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Sukuk shortage is a problem for takaful too

Reuters is reporting that takaful growth is slowing despite a large market potential with takaful representing only 17% of the total insurance markets in the Gulf and Malaysia. The article does not address the issue of cost, but it is likely that takaful is more expensive than conventional insurance because most takaful providers are smaller, they have fewer investment options to ensure that the fund will be sufficient to meet claims, and there is limited retakaful cover forcing takaful providers to keep more risk themselves.

In the context of last week's newsletter, which focused on the shortage of sukuk for pension funds, there are many overlapping problems for takaful providers. The conventional industry manages its risk in part by investing most of the premiums in fixed income to provide more predictability about the funds they will have available to meet claims in the future. Takaful providers cannot invest in the same allocation as conventional insurers because they have to look to sukuk to replace conventional bonds, and sukuk are in short supply, even in the well developed market of Malaysia.

This shortage has led takaful funds to have greater exposure to equities, real estate and alternative assets, which have greater volatility than most investment-grade bonds (or sukuk). The greater volatility likely leads takaful providers to charge higher premiums to ensure that there will be sufficient funds available well into the future to meet claims.

To some degree, this problem could be offset if takaful providers were larger and could get more diversification in the pool of clients contributing to the takaful fund, but this would not help the problem of managing the assets in the takaful fund.

Instead, most takaful providers, according to the Reuters article, are looking to find more growth in other markets, like North Africa, where takaful is less available, but these markets are likely to provide additional challenges to takaful providers in managing the takaful fund. They are either going to look to established markets for sukuk to put in their allocation, or are going to increase their exposure to equities. Both come with additional risk. The latter is clear, but the former adds a new risk: the risk of investing in sukuk denominated in foreign currencies adding foreign exchange risk which is difficult to manage in a Shari'ah-compliance way.

There are growing pains in any new industry, but as the takaful industry grows it will be constrained more and more by the problems of the Islamic finance industry generally, where they will have to find solutions that are not like those used by conventional insurance. It will likely become a continuing story until the underlying problem of too few sukuk is addressed.

Updates from the Americas

Arcapita's bankruptcy case is ongoing and a recent objection by Standard Chartered, which provided $100 million of murabaha financing to Arcapita in 2011, presumably to finance the company through its anticipated debt restructuring of the $1.1 billion murabaha whose imminent maturity led the company into bankruptcy.

The objection by Standard Chartered is based on the potential, according to

Standard Chartered, for Arcapita to make inter-company transfers of dividends that should be held for Standard Chartered due to its mortgage on the equity of a number of Arcapita subsidiaries. Standard Chartered, in a court filing, described that "if the value of the Subsidiary Guarantors, which is at best uncertain, is transferred to AIHL [Arcapita's Cayman Islands holding company] or Arcapita Bank, Standard Chartered's security interests could be rendered worthless and the Subsidiary Guarantors could impermissibly be rendered insolvent to the detriment of Standard Chartered".

Standard Chartered is asking the court to make the approval of any budgets the court is presented with by Arcapita require approval by Standard Chartered as well. More concerning for the unsecured murabaha holders, the senior position of Standard Chartered means Arcapita will have to come up with more money before lower priority murabaha creditors get paid.

In another document filed with the bankruptcy court, Barclays Bank, which is on the committee of unsecured creditors, has asked the court permission for its affiliates to trade claims on Arcapita's debt, as long as it separates those trading activities from its position as a committee member to avoid potential conflicts of interest.

As I mentioned in an earlier blog post, is the fact that the murabaha financing is being traded (and the trading is unlikely to occur at par). Yet, there has been much less controversy about this than about the potential for the Goldman sukuk to be traded since it was listed on the Irish Stock Exchange (even though it was never likely to trade).

Until next week,
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FROM THE BLOG…

SATURDAY
(Apr. 21)

What could go wrong?

When I saw the headline "Emirates Islamic offers 100% financing for UAE homes", I thought I had traveled back in time to a bygone era (specifically 6-10 years ago in the United States). I looked at the date on the article, April 14, 2012, and it surprised me that an Islamic bank would have stumbled upon a product that had so recently led to havoc in the conventional financial markets. Sure, the US housing boom was fueled by other factors (securitization and re-securitization of mortgages into complex securities), but one of the reasons the problem spread into the real economy was that a fall in home prices pushed many homeowners into a position of negative equity (owing more on their homes than it was worth).

The way that Islamic home finance works today would not insulate an Islamic bank offering this type of product from problems down the road, and since the product offered here is only for 5 years, it creates a potential refinancing risk, since most people cannot afford to pay for a house in just 5 years. A 5 year loan requires that either refinancing will be a available five years from now, or a rise in home prices (and thus a buyer expects to sell within 5 years). Both assume that the home will either remain the same price or increase, which the financial crisis and recession following it has demonstrated is a dangerous assumption.

The difference between a 100% financing product and an 80% financing (e.g. 20% down payment) is that the former incentivizes greater speculation on home price rises because it doesn't require they buyer to have 'skin in the game'. The incentive problem is made more complicated by the potential for buyers who default to be threatened with arrest. However, while this might limit the number of defaulters (in an non-optimal way), the incentive problem remains. It is a frequent refrain that Islamic finance was spared some damage during the credit because it is different from conventional finance, but if Islamic banks start moving into the same types of products that caused problems in the financial crisis, will this hold true in the future, or are we on the road to Islamic CDOs?

MONDAY
(Apr. 16)

Islamic mortgages: Is there anything new?

An article I read tonight raised an old question about Islamic mortgages that I think is interesting, specifically, whether they offer anything different from conventional mortgages. The answer (both yes and no) is a bit complicated for the basic question asked. The context is the UK market, but it applies in any market and has less to do with the specific regulatory requirements for companies offering home financing. The article describes:

Risk sharing, not profiting unjustly or unfairly, not charging excessive charges; in a residential purchase context, allowing part rent, part purchase, sharing equity upside, sharing downside property risks. These characteristics apply equally to an approved Islamic home finance plan as they do to a new conventional purchase plan designed for a housing association in the north east of England.

There are a few different themes expressed here which affect Islamic mortgage financing. The first comes up in the first two words: "risk sharing". This is often used as the big difference between conventional finance and Islamic finance, in many cases erroneously (disclaimer: if you reverse the two words you come up with the brand I operate under). There is nothing in Islamic finance that requires sharing risk any more than conventional finance. It would be perfectly acceptable for a business to structure its contracts so that they are Shari'ah-compliant and where one party accepts only minimal risk beyond the credit risk that conventional banks specialize in dealing with. For example, an Islamic bank may only offer financing using murabaha, which is the most commonly used structure for assets on Islamic banks' balance sheet .

The next part is, in my opinion, more important for what Islamic finance is designed to do: "not profiting unjustly or unfairly, not charging excessive charges". In the modern concept of finance, this is where Islamic financial institutions should be cleaning up and taking business from conventional banks (for both Muslim and non-Muslim consumers). However it has not happened and there have been failures of business models (e.g. Arcapita and Gulf Finance House) and institutions themselves (e.g. UM Financial) where ethical behavior has converged with the conventional industry or even dropped below the (low) industry standard.

This is more a problem of regulation. The Islamic investment bank models practiced in the GCC where the banks would invest and then sell on to investors at a premium with minimal disclosure (I am speaking here more of GFH where there is more evidence of the practice) would have not been allowed in more strictly regulated markets. In the case of companies like UM Financial, which escaped regulations almost entirely, had they been subject to even minimal standards of regulation in the industries they operated, they would have been shut down far earlier than they were.

More than any other financial sub-industry, Islamic finance should welcome regulation (both in the traditional sense and in the additional Shari'ah regulation). There are issues with how the industry imperfectly self-regulates today (on the Shari'ah side), with egregious abuses in conflict of interest have occurred in both Chicago (Sunrise Equities) and Toronto (UM Financial) where the companies' founders were excessively connected with the heads of their respective (supposedly independent) Shari'ah boards rendering them in practice as non-independent. One hopes that other regions have better standards, but I am not encouraged by the fact that UM Financial is still listed as a member of AAOIFI.

Regulation to prevent bad actors is necessary to maintain the credibility of the industry as a whole, especially in overly politicized environments (like the US and Canada) where any wrongdoing (or even right-doing) by an Islamic financial institution is seized upon as "evidence of a plot to impose Shari'ah".

But I have become distracted from the main point of this post, which is to address the description of Islamic mortgages: "allowing part rent, part purchase, sharing equity upside, sharing downside property risks". This was the point that inspired the post and I think is the most interesting about how Islamic finance works in practice: it is much easier for Islamic mortgage companies in the US to share in the upside of transactions than it is in the downside, but it almost never happens.

Banking regulations in the US are extremely hesitant to allow a depositor to lose money and most of the potential uses of deposits for an Islamic bank would be in mortgage financing. However, the discussion always revolves around the banking side of the equation: why do Islamic mortgage providers use Freddie Mac to provide much of the liquidity to fund Islamic mortgages? Why don't Islamic financial institutions use more of a profit-and-loss sharing method of mortgage finance?

The answer may not necessarily be the financial institutions' fault (they do have to fit within the US' financial regulations, but there are many forms they could take to serve the market if profit-and-loss sharing were demanded). It may be that most potential customers demand a Shari'ah-compliant product that leaves them with the upside. Given the evidence of the industry's roughly 40 year history, it appears that when presented with the costs and benefits most consumers prefer to keep the upside, and use more debt-based financing models for home finance.

The present form for Islamic finance is, of course, not where it will be in 10 or 20 years and it will (should) change substantially over that time period, but the key for that change in the mortgage market will be consumers themselves giving up their monopoly on the upside gain. Are financial consumers willing to give up a portion of the appreciation of their house's value to be able to pass along some of the loss if home prices fall, especially when Islamic mortgage companies are offering non-recourse Shari'ah-compliant loans? I am not sure of the answer today.