses will only hamper the development of Islamic finance.

Updates from the Americas

The Toronto Financial Services Alliance proposed regulatory changes (pdf) for the Ontario government to attract Islamic finance. The proposed changes relate to regulatory and tax changes to put Islamic finance on a level footing. Interestingly, one of the proposed changes is to “repurchase of public lands in the future”. If the change were adopted, it would open the way for the government of Ontario to issue a sukuk. In 2010, there was a Bloomberg article which suggested that three government agencies in “one Canadian province” were looking at sukuk totaling $1.5 billion. However, whether that had proposed beyond discussion phase are unclear since Omar Kalair, CEO of now-bankrupt UM Financial was the source for that information.

Until next week,
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FROM THE BLOG…

THURSDAY
(Mar. 29)

A few items that slipped through the cracks

There have been a lot of articles sitting in my feed reader and I won't have time to write more in depth on the topics, but here are the links with quick summaries.

Size of Islamic finance industry
The City UK released its latest annual report on the Islamic finance industry showing the industry has $1.3 trillion in assets. I hope to have more detail on this in another post when I have time to read it.

The Malaysian Islamic finance banking industry reached 22.4% of the country's total at the end of 2011. Despite only having 15% of the outstanding USD-denominated sukuk issuance, it has one of the best developed (i.e. liquid) sukuk market, based on a lot of domestic MYR-denominated sukuk, but still showing that size isn't everything.

Shari'ah standards
A conference participant suggests that investors and advisors should do their own Shari'ah research instead of waiting on a Shari'ah board to provide a fatwa. Not much chance of happening, but interesting to see new perspectives.

Goldman Sachs
Reuters gives the latest update on the Goldman Sachs murabaha sukuk which has attracted a lot of criticism, saying that the Shari'ah advisors have signed off and the ball is in Goldman's court. I offered my perspective on the trading issue with a murabaha sukuk in an earlier post.

IIFM-ISDA
The ISDA press release is available here for the new Mubadalatul Arbaah master agreement.

Australia
The National Bank of Australia is considering a $500 million sukuk issuance, the first from the land down under, as Islamic finance begins to develop in the country.

Hong Kong
HK returns to its work on attracting Islamic finance. Despite expressing a desire to become an Islamic finance and sukuk hub, Hong Kong has not progressed far with the only issue coming from RMB500 million ($79 million) sukuk from Khazanah.

Indonesia
The Indonesian government issued its first 4 series of project-based sukuk, although only the 30 year sukuk received bids accepted by the government. Out of a 2.18 trillion rupiah ($237 million) in total bids, only 355 billion rupiah ($38 million) was accepted, all for the PBS0004 issue due 2037.

Microfinance
A microfinance product that offers a deposit product and interest-free loan program rolled into one. When will Islamic finance get behind Islamic microfinance in a big way?

WEDNESDAY
(Mar. 28)

Islamic derivatives

While writing the post yesterday on the new profit rate swap master agreement (mubadalatul arbaah), I explained the reasons why I think the master agreement can help make a difference in developing Islamic finance and providing a product that can help 'real economic activity' by providing certainty in financing costs for companies that have floating rate financing.

However, there is an issue with Islamic derivatives in general that has been raised multiple times about the participation of 'speculators' versus those participants who are involved in 'legitimate hedging transactions'. This is a tricky issue, and one that is very hard to even define (since what transaction doesn't involve some elements of speculation.

In the context of derivatives, there will likely be some profit to be made and in general, it will be a profit that, if you view the transaction in the abstract will be gain for one party at the expense of the other. This is generally viewed as akin to gambling (maysir) in Islamic finance because the gains from one party will come at the expense of the other.

In the profit-rate swap example, viewing the transaction in the abstract misses some key elements that differentiates a profit-rate swap from others (such as, for example, a credit default swap). In a profit-rate swap, assume that the company has a two-year $100 million floating rate ijara, with a floating rate starting at 5% annual rate, which is set at the end of year 1. The ijara is structured so the cash flows are:

T=0: Company sells assets worth $100 million to the financier, which it will rent with rental payments adjusting, but beginning at $2 million a year (benchmarked to an interest rate that starts at 5%). The first payment is made.
T=1: Company pays rent benchmarked to an interest rate
T=2: Company pays repurchases the asset for $100 million

At T=0, the company enters into a profit-rate swap to exchange the rent in T=1 for cashflows of $2 million at T=1 for a floating rate based on the same benchmark with a spread (through two separate commodity murabaha). At T=1, the murabaha are paid, with the company paying $2 million and the counterparty paying $100 million * (R+e), where e is the spread paid.

Looking just at the transaction, no net payments are made when the benchmark rate is (5-e)%. If the benchmark rate is higher than (5-e)%, then the company makes the difference between the rate and (5-e)%. If the rate is lower, than the swap counterparty makes the difference between (5-e)% and the benchmark rate.

For the transaction alone, the components of the transactions are common. There is an ijara and, separately, the company enters into two murabaha with another party. However, the murabaha transactions result in the outcome of a win-lose scenario. An increase in the reference rate benefits the swap counterparty, while a decrease benefits the company, in equal amounts. The criticism of this transaction is that it is not financing any 'real economic activity', and also that the counterparty is merely speculating on the direction of the reference rate (the company is hedging its exposure to changes in the reference rates, which would be viewed as legitimate hedging activity).

There would be in most cases, a clear economic benefit of the transaction because the company would be able to lock in the cost of financing the asset it purchased. Armed with the certainty of its costs, the company wouldn't have to incorporate the uncertainty around its financing costs in its financial planning, and could devote the resources that might be held back in case the rate increased to expand its business. The counterparty would assume the risk of changes in the reference rate (in expectation of a lower rate or to hedge itself against its own fixed rate liabilities (most financial counterparties would be likely able to show enough fixed rate liabilities to justify its participation on the grounds that it is hedging, even if it were speculating).

As I mentioned, the fact that the contract is executed on an OTC basis adds some risk that the counterparty cannot meet its obligation, which would moot some of the benefits to both parties of resources freed up by hedging its profit-rate exposure. There won't be many issues with whether the parties are legitimately hedging (it is probably easy enough for the Islamic financial institution to speculate while being able to at least nominally show that it is hedging some exposure on its balance sheet). However, it will be difficult to convince the doubters of profit-rate swaps that the transaction adds value overall and is different from a transaction like a CDS.

Most arguments in support of the profit-rate swap assume that Islamic finance institutions are involved in liquidity transformation, just like conventional banks, but using Shari'ah-compliant contracts. The criticism of Islamic derivatives are mainly (but not entirely) from people who believe that Islamic financial institutions should be based entirely on profit-sharing contracts. It is difficult to offer a counter-argument, because a pure profit-sharing bank would not need to worry about liquidity constraints because it would not transform short-term liabilities into long-term assets (rather, it would, but it could pass off any losses directly to depositors).

This is how a typical mutual fund works (the fund manager acts as a mudarib or wakeel), but it is not how Islamic banks work. If an Islamic financial institution is working in a bank-like role (taking deposits and making loans) in an environment where pricing is based on interest rates (because the Islamic bank is competing with conventional bank), then there will be a role for instruments like a profit-rate swap. Arguments against profit-rate swaps are mostly shifting the discussion into a theory versus practice argument. At this point it usually turns into a discussion where people from two different perspectives are talking past one another.

There are two different things to consider, which are entirely different, when considering profit-rate swaps:

- Should Islamic financial institutions work within the regulatory system that exists today? Or should they try to change the regulatory environment to allow pure profit-and-loss sharing for Islamic banks?
- If Islamic banks work within the current banking regulations, should they be permitted to hedge their exposure to fluctuations in their profit rates which may be exposed to fluctuations determined by changes in interest rates? And does the profit rate swap contribute to an underlying economic activity?

These are two different arguments and it is important to separate them. If Islamic banking operating under a conventional regulatory system is problematic, then that is the issue, not whether a profit-rate swap is beneficial or not. However, if the presumption is taken as given that Islamic banks work within a system that evolved around a conventional banking system, then the discussion around Islamic derivatives should be focused on whether it contributes to underlying activity and stability within the Islamic financial system, and is done in a Shari'ah-compliant way.

Where I stand is that Islamic banking does operate in a regulatory environment that was designed for conventional banking and that providing a standardized way for Islamic banks to hedge against profit-rate risk will lead to a more stable banking system (counterparty issues still unresolved) and will provide a benefit to the non-financial who enter into profit-rate swaps to fix their costs as a part of their financial planning.

TUESDAY
(Mar. 27.)

Profit rate swap master agreement

The International Islamic Financial Market (IIFM) and the International Swaps and Derivatives Association (ISDA) announced their newest master agreement for a profit rate swap (mubadalatul arbaah). This is a good development in my opinion because it provides a lower cost way for Islamic financial participants to hedge against fluctuations in the interest rates that are used to determine the cost of Islamic financial products.

The idea of Islamic derivatives have been controversial because they are often viewed as instruments for speculation, which is viewed as not being in the spirit of Islamic finance. Speculation financed by Islamic financial products (e.g. in the Dubai real estate market before the crisis) somehow escapes the same level of scrutiny as derivatives. Other objections have focused on the synthetic nature of Islamic derivatives as being just copies of conventional products done in a way that is Shari'ah-compliant, and is somewhat condescendingly described as not being used to finance 'real economic activity'.

However, profit rate swaps are quite easily used for legitimate hedging transactions that doesn't necessarily shift risk from one party to another at least entirely (a criticism that could be more aptly pointed at talk of developing Islamic credit default swaps). Hedging is viewed as permissible, where speculation is viewed in a negative light (again with a somewhat double standard).

Take, for example, a situation where an Islamic bank financing a widget factory through a murabaha. The bank only offers the company a floating rate loan. However, the managers of the widget factory don't want to be exposed to the risk that the financing costs increase over the term of the murabaha because it could lead to additional cost that complicates their planning for the business.

The manager of the company may then approach an investment company to lock in the financing costs, to make its finance costs predictable over the life of the murabaha. A fund approaches the company with the offer of a profit-rate swap that locks in the financing costs for the widget company through a profit-rate swap. The fund receives a stream of fixed rate payments in exchange for paying a floating rate, which it expects to benefit its investors.

The master agreement facilitates this process by lowering the costs compared to the participants having to custom build a profit-rate swap. Without the master agreement, there would be fewer transactions, which would make an impact on the 'real economy' because fewer companies would have the opportunity to fix their financing, and effectively shift the management of interest rate fluctuations to institutions that have a focus on managing those changes.

The one criticism I have of the profit rate swap is that it is an over the counter (OTC) swap. The benefits of the profit-rate swap come with the cost of counterparty risk by adding a third party into the original murabaha, which exposes the widget to the company that it will lose its fixed rate protection if the counterparty in the swap cannot fulfill the terms of the contract. However, creating an exchange for swaps is a whole different challenge that can (and probably will) wait for another day (likely well into the future).