Islamic Cost of Capital

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IIFM

- The IIFM is an international infrastructure, non-profit organization, established through the collective efforts of five countries and one multilateral institution: Bahrain, Brunei, Indonesia, Malaysia, Sudan and Islamic Development Bank.
- *IIFM's Principal Objective is to establish, develop and promote the Islamic Capital and Money Market on the principles of Shari'ah*
- IIFM's role is that of a developer and catalyst of the Islamic financial market encompassing both the short-term money market and the long-term capital market

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IIFM- Vision & Mission

- Vision:

  Active and well regulated trading and capital flows across the full spectrum of Shari'a compliant financial instruments internationally

- Mission:

  To achieve the Vision by catalyzing both national and international trading infrastructure, product innovation and information flow within strong, transparent and well regulated standards and guidelines. Promoting acceptance and integration with mainstream markets.

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IIFM – Areas of Immediate Focus

- Standardization of market related issues such as contracts and products
- Guidelines and Procedures relating to primary and secondary market
- International Islamic Trading and Liquidity management system covering aspects such as trading infrastructure, clearing and settlement
- Research and Development and Specialized events and forums to disseminate information and create awareness on Islamic Capital and Short Term Financial Market
- Development of templates for capital market segment of the Islamic Financial Services Industry

Current State Analysis of Islamic Capital Markets vs. Conventional

Accepted
- Equity

Developed, but not negotiable
- Acceptances
- Commercial Paper

Under Development
- Commodity futures
- Financial Futures

Emerging
-Bonds
-Floating rate Bonds
-Securitized loans
-Index-linked securities
-Convertibles

Non-Existent
-Preferred Stocks
-Primes & Scores
-Warrants
-Synthetics
-Swaps
-Options

Present Market Focus

Product Innovation

- Sukuks and new Structures
- Islamic Asset Backed & Mortgage Backed Securities
- Islamic Funds – Mutual and Specific
- Islamic Real Estate and REITS
- Hedge Techniques and Derivatives

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High Priority Development Areas

I. Liquidity Management issues

- Under-developed or non-existent Islamic Money Market
- Lack of adequate Shari'a complaint Money Market instruments
- Risk Management techniques
- Availability of quality assets
- Lender of last resort (LLR) privileges for day-to-day liquidity management

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High Priority Development Areas

II. Sukuk issues

- Non existence secondary market mainly due to the lack of critical mass.
- Few market makers
- Secondary Market Pricing - area of inefficiency and requires more transparency
- Usage of Sukuk as a monetary management tool by regulatory bodies
- Lack of Shari'a harmonization

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High Priority Development Areas

III. Standardization

- Standardization of products, contracts and related issues need to identified and developed, perhaps on a self-regulatory basis
- Development of Guidelines and templates
- Regulatory Framework - enforceability up to regulators

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Cost of Capital for IFSI

- Cost of Capital is the cost of finance needed to acquire the physical capital
- Cost of capital determines the minimum return required by the firm on capital deployed
- In the absence of an Islamic Rate of Return, IFI's use the interest rate mechanism (LIBOR) as a benchmark for procurement and placement of funds
- Due to current market focus and high priority development areas, little emphasis is being made on developing an alternative to LIBOR
- As the Islamic Financial Services Industry is no longer a niche market, perhaps an Islamic Rate of Return is needed

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LIBOR – Halal or Haram?

- Shari'a Scholars ruling is that if the transaction fulfils all the Shari'a requirements, then merely using an interest rate as a benchmark for determining the profit of the underlying instrument does not render the transaction as haram or invalid, because the transaction itself does not contain interest
- Some Scholars are of the view that this practice should be phased out, because
  - Using the rate of interest as an ideal for *halal* business is not desirable and
  - It does not advance the basic philosophy of Islamic economy having no impact on the system of distribution

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An Alternative to LIBOR- Abbas Mirakhor Approach

- Proposes that Cost of Capital can be measured without resort to a fixed and predetermined interest rate
- The benchmark could be created based on *Tobin q* theory
- Main assumption:
  - In the absence of a fixed and predetermined rate of interest, equity financing becomes the only source of financial capital, and as such, the economy's financial system becomes equity-based and hence, the equity market would provide a measure of the cost of capital

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An Alternative to LIBOR- Sheikh Taqi Usmani Approach

- A Benchmark can be achieved by creating a common pool which invests in asset-backed instruments like musharakah, ijarah etc.
- If majority assets are in tangible form, its units can be sold and purchased on the basis of their net asset value determined on periodical basis
- These units may be negotiable and maybe used for overnight financing
- The banks having surplus liquidity can purchase these units and when they need liquidity, they can sell them
- This arrangement may create inter-bank market and the value of the units may serve as an indicator for determining the profit

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An Alternative to LIBOR-Malaysian Approach

- Bank Negara Malaysia introduced the "Framework of the Rate of Return" to standardize the methodology on the calculation of distributable profits and the derivation of the rates of return to the depositors
- The objectives of the framework are:
  - Set the minimum standard in calculating the rates of return
  - Provide the same playing level and term of reference for the Islamic banking institutions (IBIs) in deriving the rates of return; and
  - Provide Bank Negara Malaysia with an effective yardstick to assess the level of efficiency of the IBIs

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An Alternative to LIBOR-Malaysian Approach

- The framework comprises two main components i.e. the calculation table and the distribution table
- The calculation table prescribes the income and expense items that need to be reported and sets out the standard calculation in deriving the net distributable income
- The distribution table sets out the distribution of the net distributable income posted from the calculation table among demand, savings and general investment deposits according to their structures, maturities and the pre-agreed profit sharing ratios between the bank and the depositors

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An Alternative to LIBOR-Malaysian Approach

<u>*Example: Mudarabah Inter-bank Investments (MII)*</u>

- The rate of return is based on the rate of gross profit before distribution for investments of one year of the investee bank
- The profit sharing ratio is negotiable among both parties
- The investor bank at the time of negotiation would not know what the return would be, as the actual return will be crystallized towards the end of the investment period
- The principal invested shall be repaid at the end of the period, together with a share of the profit arising from the used funds by the investee bank

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Thank You

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