

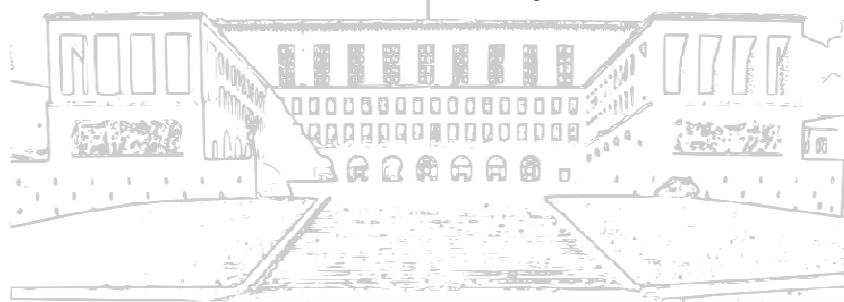
## FINANCIAL MARKETS AND INSTITUTIONS

### ISLAMIC FINANCE: BANKING, BONDS, MUTUAL FUNDS AND INSURANCE

A.Y. 2015/2016

Dott. Andrea Paltrinieri

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Seminar, 12th January 2016



## AGENDA

- Basic principles and contracts in Islamic finance
- Specialties and features of selected Islamic financial markets:
  - Islamic banking
  - *sukuk* (bonds)
  - Islamic mutual funds
  - *takaful* (insurance)

## ISLAMIC FINANCE: PRINCIPLES AND CONTRACTS

### BASIC PRINCIPLES

- All activities have to comply with religious principles
- The *Shariah*, stemming from the *Quran*, disciplines how faith is put into daily practice:
  - protection from exploitation/unfairness
  - preservation of property rights
  - “sanctity” of contracts
- Five distinguishing principles:
  1. No explicit interest rates (*riba*)
  2. No excessive uncertainty (*gharar*) or gambling (*maisir*)
  3. Exclusion of “*haram*” products (pork, alcohol, weapons)
  4. Profit&loss sharing between parties
  5. Direct link with real economy

## BASIC CONTRACTS

- Basic set of core contracts as building blocks:
  1. Transactional contracts dealing with real economic sector, to trade good and services (*Ijarah* - lease)
  2. Financing contracts: to create and extend credit, facilitate resource mobilization (*Murabahah*, *Musharakah* – investment and management partnership)
  3. Intermediation contracts: to facilitate the execution of transactional and financing contracts (*Mudarabah*, *Musharakah* – agency partnership)

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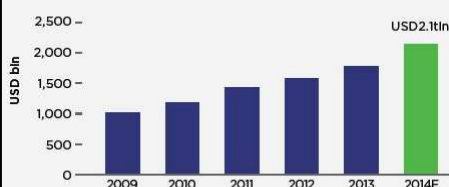
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## ISLAMIC FINANCE SEGMENTS

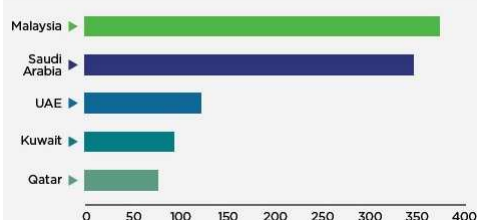
Table 1.1.1.1: Breakdown of Islamic Finance Segments by Region (USD billion, 2014 YTD\*)

Region	Banking Assets	Sukūk Outstanding	Islamic Funds Assets	Takāful Contributions
Asia	203.8	188.4	23.2	3.9
GCC	564.2	95.5	33.5	9.0
MENA (exc. GCC)	633.7	0.1	0.3	7.7
Sub-Saharan Africa	20.1	1.3	1.8	0.6
Others	54.4	9.4	17.0	0.3
<b>Total</b>	<b>1476.2</b>	<b>294.7</b>	<b>75.8</b>	<b>21.4</b>

Global Islamic Finance Assets (2009-2014E)



Islamic Finance Assets by Domicile (3Q2014)



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## ISLAMIC BANKING

## ISLAMIC BANKING

- “Consecutive partnership” models: depositors are partners during a full financial year in the proceeds, regardless of the full usage of their funds (profit/loss sharing)
  - 1. *Two tier Mudarabah model*: funds’ mobilization and utilization are based on profit-sharing between the investor ( depositor), the bank and the entrepreneur:
    - *First tier*: depositor supplies funds, the bank invests as an agent (*mudarib*) and shares profits/losses earned (limited, non-voting equity)
    - *Second tier*: contract between bank and entrepreneur agreeing to share profits
    - Assets and liabilities fully integrated

## ISLAMIC BANKING

2. *Two-windows model*: liabilities in the bank's balance sheet are divided into two (demand deposits and investment balances)
  - 100% reserve for the demand deposits, no reserve for the second window
  - no use of deposits for investments
  - depositors may be charged a service fee for the safekeeping service received
  - less risky for depositors

## ISLAMIC BANKING

- Distinct features of Islamic Banks:
1. Profit and loss sharing
  2. Enhanced monitoring
  3. Principal-agent relationship
  4. Asset-liability management less problematic
  5. *Shariah* board

## ISLAMIC BANKING: MARKET DATA

Chart 1.1.2.1: Islamic Banking Assets Growth Trend (2008–2014F)

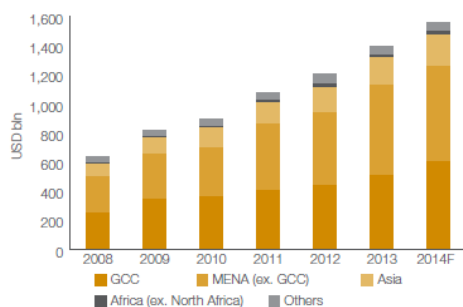
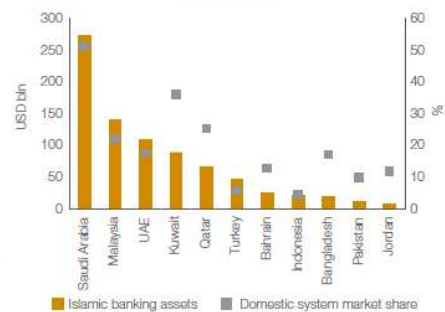


Chart 1.1.2.2: Islamic Banking Assets and Market Share (1H2014)

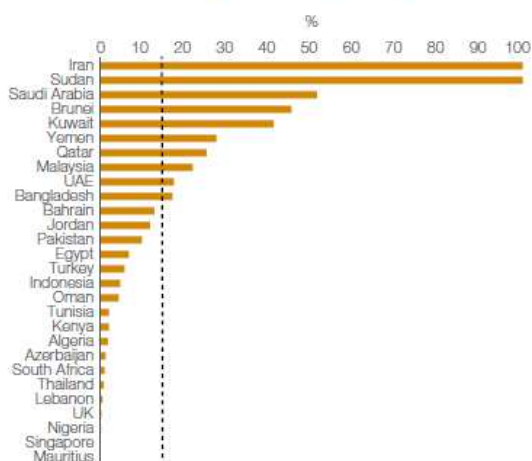


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## ISLAMIC BANKING: MARKET DATA

Chart 1.1.1.3: Islamic Banking Share in Total Banking Assets by Jurisdiction (1H2014)



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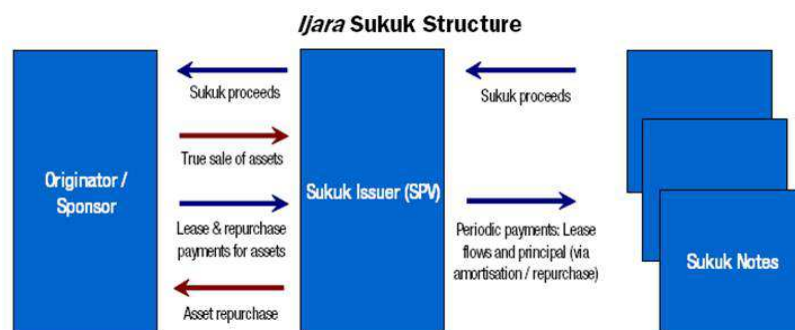
## ISLAMIC BONDS: *SUKUK*

## ISLAMIC BONDS: *SUKUK*

- Certificates reflecting participation rights in underlying assets that define the instruments' performance
- Close to conventional securitizations: structures and processes similar to those of a SPV
- Assets involved: both tangible and intangible (land and buildings, infrastructures, mortgages, credit card payoffs, home equity loans and accounts receivable)

## ISLAMIC BONDS: *SUKUK*

- The core contracts in the process of securitization to create *sukuk* are *Mudarabah/Ijara*. The process:



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## ISLAMIC BONDS: *SUKUK*

- ✓ Points to stress:
  1. The leaseback in exchange for future payments
  2. Payments based on rental income (low probability of default)
  3. Low liquidity in secondary market
  4. The price of Islamic bonds depends on expected profitability

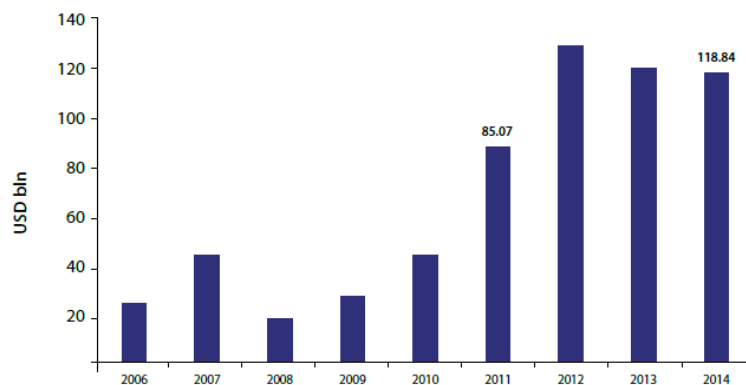
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## SUKUK MARKET DATA

### Annual Sukuk Issuances



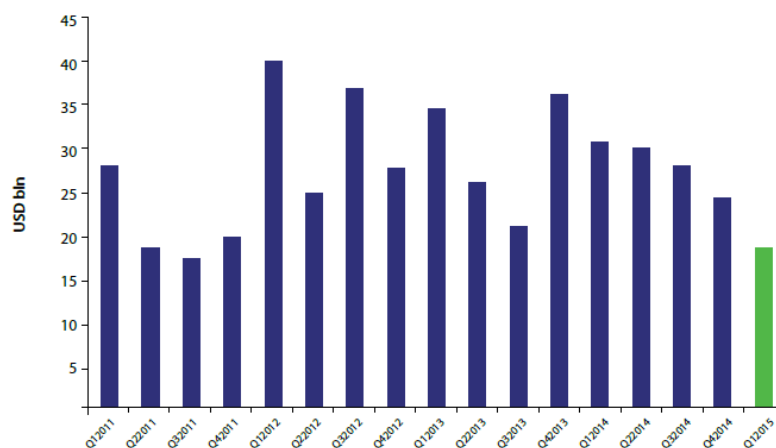
Source: ISRA, IFS, Zawya, Bloomberg

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## SUKUK MARKET DATA

### Issuances by quarter (2011-2015)



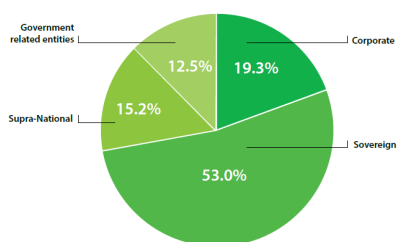
Source: ISRA database, IFS, Zawya, Bloomberg

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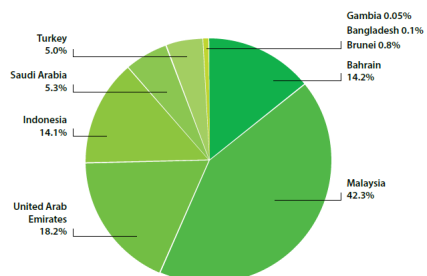
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## SUKUK MARKET DATA

Sukuk Issuances by Issuer Type (1Q2015)



Sukuk Issuances by Country (1Q2015)



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## ISLAMIC MUTUAL FUNDS

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## ISLAMIC MUTUAL FUNDS

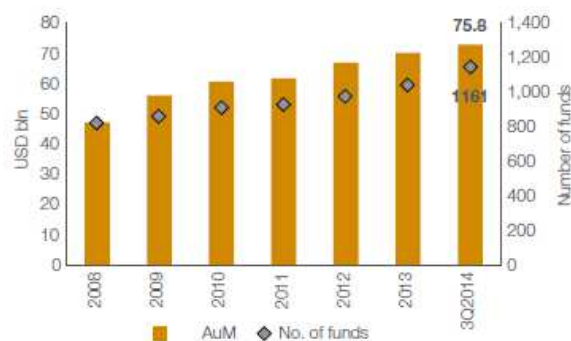
- Based on *Mudarabah* contract and similar to socially responsible investments
- Quantitative and qualitative (negative or positive) screenings
- *Shariah Board* to evaluate the compatibility of business
- Benchmark: Islamic equity indexes. Issues:
  - Negotiability and tradability
  - Practice of margin accounts
  - Speculative trading / short selling
  - Conventional bonds and preference shares

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## ISLAMIC MUTUAL FUNDS: MARKET DATA

Chart 1.1.3.13: Growth in Assets under Management and Number of Islamic Funds

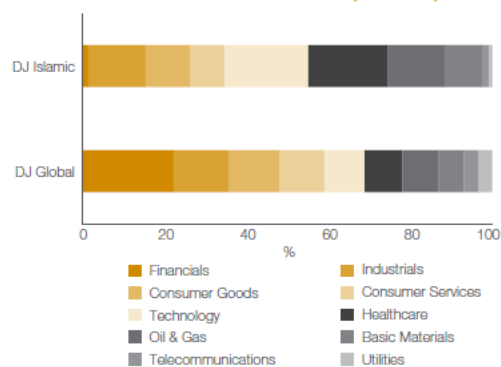


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## ISLAMIC MUTUAL FUNDS: MARKET DATA

Chart 1.1.3.11: Sector Allocation (10M2014)



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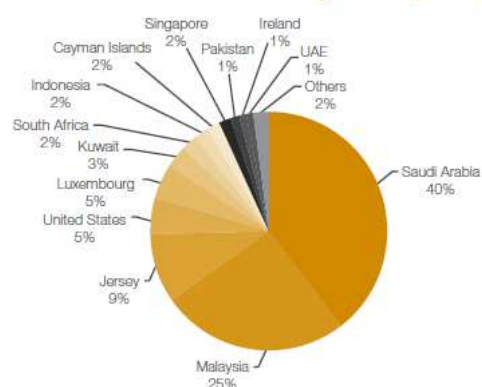
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## ISLAMIC MUTUAL FUNDS: MARKET DATA

Chart 1.1.3.16: Islamic Fund Assets by Asset Class (3Q2014)



Chart 1.1.3.14: Islamic Fund Assets by Domicile (3Q2014)



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## ISLAMIC INSURANCE: TAKAFUL

### WHAT IS IT AND HOW DOES IT WORK?

- *Takaful* originates from the concept of joint guarantee (*kafalah*) and designs a community cover compliant with *Shariah*
- Grounded on mutuality, it allows sharing between policyholders and the fund's sponsor (the *takaful* operator) acting as their agent
- No guarantees: losses and gains are jointly shared
- *Takaful* encompasses both life and non-life business, or as reinsurance (*retakaful*)
- *Shariah* board
- Different models (*mudarabah*, *wakalah*, *musharakah*, *waqf*, hybrids) distinguished by operators' responsibilities and the basis of sharing costs/revenues

## WHAT IS IT AND HOW DOES IT WORK?

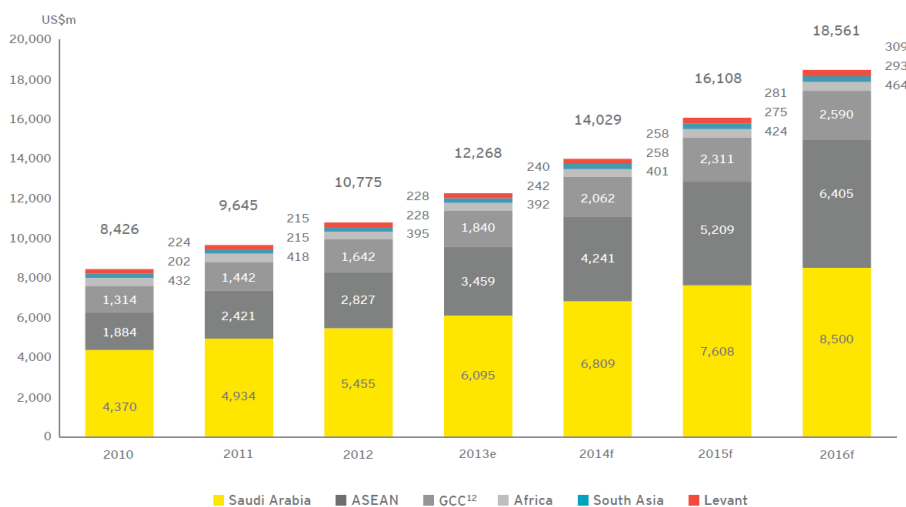
- Main issues:
  - insurance needs *VS gharar* and *maisir*
  - invest avoiding *riba* and design contracts without guarantees
  - compensate the operator for inv.&admin. services
- Solutions:
  - no separation of burden between policyholders-shareholders, operators compensated by fees
  - mutuality between participants in sharing surpluses/deficits
  - the operator may offer interest-free loans to cover deficits (against future surpluses)
  - the contribution is a donation (*tabarru*)
- Open problems: little *retakaful*, little/risky *sukuk*, HR

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## TAKAFUL: MARKET DATA

### Premiums (contributions)

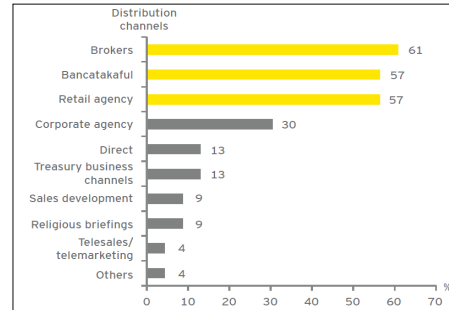
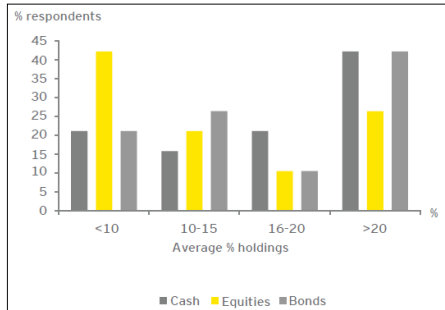


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## HOW CAN THIS MARKET BE REPRESENTED?

### Results of a recent E&Y survey



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# THANK YOU FOR YOUR ATTENTION!

Seminar, 12th January 2016

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